ILLINOIS BUSINESS LAW JOURNAL

VOLUME 22
FALL 2016

A PUBLICATION OF THE STUDENTS OF THE
UNIVERSITY OF ILLINOIS
COLLEGE OF LAW

Illinois Business Law Journal

Volume 22 2016

ILLINOIS BUSINESS LAW JOURNAL

Volume 22 2016

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VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

DRIVING SOLO: SOLUTIONS TO THE CURRENT PATCHWORK OF LEGISLATION CONCERNING AUTOMATED VEHICLES

❖ NOTE ❖

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Abstract

This Note argues that states across the nation should expand upon and in some cases begin to introduce legislation in regards to self-driving vehicles. Although there are currently a handful of states that already have some form of regulation in effect regarding self-driving vehicles, the current patchwork of legislation is not very conducive for companies and entrepreneurs that wish to enter this market. This Note looks at a gradient system of automation as the basis for legislation that could potentially lead to greater investment from car manufactures in this area of technology. If adopted, a gradient system would mean that the automated vehicle would be subject to specific regulations based on a car's level of automation. The more autonomous the car is, the more highly regulated it will become.

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I. INTRODUCTION

As technology advances to meet modern needs, companies such as Uber, Tesla, Google, and Apple (among others) have all begun a foray into the area of self-driving cars. The research into this area of technology has gone from theoretical in nature to actuality very recently in Pittsburg,[1] with more plans to roll automated cars out in Los Angles, Nashville, Tucson, and Austin.[2] The arrival of driverless cars across the United States presents unforeseen concerns that have left state and local officials scrambling to come up with rules and regulations to safely integrate this new technology into their cities and states.[3] Part II of this Note will first give a brief background on the history of self-driving cars. Part III of this Note will highlight the benefits of introducing autonomous vehicle legislation. Finally, Part IV will give an explanation of the potential benefits of introducing a gradient system of legislation these vehicles, followed by a conclusion.

II. BACKGROUND

Until recently, self-driving vehicles seemed like a concept stuck on the big screen. However, vehicle and technology manufacturers are slowly, but surely bringing the concept to life. As driverless cars hit the roads, the lack of regulation concerning these vehicles came into the spotlight very recently when Uber was unable to obtain a license to test its self-driving cars in San Francisco.[4] Currently, there exists only a patchwork of regulations for these types of cars across the country.[5] The National Highway Transportation Safety Administration only recently put out a Federal Automated Vehicle Policy ("FAVP") to aid in the transition of these cars from research fields to

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[1] Max Chafkin, *Uber's First Self-Driving Fleet Arrives in Pittsburgh This Month*, Bloomberg (Aug. 18, 2016), https://www.bloomberg.com/news/features/2016-08-18/uber-s-first-self-driving-fleet-arrives-in-pittsburgh-this-month-is06r7on.

[2] Bloomberg Philanthropies and the Aspen Institute Launch First Global Initiative to Help Leading Cities Prepare for the Advent of Autonomous Vehicles, BLOOMBERG PHILANTHROPIES (Oct. 24, 2016), https://www.bloomberg.org/press/releases/bloomberg-philanthropies-aspen-institute-launch-first-global-initiative-help-leading-cities-prepare-advent-autonomous-vehicles/.

[3] *Self-Driving Vehicle Legislation*, NAT'L CONF. OF ST. LEGISLATURES (Dec. 12, 2016), http://www.ncsl.org/research/transportation/autonomous-vehicles-legislation.aspx.

[4] Christopher Mele, *In a Retreat, Uber Ends Its Self-Driving Car Experiment in San Francisco*, N.Y. TIMES (Dec. 21, 2016), https://www.nytimes.com/2016/12/21/technology/san-francisco-california-uber-driverless-car-.html?_r=1.

[5] NAT'L CONF. OF ST. LEGISLATURES, *supra* note 3.

the America's roads.[6] The FAVP however, only lays out basic criteria for driverless vehicles and gives state and local officials much deference if and when they decide to regulate these vehicles differently than regular automobiles.[7] Since state and local governments create their own more specific rules for driving within their state or county, driverless cars would have to be equipped with the changes in driving regulations, especially if they are being used across state lines.[8] For example, in Illinois, U-turn regulations vary quite a bit from the basic statewide regulation to county or city regulations.[9] Statewide, U-turns are only legal if the car can be seen by other drivers within 500 feet of the point where turning.[10] In Chicago, however, the "driver of any vehicle shall not turn such vehicle so as to proceed in the opposite direction at any point closer than 100 feet to any intersection unless official signs are erected to permit such turns."[11] This change within a single state means driverless cars must be made aware of the change in regulation once they enter into Chicago city limits so as to not cause an infraction from occurring.

Given that there has already been one death attributed to a mistake made by a self-driving vehicle,[12] it's not illogical that cities are reluctant to let these companies test these vehicles without first fully understanding the benefits and potential risks associated with their integration into the current transportation map of their areas. The U.S. Department of Transportation has passed additional regulations to better assist in the process of

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[6] U.S. DEP'T OF TRANSP., FEDERAL AUTOMATED VEHICLE POLICY: ACCELERATING THE NEXT REVOLUTION IN ROADWAY SAFETY 3 (2016), https://www.autobeatdaily.com/cdn/cms/AV%20policy%20guidance%20PDF.pdf ("As the Department charged with protecting the traveling public, we recognize three realities that necessitate this guidance. First, the rise of new technology is inevitable. Second, we will achieve more significant safety improvements by establishing an approach that translates our knowledge and aspirations into early guidance. Third, as this area evolves, the "unknowns" of today will become "knowns" tomorrow. We do not intend to write the final word on highly automated vehicles here. Rather, we intend to establish a foundation and a framework upon which future Agency action will occur.").

[7] *Id.*

[8] Sarah Breitenbach, *As Driverless Cars Hit the Streets, States Weigh New Rules*, THE PEW CHARITABLE TRUSTS (April 21, 2016), http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/04/21/as-driverless-cars-hit-the-streets-states-weigh-new-rules.

[9] *See* statutes and ordinances cited *infra* notes 10–11.

[10] 625 ILL. COMP. STAT. 5/11-802 (2016).

[11] CHI., ILL., CODE tit. 9, Ch. 9-16-040 (2005).

[12] Bill Vlasic and Neal E. Boudette, *Self-Driving Tesla Was Involved in Fatal Crash, U.S. Says*, N.Y. TIMES (June 30, 2016), https://www.nytimes.com/2016/07/01/business/self-driving-tesla-fatal-crash-investigation.html.

manufacturing, testing, and placing these cars in homes across the country.[13] Many states, including Illinois, have yet to pass automated vehicle regulation, which places automated vehicle entrepreneurs at a disadvantage when it comes to potential investment or testing facilities. This is shown by the amount of corporate and private investment that has been funneled into states where regulations are already in effect such as California, Michigan, and Arizona.[14] In California, officials have begun to weave regulations regarding self-driving vehicles into their laws for a couple years now and have seen companies begin to invest substantial capital into their state to grow this sector of the automobile industry.[15] Michigan has gone even further, passing four bills–995, 996, 997, and 998–that establish regulations for the testing, use, and eventual sale of autonomous vehicle technology and are meant to more clearly define how self-driving vehicles can be legally used on public roadways."[16] Although driverless cars are not illegal in states lacking legislation,[17] the potential risks associated with entering markets without any sort of regulation puts companies and investors in a perilous position.[18] Automated vehicle companies such as Uber or Google may have to invest unforeseen amounts of capital into factories or research that they had not planned on when they originally entered certain markets or states, which makes investing in states that already have legislation much more appealing from a business standpoint. One option to help companies invest in this market would be to introduce a gradient system of legislation. A gradient system would have rules that vary depending on the car's level of automation and human control of the vehicle.

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[13] Federal Motor Carrier Safety Administration, 81 FR 86,069 (Nov. 29, 2016).

[14] NAT'L CONF. OF ST. LEGISLATURES, *supra* note 3; Ryan Derousseau, *What Self-Driving Cars Will Mean for Automakers' Stocks*, FORTUNE (Sept. 6, 2016), http://fortune.com/2016/09/06/auto-stocks-tesla-gm-ford/.

[15] Mark Lewis, *Documents Confirm Apple is Building Self-Driving Car*, THE GUARDIAN (Aug. 14, 2015), http://autonomousvehicleinstitute.com/wp-content/uploads/2015/08/150814-Apple-Is-Building-Self-Driving-Car-The-Guardian.pdf.

[16] Kirsten Korosec, *Michigan Just Passed the Most Permissive Self-Driving Car Laws in the Country*, FORTUNE (Dec. 9, 2016), http://fortune.com/2016/12/09/michigan-self-driving-cars/.

[17] *See,* Grayson Ullman, *Tesla's self-driving software: Is it street legal?*, FEDSCOOP (Oct. 16, 2015), https://www.fedscoop.com/teslas-self-driving-update-how-is-it-legal/.

[18] Richard Viereckl, Dietmar Ahlemann, Alex Koster, Evan Hirsh, Felix Kuhnert, Joachim Mohs, Marco Fischer, Walter Gerling, Kaushik Gnanasekaran, and Julia Kusb, *Connected car report 2016: Opportunities, risk, and turmoil on the road to autonomous vehicles*, STRATEGY& (Sept. 28, 2016), http://www.strategyand.pwc.com/reports/connected-car-2016-study

III. BETTER LEGISLATION EQUATES TO DRIVING UP A STATE'S ECONOMY

In states such as California, where technological innovations of this kind are commonplace, state officials have begun the process of instituting laws to govern these self-driving vehicles.[19] These laws, however, have yet to garner widespread popularity as noted by Uber's decision not to enter San Francisco (with automated cars) because of the licensure requirements in place.[20] Currently, California law requires a slew of requirements in order to register a fully automated vehicle in the state.[21] These requirements, however, inhibit technological expansion because of the burden placed on companies, especially if they are confident in their technology's ability to maneuver through everyday traffic.[22] One requirement in California is liability insurance in the amount of five million dollars.[23] This rule does not make it fiscally plausible for some companies to register self-driving cars within the state because of the enormous insurance premiums that will have to be paid per vehicle by the companies making breakthroughs in this market of vehicles.

Historically, companies and individuals who venture into flourishing markets tend to have higher startup costs than those who enter later.[24] With car manufacturers spending billions of dollars developing these self-driving vehicles,[25] state and local governments should level the field by allowing them to reap more of the benefits if and when these cars are ready to hit U.S.

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[19] CAL. DEP'T OF MOTOR VEHICLES, TESTING OF AUTONOMOUS VEHICLES (2017), https://www.dmv.ca.gov/portal/dmv/detail/vr/autonomous/testing ("The autonomous vehicles testing regulations were adopted on May 19, 2014 and became effective on September 16, 2014.").

[20] Mele, *supra* note 4.

[21] CAL. VEH. CODE § 38750 (West 2015).

[22] Sam Levin, *Uber cancels self-driving car trial in San Francisco after state forces it off road*, THE GUARDIAN (Dec. 21, 2016), https://www.theguardian.com/technology/2016/dec/21/uber-cancels-self-driving-car-trial-san-francisco-california ("Uber, which had previously declared that its rejection of government regulations was an 'important issue of principle', confirmed that it has stopped its pilot in a statement…").

[23] *Id.*

[24] Harold Demsetz, *Barriers to Entry*, 72 AM. ECON. REV. 47, 47–48 (1982) (discussing how high start-up costs deter initial market entry).

[25] Dana Hull, *Ford Investing $1 Billion in Startup Founded By Two Autonomous Car Pioneers*, BLOOMBERG TECHNOLOGY (Feb. 10, 2017), https://www.bloomberg.com/news/articles/2017-02-10/ford-investing-1-billion-in-ex-google-uber-engineers-startup.

roads. There are currently nine states that have passed legislation outlining the use of self-driving vehicles in their states—and what Illinois should do is balance safety and economic growth so as to reach a nexus, allowing these companies to expand their efforts in its state.

IV. THE BENEFITS OF A GRADIENT SYSTEM OF LEGISLATION

One option would be to base legislation off the FAVP which defines different levels of automation. The FAVP adopted the Society of Automotive Engineers' (SAE) levels of automation; they range from 0 to 5, with SAE level 0 being a human driver controlling the vehicle and SAE level 5 being an automated system controlling all driving tasks.[26] States that have yet to pass legislation should have less regulation for vehicles on the lower end of the spectrum. This creates incentives for different companies and manufactures to enter the market at different points of automation. California's blanket legislation for automated vehicles disproportionately forces self-driving car manufacturers at lower points of the SAE scale to adhere to more stringent rules, which makes it unfeasible for low-SAE vehicles to enter into the state, even though these cars may be just as safe because drivers are aware of the lower level of automation.

A five million dollar insurance policy may not seem irrational given the potential harm to human life that may be caused by computer error; however, by handing over the reins of the potential for liability over to the companies manufacturing these vehicles it will force them to have more skin in the game, so to speak. Looking back at California's five million dollar insurance coverage law, it would be reasonable in cars that are in levels 3-5 of automation to be insured at a higher dollar amount because it is at those levels when a vehicle is considered to be a "highly automated vehicle" ("HAV").[27] These HAV's are "vehicles with automated systems that *are responsible for monitoring the driving environment*."[28] This gradient system of regulation would help driverless automobile manufactures by having allowing them to enter the market for these cars at different points and with different levels of regulation at each point of automation. If Illinois and other states were to adopt this gradient system of regulation, they would allow for greater access to research into this technological area because of the incentives that would be in place at each level. One example of this might be a five million dollar insurance policy, but only at SAE level 5, an automation level

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[26] U.S. DEP'T OF TRANSP., *supra* note 6.
[27] *Id.*
[28] *Id.*

at which a vehicle is completely self-sufficient and does not require human input.

Grimshaw v. Ford Motor Co., a seminal case in the auto industry, would likely deter companies from manufacturing and selling automated cars that were not yet ready to enter the U.S. transportation grid because of the punitive damages that they could be ordered to pay.[29] In *Grimshaw*, Ford calculated the dollar value of potential injury as costing less than a recall of those specific cars.[30] When this came to light at trial the plaintiff was awarded $125 million in punitive damages because of the gross negligence of Ford by not recalling this car model.[31] Thus, if a company knows that their automated vehicles are not yet ready to enter public roads, they stand to lose much more than the cost of the injury to the victim.

V. Reaping the Benefits of Driverless Cars

Automated cars are the next horizon in the transportation industry and states such as Illinois should aim to play a role in their growth so as to benefit not only their citizens, but also society as a whole. States should take the wheel and begin to examine the current patchwork of legislation concerning automated vehicles and continue to protect consumers while aiding in the growth of this area of technology. Manufacturers should be fully aware of the product liability they are placing upon themselves; by deploying these cars throughout the country as a new form of public transportation, manufacturers have demonstrated the requisite time and effort to perfect these cars so as to be fully functional and safe on U.S. roads. By adopting a gradient system of regulation, pegged to the vehicle's level of automation, states can introduce legislation that would help the auto industry drive into a new era of transportation.

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[29] Grimshaw v. Ford Motor Co., 119 Cal. App. 3d 757 (1981).
[30] *Id.*
[31] *Id.*

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MOVING FORWARD FROM THE FAMILY ACT: IMPLICATIONS FOR WORKING WOMEN, BUSINESS, AND CONTEMPORARY CONDITIONS OF CARETAKING LABOR

❖ NOTE ❖

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Abstract

In response to the historical rise of women in the workforce, Congress asserted Family and Medical Leave Act (FMLA) that aimed to preserve women's employment status through mandating unpaid parental leave. While still in force today, the Act fails to adequately deliver its promise to resolve the difficult choice women face between work and family care. The Family and Medical Insurance Leave Act (FAMILY Act) unsuccessfully sought to provide a comprehensive, national paid parental leave program. This Note argues that a national paid leave program should be resurrected to ameliorate the gender disparity embedded in conditions of parental caretaking. The Note examines the historical development of the FAMILY Act through discussion of FMLA's goals and limits. Additionally, the Note analyzes popular arguments put forth by the FAMILY Act's supporters and critics and explains how the Act would have positively affected women and businesses alike. Most significantly, the Note concludes that efforts towards implementing a national paid parental leave program are necessary to address structural imbalances between gender, family, and work that flow from modern American workplace inequality.

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I. INTRODUCTION

In 2016, the Family and Medical Insurance Leave Act (FAMILY Act) was poised to make significant federal advances toward workplace protections for women just as New York became the fourth state to adopt a mandatory paid parental leave program.[1] The bill introduced the most ambitious effort to date towards realizing a national policy of paid parental leave; and despite not becoming enacted in the last Congress, the FAMILY Act bill established a meaningful legal foundation for future policy proposals for national paid parental leave. Legislation similar the FAMILY Act should be passed in Congress because it will help working women retain their financial security, employers reduce costs and enhance their workplace environment. An additional reason for passage of a similar bill is that the FAMILY Act attempts to restructure the gender division in parental caretaking. This Note begins with the historical background of the FAMILY Act, describes its objectives, and outlines its supporting and opposing arguments. In Part II, this Note analyzes the legal and business issues associated with a national paid parental leave program through discussing how it impacts women and businesses. Finally, this Note recommends that a national paid parental leave program should be established to improve problematic conditions of caretaking labor that disadvantage women and points out how the current federal policy for unpaid parental leave reinforces gender inequality.

II. HISTORICAL BACKGROUND

The Family and Medical Insurance Leave Act (FAMILY Act) stands on the shoulders of the Family and Medical Leave Act (FMLA), which was enacted in 1993.[2] The FMLA importantly expanded the opportunity for working women to take leave for specified familial or medical reasons such as to give birth, raise newborns and take care of ill family members. Under the

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[1] S. 786, 114th Cong. § 1 (2015); Christina Cauterucci, *New York Just Established the Best Paid Family Leave Policy in the Country*, SLATE (Apr. 1, 2016, 12:29 PM), http://www.slate.com/blogs/xx_factor/2016/04/01/new_york_established_the_best_paid_family_leave_policy_in_the_country.html.
[2] Family and Medical Leave Act of 1993, Pub. L. No. 103-3, 107 Stat. 6.

Act, eligible employees–regardless of gender–are entitled to twelve work weeks of unpaid leave if they or their spouse gives birth, adopts or has placed a new foster child, seeks to care for a parent, spouse or child with a serious medical condition, or cannot work because of their serious medical condition.[3] Congress expressed that the purpose of FMLA was to "further balance the demands of the workplace with the needs of families, to promote the stability and economic security of families, and to promote national interest in preserving family integrity."[4] The FMLA signified social progress for working women because it helped alleviate the burden of choosing between job security and parenting as women disproportionately served as the family's primary caretaker.[5]

Nevertheless, today–a little over twenty years later–FMLA still imposes provisions that noticeably limit women's mobility and security in the workplace. FMLA's benefits are conditioned on the basis that an employee has worked for the employer for a minimum of twelve months or 1250 hours in the past twelve months and that employers have at least fifty or more employees.[6] This means that FMLA critically fails to cover women and other employees who work in part-time, temporary positions, or in small businesses. In 2015, an estimated 64.2% of all part-time workers were women compared to 35.8% of men.[7] Furthermore, for low-income women and single mothers, FMLA's unpaid parental leave deeply threatens family finances because not working means little to no family income.[8] Therefore, FMLA represents just a minimum threshold of employment protection or benefits for working women with familial caretaking obligations.

The FAMILY Act's proposed paid parental leave presents a significant, progressive policy milestone for working women without unduly burdening their employers. Senator Kirsten Gillibrand and Representative Rose DeLauro sponsored a 2013 bill that proposed to allow eligible employees to collect 66% of their income for up to twelve weeks when they take family or

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[3] 29 U.S.C. § 2602(a)(1) (2012).
[4] *Id.* § 2601(b)(1).
[5] *Id.* § 2601(a)(5).
[6] *Id.* § 2611(2)(A).
[7] *Latest Annual Data*, U.S. DEP'T. OF LABOR, https://www.dol.gov/wb/stats/latest_annual_data.htm#part (last visited Feb. 20, 2017).
[8] MICHELLE I. NAPLES, FAMILY LEAVE FOR LOW-INCOME WORKING WOMEN: PROVIDING PAID LEAVE THROUGH TEMPORARY DISABILITY INSURANCE: THE NEW JERSEY CASE 1–2 (2001), http://www.iwpr.org/publications/pubs/family-leave-for-low-income-working-women-providing-paid-leave-through-temporary-disability-insurance-the-new-jersey-case/at_download/file.

medical leave.[9] Conditions entitling leave included pregnancy, childbirth or child adoption, childcare, health treatment for employee or employee's spouse, parent, partner or children, and particular military caregiving and leave, which are equivalent to the reasons permitting parental leave under FMLA.[10] The proposed bill would have applied to all employers regardless of number of employees and not take into account the length of time an employee has worked, unlike FMLA.[11] Furthermore, the FAMILY Act would not have unduly burdened employers because it would not have required employers to fully pay the partial wage replacement during the employee's leave.[12] Instead, the replacement wages would have come from an insurance fund administered by a new Office of Paid Family and Medical Leave within the Social Security Administration.[13] The bill would have required employees and employers to contribute two-tenths of one percent each, or about $1.50 per worker around median salary per week to a national insurance fund.[14]

Unsurprisingly, the FAMILY Act encountered a wide range of supporters and detractors who articulated contrasting claims about its future effects. FAMILY Act supporters claim that it would have greatly improved maternal, newborn and child health outcomes. Through paid leave, new mothers can continue breastfeeding and ensure young children and newborns receive more important health services, such as immunizations.[15] For example, longer contact with newborns leads to improved bonding that "improve[s] a child's brain development, social development, and overall well-being."[16] Consistent, positive interaction between young children and their parents may reduce the impact of adversity and help foster stronger relationships between parents and children.[17] The FAMILY Act would have afforded new mothers the

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[9] S. 1810, 113th Cong. (2013).
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] NAT'L P'SHIP FOR WOMEN & FAMILIES, THE FAMILY AND MEDICAL INSURANCE LEAVE ACT 1 (March 2015), http://www.nationalpartnership.org/research-library/work-family/paid-leave/family-act-fact-sheet.pdf.
[14] S. 1810.
[15] Naples, *supra* note 13.
[16] *See* HUMAN IMPACT PARTNERS, FACT SHEET: PARENTAL LEAVE AND THE HEALTH OF INFANTS, CHILDREN AND MOTHERS 1 (Nov. 2011),http://www.humanimpact.org/doc-lib/finish/7-policy-hias/149-paid-family-leave-factsheet.
[17] NAT'L P'SHIP FOR WOMEN & FAMILIES, THE CHILD DEVELOPMENT CASE FOR A NATIONAL PAID FAMILY AND MEDICAL LEAVE INSURANCE PROGRAM 1 (March 2015), http://www.nationalpartnership.org/research-library/work-family/paid-leave/the-child-development-case-for-a-national-paid-family-and-medical-leave-insurance-program.pdf

chance for longer leave periods, which are linked to a decline in depressive symptoms and the likelihood of severe depression, and improved health outcomes.[18]

Critics of the FAMILY Act argued that the FAMILY Act nevertheless would have unfairly burdened employers, particularly small businesses, who may not have been able to easily absorb the costs of contributing to a national insurance fund because of thinner profits.[19] Furthermore, critics claimed that the new policy may harm women because companies would hire fewer women out of concern that they would be encouraged to take parental leave and increase the likelihood for employers' to have to seek a paid replacement for their absence.[20] In recent years, states and cities have enacted their own, more limited versions, of the FAMILY Act. In California, parents are now provided with six weeks of paid parental leave during or after pregnancy; in New Jersey, parents are allowed six weeks of paid parental leave at two-thirds of monthly income. [21] The rise of states enacting broad paid parental leave alludes to increased opportunity and public support for national paid parental leave.

III. STRENGTHENING WOMEN AND THEIR WORKPLACE

Federal policies for paid parental leave like the FAMILY Act would help reduce the job risks that fall upon women across the fifty states, which have historically disadvantaged them when they have taken work leave to give birth and care for family members. Since women are traditionally the primary caretakers of the family, women more than men, have had to face choosing between taking unpaid leave to raise young children or care for family and sacrificing familial relationships in order to earn necessary wages and retain their job. Mandatory paid parental leave provides the wage replacement that otherwise makes taking unpaid parental leave a financial impossibility. The FAMILY Act would have enabled women to not only have income stability, but also job security during childbirth, which is considered to be "the most expensive health event that families face during childbearing years."[22]

(citing EDWARD ZIGLER, SUSAN MUENCHOW, & CHRISTOPHER J. RUHM, TIME OFF WITH BABY: THE CASE FOR PAID CARE LEAVE (2012)).

[18] *Id.*

[19] Wendy McElroy, *The FAMILY Act is Smart Politics but Bad for Business,* THE HILL (Nov. 4, 2014), http://thehill.com/blogs/pundits-blog/healthcare/219766-the-family-act-is-smart-politics-but-bad-for-the-economy.

[20] *Id.*

[21] Anne Bartel et al., *California's Paid Family Leave Law: Lessons from the First Decade* (June 23, 2014), https://www.dol.gov/asp/evaluation/reports/PaidLeaveDeliverable.pdf.

Additionally, mandatory paid parental leave helps ensure retirement security for employed women who have intensive elder care responsibilities, such as for aging parents.[23] For example, adult female children, typically over the age of 50, who take care of their parents lose an average of $142,693 as a result of their decision; in contrast, adult male children only lose an average of $89,107 despite having the same obligations from income and retirement benefits lost from reduced work hours and leaving the work force early.[24] Therefore, mandatory paid parental leave helps women stay employed when they are facing some of their most challenging and vulnerable life events and encourages them to not leave the workplace early.

Additionally, the FAMILY Act would have helped businesses by reducing excessive costs, contributing to greater profits, and improving the workplace environment. First, unpaid parental leave under the FMLA leads to working women prematurely leaving their jobs and businesses incurring extra expenses locating and training a replacement.[25] Since turnover costs can be high, up to an average of one-fifth of employee's salary, paid parental leave encourages valued female employees to stay at their job.[26] In fact, first time mothers who took paid parental leave were shown to be more likely to return to their same employer after their leave than mothers who did not take paid parental leave.[27] California's state paid parental leave program revealed that 87% of businesses reported no increased costs because of the program and instead discovered increased savings due to higher employee retention and reduced costs associated with private parental leave benefits.[28] 90% of businesses also reported positive or no noticeable effect of the program on employee productivity and morale.[29] Businesses, knowing that their

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[22] NAT'L P'SHIP FOR WOMEN & FAMILIES, THE CASE FOR THE FAMILY ACT 2 (March 2015), http://www.nationalpartnership.org/research-library/work-family/paid-leave/the-case-for-the-family-act.pdf.

[23] *Id.*

[24] METLIFE MATURE MARKET INST., CAREGIVING COSTS TO WORKING CAREGIVERS: DOUBLE JEOPARDY FOR BABY BOOMERS CARING FOR THEIR PARENTS 1 (June 2011), https://www.metlife.com/assets/cao/mmi/publications/studies/2011/Highlights/mmi-caregiving-costs-working-caregivers-highlights.pdf.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *See* E. APPELBAUM & R. MILKMAN, UNFINISHED BUSINESS: PAID FAMILY LEAVE IN CALIFORNIA AND THE FUTURE OF U.S. WORK-FAMILY POLICY 78–79 (2013).

[29] *See* E. Appelbaum & R. Milkman, *Leaves That Pay: Employer and Worker Experiences with Paid Family Leave in California*, CTR FOR ECON. AND POLICY RESEARCH (Jan. 2011), http://www.cepr.net/index.php/publications/reports/leaves-that-pay.

employees have access to paid parental leave, may improve their bottom line through avoiding costly worker turnover and retaining valuable and profitable employee talent. Thus, the FAMILY Act and other mandatory paid parental leave policies are not likely to hurt businesses economically, as evidenced by similar state programs.

IV. REPOSITIONING WOMEN IN GENDERED WORK POSITIONS

On a societal level, paid parental leave policies, such as the FAMILY Act, should be passed in Congress and apply to the public on a national scale because they reform underlying structural inequality facing women. While working women are individual actors, their actions are informed by social, cultural and economic systems in place that import certain, and sometimes problematic, values on gender. The current national system of unpaid parental leave under the FMLA reinforces traditional gender roles for men and women in the workplace by supporting a troubling presumption of women as primary caretakers. In *Garska v. McCoy*, the Supreme Court of West Virginia held that child custody belongs to the primary caretaker who performs duties such as cooking, bathing, dressing, putting the child to bed.[30] While the ruling was dressed in gender-neutral language, it effectively favored awarding custody to mothers because housework and childcare generally fall upon mothers more than fathers.[31] This presumption of mothers as primary caretaker still animates contemporary family court custody rulings, as mothers win custody of children around two-thirds of the time during divorce.[32]

However, seeing childcare as primarily a woman's role supports a gendered structure of emotional labor, which ultimately disadvantages women. Emotional labor is based on the management and expression of one's own emotions as well as those of others involved in certain forms of public and private work.[33] Scholar Nicky James theorizes that "its value lies in its contribution to the social reproduction of labour power and the social

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[30] Garska v. Mccoy, 167 W.Va. 59 (1981).
[31] Kim Parker & Wendy Wang, *Modern Parenthood: Roles of Moms and Dads Converge as They Balance Work and Family*, PEW RESEARCH CTR (March 14, 2013), http://www.pewsocialtrends.org/2013/03/14/modern-parenthood-roles-of-moms-and-dads-converge-as-they-balance-work-and-family/.
[32] TIMOTHY S. GRALL, U.S. CENSUS BUREAU, CUSTODIAL MOTHERS AND FATHERS AND THEIR CHILD SUPPORT: 2013 (January 2016), https://www.census.gov/content/dam/Census/library/publications/2016/demo/P60-255.pdf.
[33] Nicky James, *Emotional Labour: Skill and Work in the Social Regulation of Feelings*, 37 THE SOCIO. REV., 1, 15 (1989).

relations of production, with the divide between home and work and the gender division of labour influencing the forms in which it is carried out."[34] She highlights that there is:

> the supposed 'naturalness' of women's caring role is central to the significance, value and invisibility of emotional labour and its development through gender identity and work roles. Part of women's caring role is that they are deemed to be 'naturally' good at dealing with other people's emotions because they are themselves 'naturally' emotional . . . .[35]

Pregnancy, childcare and elder care–which requires mothers to intensively regulate their emotions and absorb and manage those of their family–readily characterize emotional labor. By taking unpaid parental leave under FMLA to perform these familial caretaking tasks, working women are forced to accept a form of unpaid emotional labor.

The negative impact from this widespread, unremunerated emotional labor primarily falls upon women, which disparately harms women and exacerbates structural gender inequality. The lack of remuneration for women's emotional work reinforces a dichotomy that gainful employment on the marketplace indicates a masculine endeavor while familial caretaking constitutes feminine, domestic work that is part of women's supposed natural or moral duty, which despite requiring women to sacrifice substantial time, energy and personal expenses, can ultimately be had for nothing. Invisible expectations that women should take care of children leaves most women with a bleak option of either having to suffer loss of wages from taking leave or limiting critical bonding time with their newborn from returning to work very soon after childbirth. Unpaid leave perpetuates the questionable message that family is distinct from work, which hides women's historical struggle of navigating the tensions between and demands of both spheres of labor and silences the voices of working women who speak out against the compulsory divide.

The FAMILY Act addressed this systemic issue of unpaid emotional labor by providing partial wage replacement that tries to minimize income insecurity that discriminately face women because of gendered division of labor in society. It boldly asserts that women's caretaking is important enough to not be free. Thus, FMLA's unpaid parental leave policy

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[34] *Id.* at 19.
[35] *Id.* at 22.

unfortunately helps reproduce social conditions of gender inequality that it sought to remedy in the first place. Therefore, when it comes to national policy, Congress and the public should strive for inclusive programs like paid parental leave that define "family" to incorporate and foster the full agency of mothers and equalize the economic stakes or values involved in American women's common dilemma of deciding between work and family.

V. CONCLUSION

With the inception of the Trump administration and a Republican-controlled Congress, establishing mandatory and fair paid parental leave through national policy appears more than ever to be an uphill battle; however, these antagonistic conditions emphasize the importance of its legal advocacy.[36] During his presidential campaign, Trump proposed six weeks of paid maternity leave, which would be funded by the savings gained from eliminating waste in unemployment insurance.[37] But, Trump's proposal would be limited to married women who give birth, leaving behind many other types of working women and men participating in childcare, adopted, foster or step children, and affirms antiquated gender roles.[38] Furthermore, Trump estimated that such a program would cost around $2.5 billion, financed from unemployment fraud overpayments, but the problem remains that out of the $3.2 billion in estimated unemployment overpayments, only $850 million is thought to have come from fraud.[39] Unemployment overpayments due to fraud does not reasonably indicate a predictable and consistent source of money either. Nevertheless, the recent trend of state-administered paid parental leave programs reflects positive progress, but should not constitute its own ends, but rather a means to an end: a national

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[36] *See* Erin Gloria Ryan, *One of These Paid-Leave Policies Is Not Like the Other,* THE DAILY BEAST (Feb. 10, 2015), http://www.thedailybeast.com/articles/2017/02/10/one-of-these-paid-leave-policies-is-not-like-the-other.html.

[37] Sean Sullivan & Robert Costa, *Donald Trump Unveils Child-care Policy Influenced by Ivanka Trump*, N.Y. TIMES (Sept. 13, 2016), https://www.washingtonpost.com/news/post-politics/wp/2016/09/13/donald-trump-joined-by-ivanka-trump-to-outline-child-care-policy/?postshare=4881473768713550&tid=sm_tw&utm_term=.442db8088d89.

[38] *Id.*

[39] Mark Gimein, *Why Trump's Maternity-Leave Plan Won't Work*, THE NEW YORKER (Sept. 16, 2016), http://www.newyorker.com/business/currency/why-trumps-maternity-leave-plan-wont-work (citing U.S. Dept. of Labor, *Unemployment Insurance (UI) Improper Payments*, https://www.dol.gov/general/maps/data (last visited Feb. 20, 2017)).

program for paid parental leave that imparts new life into the legacy of the FAMILY Act.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

IS YOUR BANK ACCOUNT SAFE? FINANCIAL INSTITUTIONS' BAD FAITH MALPRACTICE

❖ NOTE ❖

*Claire Chung**

Abstract

This Note argues that a poisonous culture in the banking industry, to indiscriminately profit by cutting legal and ethical corners, led to the Wells Fargo scandal in 2016. Wells Fargo had wrongfully profited by incentivizing its employees to meet sales quotas by creating phony accounts using confidential customer information without consent. Although the employees acted alone, liability lies on the employer, Wells Fargo, under the theory of respondeat superior. In doing so, Wells Fargo violated unfair and deceptive financial practices law. Also the scandal raised the issue of whether the mandatory arbitration clause in a financial product purchase agreement should be enforced against consumers or not. This Note proposes a multifaceted solution to address the pandemic of bad faith banking practices.

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I. INTRODUCTION

Moral hazard issues are a common theme in white-collar crimes. There are several notorious white-collar crimes in history such as Bernie Madoff's Ponzi scheme, Enron's deceptive accounting practices in the 2000s, and WorldCom CEO defrauding his own business in order to buoy his other failing business in 1990s.[1] More recently, Wells Fargo has been clouded by a scandal which may represent the most notorious white-collar crime of 2016.[2]

Wells Fargo's 2016 scandal incurred the highest punitive damages enforced since the Consumer Financial Protection Bureau ("CFPB") was established in 2011 to oversee consumer protection in the financial sector.[3] The public was shocked that Wells Fargo committed such a widespread scam of creating unauthorized bank accounts with consumer's personal information that remained unnoticed for several years. [4] This Note will delve into the scandal in detail by providing a background of the scandal in Part II. Part III will analyze who is liable, which relevant laws were violated, and the moral hazards involved in this scandal. Part IV will recommend that systemic change must be brought to banking institutions to dis-incentivize client scamming. Lastly, Part V will conclude with a notion that financial institution should be subject to more stringent regulations than other businesses given the business model of the financial institutions relies on consumer's trust.

II. BACKGROUND

Wells Fargo is one of the largest consumer banks in the United States, boasting the highest market valuation in the United States.[5] In September

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[1] MC, *The 10 Most Notorious White-Collar Criminals*, THE RICHEST (Oct. 18, 2014), http://www.therichest.com/business/the-10-most-notorious-white-collar-crimes.
[2] CONSUMER FINANCIAL PROTECTION BUREAU, *Consumer Financial Protection Bureau Fines Wells Fargo $100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts* (Sep. 08, 2016), https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/.
[3] *Id.*
[4] *Id.*
[5] *Wells Fargo Today, 3rd Quarter 2016 Quarterly Fact Sheet*, WELLS FARGO (2016), https://www08.wellsfargomedia.com/assets/pdf/about/corporate/wells-fargo-today.pdf.

2016, Wells Fargo was accused of a national scheme of creating over 1,500,000 phony accounts and more than 500,000 credit card applications since 2011.[6] Wells Fargo profited from charging clients various fees including annual fees, interest charges, and overdraft protection fees on phony accounts created by using confidential customer information without consent.[7] Wells Fargo employees were incentivized to open the unauthorized accounts to meet unrealistically high sales goals for a commission.[8] Subsequently, 5,300 employees who did not meet their quota by engaging in the fraudulent scam were fired.[9] As a result, Wells Fargo was denounced by public outcry, fined $185 million, and ordered to refund $5 million to their affected customers.[10]

III. ANALYSIS

A. Liabilities of the Parties

Wells Fargo employees engaged in tortious and fraudulent activities, but pursuant to agency law they may not be liable if the wrongful acts that were (1) committed within the scope of employment at the workplace while (2) interacting with the customers to serve the employer's interest.[11] Arguably, by creating these unauthorized accounts, the Wells Fargo employees were attempting to serve their own personal interests, which would not fall within the scope of employment. However, the employees would not have engaged in the wrongful acts but for the incentive program imposed by Wells Fargo to maximize the firm's profit.[12] This mixed purpose of personal interest and employer's interest is enough to put employees within the scope of employment because a significant portion of the purpose is attributable to serving the employer's interest.[13] Therefore, Wells Fargo is liable for its

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[6] Matt Egan, *5,300 Wells Fargo Employees Fired over 2 Million Phony Accounts*, CNN: MONEY (Sep. 9, 2016, 8:08 AM), http://money.cnn.com/2016/09/08/investing/wells-fargo-created-phony-accounts-bank-fees/.
[7] *Id.*
[8] Nick Clements, *The Wells Fargo Reminder: Incentives Can Be Dangerous*, FORBES (Sep. 27, 2016, 5:55 PM), http://www.forbes.com/sites/nickclements/2016/09/27/the-wells-fargo-reminder-incentives-can-be-dangerous/#50d8c93d4c49.
[9] *Id.*
[10] Egan, *supra* note 5.
[11] Lisa M. v. Henry Mayo Newhall Mem'l Hosp., 907 P.2d 358, 360–62 (1995). (discussing that employees are not liable for torts committed within the scope of employment under the agency law); RESTATEMENT (SECOND) OF AGENCY § 1 (1958) [hereinafter RESTATEMENT (SECOND)].
[12] Reynolds v. L & L Mgmt., Inc., 492 S.E.2d 347, 350 (1997).
[13] *Id.*

employees creating phony accounts while working within the scope of employment. Furthermore, under corporate agency law, Wells Fargo's board of directors has an agency relationship with Wells Fargo because they (1) work on behalf of the principal, Wells Fargo, and (2) are subject to Wells Fargo's control on how to conduct daily tasks such as providing banking services to customers.[14] The agency relationship means that the directors owe a fiduciary duty to the company as agents to ensure their duty of loyalty and care.[15] Problems arose when the board members breached their fiduciary duty to the company by encouraging its employees to engage in white-collar crimes to meet unrealistically high sales goals.[16] As a result, the scandal tainted the company's reputation through blatantly overcharging its clients. [17]

B. Relevant law

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was enacted in response to the financial crisis in 2009 to change the financial regulatory system in the U.S.[18] Dodd-Frank specifies that CFPB can only declare acts and practices unfair if, "the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers, and such substantial injury is not outweighed by countervailing benefits to consumers or to competition."[19]

By engaging in these wrongful acts, Wells Fargo employees violated 12 U.S.C. § 5531(C)(1) which prohibits unfair acts or practices. [20] The employees violated the provision by causing a substantial injury to the customers that is not reasonably avoidable, and it is not outweighed by countervailing benefits to consumers.[21] Also, they materially interfered with the consumers' full ability to understand a term or condition of the financial product by disclosing phony accounts created through identity theft.[22]

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[14] RESTATEMENT (SECOND), *supra* note 11.
[15] Harding Co. v. Sendero Res., Inc., 365 S.W.3d 732, 744 (Tex. App. 2012).
[16] *Id.*; Clements, *supra* note 7.
[17] Egan, *supra* note 5 (quoting "they lost me as a banking customer and I have warned family and friends.").
[18] *Dodd-Frank Act*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm (last visited Jan. 26, 2017).
[19] Melissa B. Jacoby, *Dodd-Frank Regulatory Innovation, and the Safety of Consumer Financial Products*, 15 N.C. BANKING INST. 99, 105 (2011) (quoting Dodd-Frank Act § 1031(c), 12 U.S.C. § 5531(c)).
[20] 12 U.S.C. § 5531(C)(1)(a) (2012).
[21] Egan, *supra* note 5 (explaining that the scandal "incurred over $400,000 in fees . . . .").
[22] 12 U.S.C. § 5531(d)(1).

Finally, the firm took unreasonable advantage of the inability of the consumers to protect their interests in making an informed decision to select the right financial product.[23] Although the employees acted wrongly and broke the law, Wells Fargo will be vicariously liable for its employees' wrongdoing under the *respondeat superior* theory.[24] Under the theory of respondeat superior, the firm is vicariously liable for its employees acting on its behalf and subject to its control within the scope of employment. [25] It might be the case that Wells Fargo only provided an incentive for commission for sales quota. However, those who could not meet the sales quota were fired – which may be viewed as compulsory from the employee's perspective. [26] Although employees were not assigned to create phony accounts, the whole scam was to serve the purpose of the incentive program.[27]

Furthermore, the scandal raises a dispute whether a pre-arbitration "gotcha" clause commonly put in a financial product purchase agreement should be enforced or not.[28] The "gotcha" clause is a boilerplate clause waiving consumers' rights to bring a class action lawsuit when there is a legal dispute concerning the purchase of the financial product.[29] Currently facing class action lawsuits respectively brought by the former employees, shareholders, and consumers, Wells Fargo can avoid a class action brought by a number of affected consumers if the mandatory arbitration clause were intact. [30] Firms favor this clause because it prevents private parties from bringing a class action lawsuit against the firm, and the arbitration process usually yields more generous results in favor of firms. [31] Recently, the CFPB

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[23] 12 U.S.C. § 5531(d)(2).
[24] RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).
[25] *Id.*
[26] Clements, *supra* note 8.
[27] RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).
[28] *See* W.B. Lytton, *The State of Consumer ADR: Negotiation Ethics, International ADR, and Reparations Claims Facilities*, 21 INT'L INST. FOR CONFLICT PREVENTION & RESOLUTION 79, 86–87 (2003).
[29] CONSUMER FINANCIAL PROTECTION BUREAU, *CFPB Proposes Prohibiting Mandatory Arbitration Clauses that Deny Groups of Consumers their Day in Court*, (May 5, 2016), http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-prohibiting-mandatory-arbitration-clauses-deny-groups-consumers-their-day-court/.
[30] *Id.*; Egan, *supra* note 5; Heather Kelly, *Wells Fargo Used by Customers Over Fraudulent Accounts*, CNN: TECHNOLOGY (Sep. 16, 2016, 7:21 PM), http://money.cnn.com/2016/09/16/technology/wells-fargo-lawsuit/.
[31] Michael Hiltzik, *How Wells Fargo Exploited a Binding Arbitration Clause to Deflect Customers' Fraud Allegations*, L.A. TIMES (Sep. 26, 2016, 11:55 AM),

proposed 12 C.F.R. § 1040 to remove the mandatory arbitration "gotcha" clauses because the study showed consumers found the class action provides more effective means for public interest than arbitration does.[32] The study further showed that the class action could be effective in collecting small amounts of money just like the victims of Wells Fargo scandal.[33] Although Wells Fargo already paid out a substantial penalty fee to the CFPB, it might want to minimize the pending class action lawsuits against it by dropping the one brought by the consumers. Not surprisingly, Wells Fargo wants to enforce the mandatory arbitration clause enforcement, and the CFPB's proposal to prohibit such usage of the clause will be considered.[34]

C. Enforcement Action

Soon after the scandal was discovered, Wells Fargo paid full refunds of $5,000,000 to all affected consumers of fees paid on unauthorized accounts and paid $185,000,000 of penalties to the CFPB's Civil Penalty Fund.[35] In an attempt to mitigate a negative public opinion, Wells Fargo hired an independent consultant to conduct a thorough review of procedure.[36] In addition, Wells Fargo employed heightened work ethic training and replaced CEO John Stumpf with Timothy Sloan.[37] Finally, Wells Fargo amended its bylaws in November 2016 to require separation of chairman and CEO roles and appointed Vice Chairman as an independent director to restore the trust of its customers and team members.[38] This separation of two positions of power and the independent audit committee installation are better for Wells

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http://www.latimes.com/business/hiltzik/la-fi-hiltzik-wells-arbitration-20160926-snap-story.html.

[32] CONSUMER FIN. PROT. BUREAU, PROPOSED RULE WITH REQUEST FOR PUBLIC COMMENT (2015), http://files.consumerfinance.gov/f/documents/CFPB_Arbitration_Agreements_Notice_of_Proposed_Rulemaking.pdf; Yvette Ostolaza, *Overview of Arbitration Clauses in Consumer Financial Services Contracts*, 40 TEX. TECH L. REV. 37, 37 (2007).

[33] *Id.* at 50.

[34] Hiltzik, *supra* note 30.

[35] Egan, *supra* note 5.

[36] Lucinda Shen, *Wells Fargo's Phony Account Scandal May Not Actually End Up Costing That Much*, FORTUNE: FINANCE (Dec. 6, 2016), http://fortune.com/2016/12/06/wells-fargo-phony-accounts-legal-costs.

[37] Emily Glazer, *Wells Fargo CEO John Stumpf Steps Down*, WALL ST. J.: MARKETS (Oct. 12, 2016, 8:12 PM), http://www.wsj.com/articles/wells-fargo-ceo-stumpf-to-retire-1476306019.

[38] Ross Kerber & Dan Freed, *Wells Fargo Amends Bylaws to Separate Chairman and CEO Roles*, REUTERS: BUSINESS NEWS (Dec. 1, 2016, 5:02 PM), http://www.reuters.com/article/us-wells-fargo-accounts-managementchange-idUSKBN13Q5N7.

Fargo corporate governance because it can effectively police unethical banking practices better than when insiders with conflicts of interest are solely responsible for corporate policy.[39]

The bylaws amendment will hopefully promote not only the transparency of accounting and banking practices but also the moral standards of the board of directors and the employees. When the 2007 subprime mortgage crisis struck Wall Street, declines in residential investment caused global financial institutions to default. [40] However, the institutions were closely interconnected with each other so that one of their failures had a cascade effect on the whole U.S. economic system. [41] In response to this, the federal government intervened and bailed out the lenders, the institutions. [42] The underlying theory of the intervention has been criticized as a moral hazard of 'too big to fail' because the troubled institutions leveraged their intertwined position to enjoy policy preference and kept seeking high-risk high-return investments. [43] The costs of the high risk were left in the hands of consumers who invested in these institutions, and the bailed-out institutions did not pay full restitution.[44] The 2007 subprime mortgage crisis and Wells Fargo scandal are similar in a nutshell because both financial institutions had an incentive to pass off the cost of risky and bad faith practices to their consumers, by leveraging their positions as large institutions which are too intertwined with one another to let fail as a matter of U.S. policy, and also as employers pressuring employees with the problematic incentive programs respectively. [45] It is a moral hazard for firms to make profits by cutting legal and ethical corners through incentivizing employees to breach consumer trust.

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[39] Angie Mohr, *3 Reasons to Separate CEO AND Chairman Positions*, INVESTOPEDIA, http://www.investopedia.com/financial-edge/0912/3-reasons-to-separate-ceo-and-chairman-positions.aspx (last visited Feb. 16, 2017).
[40] John v. Duca, *Subprime Mortgage Crisis*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/55.
[41] Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 2 (Sep, 2009), http://www.naic.org/documents/topics_white_paper_namic.pdf.
[42] *Id.*
[43] *Id.* at 21.
[44] Saul Perez, *Must-know: Why "Too-big-to-fail" is Like Moral Hazard in Banks*, MARKET REALIST (Sep. 1, 2014, 11:38 AM), http://marketrealist.com/2014/09/big-fail-moral-hazard-banks/.
[45] *Id.*; Egan, *supra* note 5.

IV. RECOMMENDATION

Similar to the Wells Fargo breach of trust, when large consumer banks engaged in banking malpractice by rearranging debit transactions in order to maximize overdraft fees, the CFPB held this practice to be unfair under Dodd-Frank.[46] These banks tweaked real-time transaction by rearranging them on the books to show a false large transaction to bring the account into a deficit, and then when the bank account holder makes other transactions (e.g. withdrawing money at an ATM), she incurs overdraft fees.[47] In response, the CFPB reinforced an opt-in requirement, mandating consumers' affirmative consent to be charged an overdraft fee, and it awarded a penalty of $7,500,000 million.[48] This case is very similar to the Wells Fargo scandal because it also harmed consumer trust and financial interests by making the fundamental tools to manage people's funds artificially more expensive.

There are a number of recommendations to improve the pandemic moral hazards and bad faith practices in the banking industry. Thomas Curry, one of the chief banking regulators in the United States, testified about the Wells Fargo scandal by stating that all other national and regional banks employ similar borderline unlawful practices and under the similarly immense pressure to engage in bad faith sales tactics.[49] His testimony implies that this is a serious industry-wide problem, not just Wells Fargo's.

From the industrial standpoint, the poisonous culture to indiscriminately sell dangerous financial products to customers must be addressed. The regulatory agencies' continuing role as watchdogs in the banking industry will be helpful. From an institutional level, the heightened transparency in banking practices and the deterrence of risky incentive practices must be sustained through independent audit committees. Finally, from the judiciary's standpoint, punitive damages should be high enough to deter future anti-consumer conduct from bankers. Indeed, in the Wells Fargo case, the harsh punitive damages assessed against Wells Fargo sent an important

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[46] Regions Bank, CFPB No. 2015-CFPB-0009, http://files.consumerfinance.gov/f/201504_cfpb_consent-order_regions-bank.pdf (Apr. 28, 2015).

[47] *Id.*

[48] *Id.*; Kathy Kristof, *Nearly Half of Banks Still 'Reorder' Checks, Boosting Overdraft Fees*, CBS: MONEY WATCH (Apr. 9, 2014, 4:00 PM), http://www.cbsnews.com/news/nearly-half-of-banks-still-reorder-checks-boosting-overdraft-fees/.

[49] CNN Wire, *Wells Fargo is Not the Only One: Other Bank Workers Describe Intense Sales Tactics*, FOX (Sep. 22, 2016, 11:02 AM), http://fox43.com/2016/09/22/wells-fargo-isnt-the-only-one-other-bank-workers-describe-intense-sales-tactics/.

message to the whole financial industry to strictly regulate their sales culture and financial products.

After systemic changes are implemented, from the consumer standpoint, there will be wide public awareness of potential fraud, which should result in caution when purchasing financial products. Consumers are also recommended to take an active role such as consulting with an external financial consultant when in doubt, although this may be an impossibility for many consumers who cannot afford third party advice. This will help consumers safeguard their financial interests and make informed financial decisions.

V. CONCLUSION

To avoid bad faith malpractice and moral hazards in the banking industry and to better safeguard consumers, changes need to be made from both the consumer and corporate standpoints. Financial institutions need to reconsider the defective system of managing, training, supervising, hiring, rewarding, and punishing their employees. A more stringent standard should be enforced especially against trust institutions such as consumer banks because the core of their business model relies on consumer trust. Problematic incentive programs need to be closely regulated internally and externally by the CFPB. On the consumer side, the consumers should make an informed decision when entering into a purchase contract with a bank by regularly reviewing bank statements.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

DIGITAL MILLENNIUM COPYRIGHT ACT: NOTICE AND TAKEDOWN ON FAIR USE

❖ NOTE ❖

*Niya Ge**

ABSTRACT

This Note argues that the current standard for monitoring the DMCA takedown process holds copyright holders to little accountability, allowing abuse of the process and disregarding whether the material was fair use or not. This Note navigates common abuses of the takedown process, from broad automatic algorithms, to issuing DMCA takedown notices to intentionally censor the targeted material. Although the current subjective standard for monitoring the legitimacy of suspect infringing materials requires copyright holders to consider fair use, it outlines no actual process or standard to do so, and creates no incentive for proper monitoring or accuracy. This Note argues that an objective standard would be more appropriate in curbing abuse instead of a subjective standard that incentivizes negligent monitoring.

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I. INTRODUCTION

The battle of the "Dancing Baby" lawsuit has been a long and arduous suit since it was first filed in 2007.[1] Its significance grows as fair use of copyrighted works on the internet becomes ever more prevalent in the daily lives of the public through discussions, education, criticism, and entertainment, especially because of its easily accessible outlet.[2] Parallel to the increasing engagement with fair use works by the public, problems arise when copyright holders follow an increasing pattern in abusing the extrajudicial takedown procedures granted by the Digital Millennium Copyright Act (DMCA).[3]

The DMCA protects "service providers"[4] performing certain functions[5] from copyright infringement liability through the safe harbor provision of Section 512. Focusing on a subset of service providers (those performing functions defined in subsection (c) who host materials[6] and subsection (d) who function as search engines), safe harbor protection is lost if the service provider satisfies the state of mind threshold of knowledge. Actual knowledge is when the provider actually knows that the material or an activity using the

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[1] Lenz v. Universal Music Corp., 801 F.3d 1126 (2015). This case earned the nickname "Dancing Baby." *Important Win for Fair Use in 'Dancing Baby' Lawsuit*, ELECTRONIC FRONTIER FOUND. (Sept. 14, 2015), https://www.eff.org/press/releases/important-win-fair-use-dancing-baby-lawsuit.

[2] Whether a work is fair use is determined on a case by case basis, according to: "(1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work." 17 U.S.C. § 107 (2012). The statute provides examples that, materials "for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright." *Id.*

[3] Pub. L. No. 105-304, 112 Stat. 2860 (1998).

[4] Defined in Section 512(k)(1) as "an entity offering the transmission, routing, or providing of connections for digital online communications, between or among points specified by a user, of material of the user's choosing, without modification to the content of the material as sent or received," for purposes of 512(a). 17 U.S.C. § 512 (2012). For functions (*see infra* note 5) other than subsection (a), it is defined as "a provider of online services or network access, or the operator of facilities therefor." *Id.*

[5] The safe harbor provision only protects service providers performing functions covered in Section 512(a) to (d): (a) transitory digital network communications (b) system caching (c) information residing on systems or networks at direction of users (in other words, hosting user-uploaded materials) (d) information location tools. *Id.*

[6] Such as YouTube, a website that hosts user-generated content. Viacom Int'l, Inc. v. YouTube, Inc., 676 F.3d 19, 38 (2d Cir. 2012).

material on the system or network is infringing.[7] Safe harbor is also lost if the provider has "red flag" knowledge – where it is aware of facts or circumstances from which infringing activity is apparent; or upon obtaining such knowledge or awareness, does not act expeditiously to remove, or disable access to, the material.[8] The service provider also loses safe harbor protection if it has the right and ability to control the infringing activity and receives financial benefit.[9] In acting expeditiously to remove or disable the infringing material, the provider must follow the "notice and takedown" process, and notify the content uploader.[10] If the uploader makes a counterclaim to reinstate the content on the basis that they have a good faith belief it was erroneously removed, the service provider must notify the copyright holder and restore the content in no less than ten and no more than fourteen days, unless the copyright holder gives notice of a suit being filed.[11]

The DMCA places the burden on the copyright holder to seek out infringing material and notify service providers to take them down. Among other requirements to be an effective takedown notification, the claimant must also have a "good faith belief that use of the material in the manner complained of is not authorized by the copyright owner, its agent, or the law."[12] To protect the integrity of the process, abuse by "[a]ny person who knowingly materially misrepresents under this section-- (1) that material or activity is infringing, or (2) that material or activity was removed or disabled by mistake or misidentification," will subject them to liability.[13] Part II of this Note will first discuss a common abuse of the takedown process in employing reckless algorithms, and part III will discuss using DMCA takedowns as a method of intentional censorship. Part IV will discuss the Ninth Circuit decision in *Lenz* and how the decision does little to remedy the problems of part II and III. Finally, this Note will conclude by arguing that copyright holders should be held to a higher standard in monitoring the legitimacy of suspect infringing materials.

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[7] 17 U.S. C. § 512 (2012).
[8] *Id.*; *Viacom*, 676 F.3d at 31.
[9] § 512.
[10] *Id.*
[11] Lenz v. Universal Music Corp., 801 F.3d 1126, 1131 (2015).
[12] 17 U.S. C. § 512 (2012).
[13] *Id.*

II. THE PROBLEM OF RECKLESS ALGORITHMS

Yet, the seemingly straightforward and simple procedures of Section 512 are betrayed by the perplexities that plague the notice and takedown process. The burden to seek out and investigate copyright infringement is on the copyright holder, and the service provider is given no choice but provide notice and take down the material, if notified by the holder.[14] However, the sheer mass of the internet as a whole, the fast speed at which information spreads, and the large volumes of infringements daily is enough to overwhelm even the largest copyright holders.

The rapid development and dependence on information technology has eliminated the human presence in infringement investigations for a more quick and efficient process of automated algorithms because the "laboriousness of identifying infringing materials and generating takedown notices sharply constrained the system's overall scale."[15] As the scale of the task grew, automated systems overtook the job of human employees searching and assessing each material by hand, "deploying automated systems that search sites for title matches, artist matches, or other indicators of unauthorized content. By design, such systems are intended to address large-scale Internet infringement by moving far beyond human capacity to search for and identify possible infringements."[16] The efficiency of these systems skyrocketed takedown notices received by service providers. In 2009, the major service provider, Google, received 4,275 notices, but in 2012, the number of notices it received increased to 441,370.[17] This statistic is compounded by the fact that in each notice to a service provider, there may contain numerous takedown requests. For example, the 441,370 notices sent to Google in 2012 contained over 54 million requests.[18] The speed at which the volume of notices has multiplied is demonstrated by Google's receipt of takedown requests between 17 and 21 million per week in early 2016.[19] With these numbers, it is no surprise that mistakes are bound to happen. False positives include when takedown notices are issued against completely legitimate uses of copyrighted work.

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[14] *Id.*
[15] JENNIFER M. URBAN, JOE KARAGANIS & BIANNA L. SCHOFIELD, U.C. BERKELEY, NOTICE AND TAKEDOWN IN EVERYDAY PRACTICE 31 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2755628.
[16] Urban et al., *supra* note 15, at 31.
[17] Urban et al., *supra* note 15, at 32.
[18] *Id.*
[19] *Id.*

Distressingly, the amount of improper takedowns speaks less of genuine mistakes bound to happen in even the most careful process, but rather from a reckless overbroad issuing of takedown claims.[20] A recent study documenting over 108 million claims during a six-month period, nearly 30% of the approximate total of 108 million takedown claims were of questionable validity.[21] The study also noted that in 4.5 million requests, the targeted copyright content did not even match that of the supposedly infringing material.[22] The breadth of these automated systems matching targeted copyright work with that of infringing material on the web has enjoyed some notoriety, where "[o]verbroad matching algorithms lead copyright owners to send takedown notices targeting mere reporting on their works, and even to demand takedowns of links to their own websites."[23] Given the low cost and lack of consequence for frivolous claims, copyright holders can only be expected to take advantage of the process leveraged in their favor. Why would any copyright holder expend the time, money, and resources to closely monitor the legitimacy of suspect materials when there is neither incentive nor consequence to do so?

III. INTENTIONAL CENSORSHIP

More maliciously, the low cost, effective nature, and lack of consequence for illegitimate takedown claims provides an economical tool in the takedown process for businesses to silence competitors. It also provides a means to curtail poor reviews of a company's products and for politicians to subdue criticisms. Unfortunately, abusing DMCA takedowns by intentionally attacking certain material under the guise of copyright infringement is not uncommon. It is fast, effective, and costs next to nothing, in comparison to filing a lawsuit for defamation.[24]

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[20] Urban et al., *supra* note 15, at 2.
[21] *Id.*
[22] *Id.*
[23] Rebecca Tushnet, *Fair Use's Unfinished Business*, 15 CHI. KENT J. INTELL. PROP. 399, 401 (2016).
[24] Initiating a DMCA takedown is a simple and costless process on major websites. For example, Twitter offers a webpage form on which the copyright holder or an authorized representative of the copyright holder may fill out the required information to issue a notice. *Report Copyright Infringement*, TWITTER HELP CENTER, https://support.twitter.com/forms/dmca (last visited Feb. 20, 2017). For websites with no such web-form, issuing a takedown notice still incur no more than a nominal cost for postage, as it an be physically or electronically mailed to the designated agent of the service

The use of the DMCA takedown notice as a tool to remove unfavorable internet content extends beyond the United States' borders. Even foreign businesses have found the handiness of U.S. law; it is a cheap and easy tactic to force removal of criticisms of their services.[25]

The takedown process also notably creates a special advantage for parties who are politically motivated to suppress criticisms of individual web-based creators. "There are short timeframes in which speech can have influence," and in requiring a ten-day delay before a counterclaim can be effective, a takedown often has the effect of removing the material to the realm of irrelevance.[26] "A speaker's ability to engage in political speech . . . is stifled if the speaker must first commence a protracted lawsuit."[27]

The DMCA takedown procedure is thus hugely leveraged in the claimant's favor. In any instance a takedown claim is received, service providers are forced to take the approach of "guilty until proven innocent" in regards to the challenged material.[28] Few have the ability or resources to challenge copyright infringement claims, in fear that it would open them up to being dragged through lengthy and expensive litigation in court.

IV. THE NINTH CIRCUIT DECISION IN *LENZ*

The battle over the rights of internet users like Stephanie Lenz brought to light copyright holders' blatant disregard of legitimate fair use of their copyrighted works. Lenz sought to upload to YouTube a twenty-nine second video recording of her toddler son dancing to Prince's "Let's Go Crazy."[29] Universal, the copyright holder of Prince's song, at the time employed monitors to seek out infringing YouTube content and file DMCA takedown claims.[30] The employees were given a standard of evaluating whether a video may be infringing, but did not consider whether the video

provider (which is required of service providers, to be eligible for safe harbor protection). 17 U.S. C. § 512 (2012).

[25] Alex Hern, *Revealed: How Copyright Law is Being Misused to Remove Material from the Internet*, THE GUARDIAN (May 23, 2016), https://www.theguardian.com/technology/2016/may/23/copyright-law-internet-mumsnet/ (reporting that a London building firm forced the delisting of an entire thread from the Google search engine by filing a DMCA takedown claim with Google because the thread contained one post that reviewed its services poorly).

[26] Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 334 (2010).

[27] *Id.*

[28] 17 U.S.C. § 512 (2012).

[29] Stephanie Lenz, *"Let's Go Crazy" #1*, YOUTUBE (Feb. 7, 2007), https://www.youtube.com/watch?v=N1KfJHFWlhQ.

[30] Lenz v. Universal Music Corp., 801 F.3d 1126, 1129 (9th Cir. 2015).

may be fair use.[31] The Ninth Circuit held that because fair use is not copyright infringement, the copyright holder must consider whether the material is fair use.[32]

However, the court's decision–which at first blush is a seemingly major step forward towards resolving the issue of improper takedown claims in its jurisdiction–does little to mend the issue. With respect to the legal question of whether Universal knowingly misrepresented the material as infringing, the rule laid down by the court's decision only requires the copyright holder to "form a subjective good faith belief that a use is not authorized."[33] To comply with the Section 512 takedown procedures, the court's decision seems to do little more than have copyright holders introduce a statement in the notice that they believe it the material is not fair use.[34] The court confirms that the consideration "need not be searching or intensive" and "does not require investigation."[35] Though the court acknowledges that mere "lip service" to the consideration of fair use is not enough, the requirement creates no more than an illusory process, which easily allows negligent or devious copyright holders to comply with the low standard.

V. CONCLUSION

Despite the major flaws of the DMCA takedown process, entities such as the Motion Picture Association of America (MPAA), an association representing six major Hollywood studios, is pushing for stronger copyright holder protection in a reform of the notice and takedown process with a "notice and stay-down" process.[36] On the copyright holder's side, a major problem is that more popular works are likely to be promptly reposted by either the same or different users after the first infringement is taken down, likened to as the "whack-a-mole" problem.[37] Proponents of the "notice and stay-down" process push for the DMCA safe harbor protection to be

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[31] *Id.*
[32] *Id.* at 1133–34.
[33] *Id.*
[34] *Id.* at 1135.
[35] *Id.*
[36] Colin Mann, *MPAA: "Takedown Must Mean Stay-down"*, ADVANCED TELEVISION (Mar. 24, 2014), http://advanced-television.com/2014/03/24/mpaa-takedown-must-mean-stay-down/.
[37] U.S. DEP'T OF COMMERCE, DEPARTMENT OF COMMERCE MULTISTAKEHOLDER FORUM ON IMPROVING THE OPERATION OF THE DMCA NOTICE AND TAKEDOWN POLICY: SECOND PUBLIC MEETING, 88 (May 8, 2014), http://www.uspto.gov/sites/default/files/ip/global/copyrights/2nd_forum_transcript.pdf.

contingent on service providers to put in place filtering systems – that after a provider receives a takedown notice, its automated filtering system should prevent the copyrighted material from being posted on its service platform again. Calling for a "both more efficient and more effective" process that "actually reduces online infringement," the MPAA seeks to have the takedown process be a permanent removal of the challenged material, with no chance of reinstatement.[38] However, the proposal that service providers, themselves, filter content neglects that it bears the same issues brought by copyright holders' broad algorithms. Already demonstrated by large service provides such as YouTube, where a large portion of uploaded content is, in fact, fair use, its automated filtering system "Content ID"[39] holds the same adverse effects of stifling independent creators, and opens users to abuse of the Content ID procedure as intentional censorship.[40]

The Ninth Circuit in *Lenz*, in response to the plaintiff's request to impose an objective standard, stated that "Congress could have easily incorporated an objective standard of reasonableness. The fact that it did not do so indicates an intent to adhere to the subjective standard traditionally associated with a good faith requirement."[41] However, a subjective evaluation standard of fair use is no standard at all because monitors can arbitrarily decide the fate of allegedly infringing material, and therefore creates no incentive for copyright holders to change their automated algorithms to consider fair use. Meanwhile, the content poster must shoulder the high burden of proving the copyright holder had actual subjective knowledge that the material was not infringing.[42] Having the playing field leveraged in favor of the copyright holder from the beginning–starting with the takedown process, to having the impossible burden of proving actual knowledge that the material was not infringing–essentially nullifies Section 512's safeguards against the misuse of takedown notice against all but the most extreme cases where evidence of actual knowledge is discoverable. The future of the DMCA

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[38] Mann, *supra* note 36.

[39] *Using Content ID*, YOUTUBE, https://support.google.com/youtube/answer/3244015?hl=en&ref_topic=4515467 (last visited Feb. 20, 2017).

[40] Channel Awesome, *Where's The Fair Use? - Nostalgia Critic*, YOUTUBE (Feb. 16, 2016), https://www.youtube.com/watch?v=zVqFAMOtwaI. Fair use content creators who focus on reviewing films have videos taken down no matter if "review" is in the title of the video, or if the video had no visual imagery of the film being critiqued; independent filmmakers who receive poor video reviews can easily silence the criticism by filing a takedown notice on the video. *Id.*

[41] Lenz v. Universal Music Corp., 801 F.3d 1126, 1134 (2015).

[42] *Id.* at 1137.

should not be what the MPAA wants, i.e. a more stringent standard that permanently brings down content with a single notice. Instead, the DMCA should hold copyright holders accountable for their overly broad algorithms and misuse of the takedown procedure by evaluating their takedown claims under a different standard, and that standard should be what copyright holders reasonably should have known.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

OUR BROKEN SYSTEM: MODIFYING THE U.S. PHARMACEUTICAL REGULATORY SCHEME TO DECREASE SURGING PRESCRIPTION DRUG PRICES

❖ NOTE ❖

*Dan Gutt**

Abstract

The pharmaceutical industry's societal purpose is to improve the health of the citizenry. However, the industry is beginning to fail that purpose by producing expensive prescription drugs, which are becoming inaccessible to the average person. Pharmaceutical prices began to spike in 2014, and there is no evidence that this trend will abate in the future. The causes of this phenomenon stem from several factors: expensive patented drugs, a reduction in the supply of generic drugs, and the pharmaceutical industries large marketing and sales expenditures. In summation, this is a complex problem that cannot be solved by a single solution, nor can it be solved by cost covering measures. Instead, innovative solutions that target the root causes of spiking pharmaceutical prices need to be applied. Examples of these solutions include governmental bulk-buying power, longer patent terms, referencing pricing for patented drugs, and improved FDA approval times for generic drugs. If these solutions are implemented, the pharmaceutical industry will continue to deliver low-cost and life-altering pharmaceuticals to their customers. In essence, the pharmaceutical industry will continue to improve the health of the common man.

TABLE OF CONTENTS

* J.D. Candidate, Class of 2017, University of Illinois College of Law. I would like to thank the editors and staff of the *Illinois Business Law Journal* for their hard work, steadfast dedication, and endless patience. I dedicate this Note to my family, for without their love and support, I would not be the man I am today.

I. INTRODUCTION

The average person will no longer be able to afford his or her medication if the trend of surging prescription drug prices continues. Prices began to spike in 2014, and this trend continues with no signs of stopping.[1] The recent surge is the result of a number of problems. First and foremost, our system encourages expensive patented drugs.[2] Pharmaceutical companies have also begun to focus on strategies that increase generic drug prices, such as growth pharma, which attempts to decrease competition for certain generic drugs.[3] Increased generic prices are a problem because our system balances

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[1] Joseph Walker, *For Prescription Drug Makers, Price Increases Drive Revenue*, WALL ST. J. (Oct. 5, 2015, 9:59 PM), http://www.wsj.com/articles/for-prescription-drug-makers-price-increases-drive-revenue-1444096750 [hereinafter Price Increases Drive Revenue].
[2] *See* Ranit Mishori, *Why are generic brands cheaper than brand-name ones?*, THE WASH. POST (July 11, 2011), https://www.washingtonpost.com/national/health-science/why-are-generic-drugs-cheaper-than-brand-name-ones/2011/07/05/gIQAwZdL9H_story.html.
[3] Priyanka Dayal McCluskey, *As Competition Wanes, prices for generics skyrocket*, BOS. GLOBE (Nov. 6, 2015), https://www.bostonglobe.com/business/2015/11/06/generic-drug-price-increases-alarm-insurers-providers-and-consumers/H3iA9CSxAUylnCdGjLNKVN/story.html; Jen Wieczner, *The real reasons for the pharma merger boom*, FORTUNE (July 28, 2015), http://fortune.com/2015/07/28/why-pharma-mergers-are-booming/.

the high cost of patented drugs with cheap generics.[4] Furthermore, the Food and Drug Administration's (FDA) extremely slow approval process[5] impedes the availability of new generics, which exacerbates the problems caused by growth pharma.[6] As a result, the prices of many generics have increased dramatically: at least 315 generics have doubled in price since 2010, many of which suffer from low competition.[7] The fractured American model of private insurance companies and pharmacy benefit managers interacting with pharmaceutical companies also makes it more difficult for consumers to negotiate for lower prescription drugs prices.[8] All the while, prescription drug prices continue to increase.

Because the problem arises from several sources, several solutions are needed. These include employing bulk-buying power, increasing effective patent terms, implementing reference pricing for drugs on patent, and improving FDA-approval rates for low competition generics. However, if our system of prescription drug delivery does not change, the pharmaceutical industry will fail its customers by putting the medications they need out of reach.

Part II of this Note will delve into the evidence that shows prescription drug prices are rising, the effects of rising prices on consumers, and the reasons behind rising prescription drug prices. Part III of this Note will describe the various regulatory solutions that could be employed to stop surging prescription drug prices. Part IV of this Note will conclude that several changes to the U.S. pharmaceutical regulatory scheme are necessary.

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[4] John Russell, *Generic drugs: A bargain or sticker shock?*, CHI. TRIB. (Jan. 5, 2016), http://www.chicagotribune.com/business/ct-generic-drug-prices-pass-inflation-0106-biz-20160105-story.html.

[5] *See* Zachary Brennan, *GDUFA II: FDA Looks to Speed Up Generic Drug Approval Process*, REG. AFF. PROFESSIONALS SOC'Y (Sept. 26, 2016), http://www.raps.org/Regulatory-Focus/News/2016/09/26/25898/GDUFA-II-FDA-Looks-to-Speed-Up-Generic-Drug-Approval-Process/.

[6] Jeremy A. Greene, M.D., PhD. et al., *Role of the FDA in Affordability of Off-Patent Pharmaceuticals*, JAMA (Feb. 2, 2016), http://jama.jamanetwork.com/article.aspx?articleid=2480263#jvp150208r7.

[7] Brennan, *supra* note 5.

[8] Nadia Kounang, *Why pharmaceuticals are cheaper abroad*, CNN (Sept. 28, 2015), http://www.cnn.com/2015/09/28/health/us-pays-more-for-drugs/; Valerie Paris, *Why do Americans spend so much on pharmaceuticals*, PBS NEWSHOUR (February 7, 2014), http://www.pbs.org/newshour/updates/americans-spend-much-pharmaceuticals/.

II. BACKGROUND & ANALYSIS

A. Rising Prescription Drug Prices and their Effects on Consumers

Prescription drug prices in the United States have dramatically increased in recent years. From 2007 to 2013, U.S. prescription drug expenditures increased on average about 2.7% a year.[9] In 2014, however, prescription drug prices spiked: U.S. prescription drug expenditures increased by about 12.7%.[10] Prescription drug prices fared no better in 2015. By some estimates, prices increased from 9.8% to 10.4%,[11] and U.S. prescription drug expenditures increased by 14%.[12] In fact, prescription drugs had "the second-highest increase among the 20 largest products and services tracked by the Bureau of Labor Statistics' Producer Price Index" in 2015.[13] Moreover, wholesale-price increases for the top 30 selling prescription drugs from 2010-2014 increased on average by 76% over the five-year stretch, which was "more than eight times general inflation" for the same period of time.[14] Examples include the EpiPen, which has steadily increased in price from $100/pack in 2009 to $608/pack in 2016[15] and Daraprim, which increased in price from $13.50/pill to $750/pill in 2015.[16] Other examples include Tetracycline, an antibiotic, which increased in price from $0.06/250 mg pill

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[9] Price Increases Drive Revenue, *supra* note 1.
[10] *Id.*
[11] Laura Lorenzetti, *CVS Health Says Prescription Drug Spending Dropped Dramatically*, FORTUNE (Feb. 23, 2016), http://fortune.com/2016/02/23/cvs-health-slows-drug-price-spending/; Joseph Walker, *Drugmakers' Pricing Power Remains Strong: Price increases continue despite pushback from insurers, U.S. lawmakers*, WALL ST. J. (July 14, 2016), http://www.wsj.com/articles/drugmakers-pricing-power-remains-strong-1468488601 [hereinafter Pricing Power].
[12] Bill Alpert, *Pharmacy-Benefit Managers Under Pressure: American Express, Coca-Cola and others team up to try to cut high drug prices. Shares of Express Scripts, CVS, UnitedHealth are at risk*, BARRON'S (July 23, 2016), http://www.barrons.com/articles/pharmacy-benefit-managers-under-fire-1469247082.
[13] Pricing Power, *supra* note 11.
[14] Price Increases Drive Revenue, *supra* note 1.
[15] Tara Parker-Pope & Rachel Rabkin Peachman, *EpiPen Price Rise Sparks Concern for Allergy Sufferers*, N.Y. TIMES (August 22, 2016), http://well.blogs.nytimes.com/2016/08/22/epipen-price-rise-sparks-concern-for-allergy-sufferers/.
[16] Emily Mullin, *Turing Pharma Says Daraprim Availability Will Be Unaffected By Shkreli Arrest*, FORBES (Dec. 21, 2015), http://www.forbes.com/sites/emilymullin/2015/12/21/turing-pharma-says-daraprim-availability-will-be-unaffected-by-shkreli-arrest/#2e22f8d02e82.

in 2013 to $4.60/250 mg pill in 2015,[17] and cancer drugs: "the cost for each additional year lived by a patient [using cancer drugs] has skyrocketed from $54,000 in 1995 to $207,000 in 2013."[18]

It is not at all surprising that increases in prescription drug prices have occurred simultaneously with increases in private health insurance and Medicare expenditures. To save costs, many employer-based plans have increased their deductibles.[19] In fact, employer-based plans now have deductibles that are 50% bigger than they were five years ago,[20] and 80% of employees now pay deductible of at least $1500.[21] Moreover, premiums for employer-based plans have increased by 20% since 2011,[22] and for plans sold on the Affordable Care Act's exchanges, the average premiums will increase by 25% in 2017.[23]

Medicare Part D increased its deductible from $320 in 2015 to $400 in 2017.[24] Premiums have also begun to increase for certain Medicare Part D plans. The average monthly premiums for stand-alone PDP plans increased by 6% in 2016.[25] But, premiums for three of the most popular PDPs increased by at least 20% in 2016.[26] It is also becoming more common for

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[17] McCluskey, *supra* note 3.

[18] Lenny Bernstein, *Cancer experts call for curbs on rising drug prices*, THE WASH. POST (July 23, 2015), https://www.washingtonpost.com/national/health-science/cancer-experts-call-for-curbs-on-rapidly-rising-drug-prices/2015/07/22/9dafc7b0-3082-11e5-8f36-18d1d501920d_story.html.

[19] Reed Abelson, *Workers pay more for health care costs as companies shift burdens, Survey Finds*, N.Y. TIMES (Sept. 14, 2016), http://www.nytimes.com/2016/09/15/business/health-insurance-analysis-kaiser.html.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] Michael Hiltzik, *Obamacare premiums are spiking 25% next year. How bad is that?*, L.A. TIMES (Oct. 25, 2016), http://www.latimes.com/business/hiltzik/la-fi-hiltzik-obamacare-premiums-20161025-snap-story.html.

[24] *The Medicare Part D Prescription Drug Benefit*, KAISER FAM. FOUND. 1, 7 fig. 6 (Sept. 26, 2016), http://kff.org/medicare/fact-sheet/the-medicare-prescription-drug-benefit-fact-sheet/.

[25] Jack Hoadley et al., *Medicare Part D in 2016 and Trends Over Time, Summary*, KAISER FAM. FOUND. 1, 1 (Sept. 26, 2016), http://kff.org/medicare/report/medicare-part-d-in-2016-and-trends-over-time/ (noting that 60% of Medicare Part D beneficiaries are in Stand-Alone PDP plans).

[26] Jack Hoadley et al., *Medicare Part D in 2016 and Trends over Time, Findings, Section 2: Part D Premiums,* KAISER FAM. FOUND. 1, 1 (Sept. 26, 2016), http://kff.org/medicare/report/medicare-part-d-in-2016-and-trends-over-time/ (showing, in exhibit 2.4, that these plans cover about 5.5 million beneficiaries).

Medicare Part D plans to use coinsurance instead of copayments.[27] The consequence of such a trend could be larger out-of-pocket costs for beneficiaries.[28]

B. The Reasons Behind Surging Prescription Drug Prices

1. The Cost of Patented Drugs

Drugs under patents are significantly more expensive than their generic counterparts.[29] The cost of research and development (R&D) is a major contributor to the difference in price.[30] The R&D process is a long and laborious process, and it has a very low rate of success: "the likelihood that a drug entering clinical testing will eventually be approved is estimated to be less than 12%."[31] The cost of bringing a prescription drug to market, therefore, must include the development costs of all failed drugs.[32] Ultimately, the average total cost to bring one prescription drug to market reaches a baffling $2.6 billion, and the process takes between 10 to 15 years.[33]

To protect this large investment, drug companies file for patent protection concurrently with the research process.[34] Patents offer 20 years of intellectual property protection from the date the inventor and the inventor's assignees file with the United States Patent and Trademark Office (USPTO).[35] Patent protection is incredibly important because, once a drug

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[27] Michelle Andrews, *Coinsurance Trend Means Seniors Likely To Face Higher Out-Of-Pocket Drug Costs, Report Says*, KAISER HEALTH NEWS (Mar. 18, 2016), http://khn.org/news/coinsurance-trend-means-seniors-likely-to-face-higher-out-of-pocket-drug-costs-report-says/.
[28] *Id.*
[29] Mishori, *supra* note 2.
[30] *Id.*
[31] *Biopharmaceutical Research & Development: The Process Behind New Medicines*, PHRMA 1, 1 (2015), http://www.phrma.org/sites/default/files/pdf/rd_brochure_022307.pdf.
[32] *Id.* (asserting that there can be thousands or even millions of failed drugs).
[33] Amy Nordum, *Why Are Prescription Drugs So Expensive? Big Pharma Points To The Cost Of Research And Development, Critics Say That's No Excuse*, INT'L BUS. TIMES (May 19, 2015), http://www.ibtimes.com/why-are-prescription-drugs-so-expensive-big-pharma-points-cost-research-development-1928263.
[34] *See* JANICE M. MUELLER, PATENT LAW 24 (Vicki Been et al. eds., 4th ed. 2013).
[35] 35 U.S.C. § 154(a) (2012); *see also* Mueller, *supra* note 34, at 6 (stating that the American Invents Act of 2011 changed U.S. patent law from a first-to-invent system to a first-to-file system for patents filed on or after March 16, 2013).

goes off patent, it can lose up to 80-90% of its value to generic competition.[36] Thus, every year a drug has on patent is incredibly valuable to its developers. However, effective terms for most patents are significantly less than 20 years.[37] In fact, the average effective term for pharmaceutical patents is 11-12 years and can range as lows as 7 years.[38] More importantly, drug patents' effective terms are suffering from a debilitating downward trend; therefore, pharmaceutical companies have less time to recoup costs.[39]

Another issue, for pharmaceutical R&D, is that it has becoming increasingly inefficient in recent years. The cost to develop new drugs, new chemical entities (NCE)[40], and new biological entities (NBE)[41] has steadily increased since the 1970s.[42] In 1979, the cost to develop a NCE or a NBE was $199 million.[43] In 2012, that number had increased to $1.5 billion.[44]

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[36] Josh Bloom, *Should Patents on Pharmaceuticals Be Extended to Encourage Innovation?: Yes: Innovation Demands It*, WALL ST. J. (Jan. 23, 2012), http://www.wsj.com/articles/SB10001424052970204542404577156993191655000 ("Yet [generics] take up to 90% of sales away from the comparable brand-name drugs."); Mathew Herper, *Solving the Drug Patent Problem*, FORBES (May 5, 2002), http://www.forbes.com/2002/05/02/0502patents.html ("Once the patent expires, 80% of the brand name sales can vanish within a year as generic competitors reach the market.").
[37] Kimiya Sarayloo, *A Poor Man's Tale of Patented Medicine: the 1962 Amendments, Hatch<Minus>Waxman, and the Lost Admonition to Promote Progress*, 18 QUINNIPIAC HEALTH L.J. 1, 59 (2015).
[38] Sarayloo, *supra* note 37, at 59 and Dr. Ananya Mandal, *Drug Patents and Generic Pharmaceutical Drugs*, NEWS MEDICAL (Sept. 8, 2014), http://www.news-medical.net/health/Drug-Patents-and-Generics.aspx.
[39] Bloom, *supra* note 36.
[40] 21 C.F.R. § 314.108(a) (2016) (emphasis added) ("*New chemical entity* means a drug that contains no active moiety that has been approved by FDA in any other application submitted under section 505(b) of the act.").
[41] Sarah K. Branch & Israel Agranat, *"New Drug" Designations for New Therapeutic Entities: New Active Substance, New Chemical Entity, New Biological Entity, New Molecular Entity*, 57 J. OF MEDICINAL CHEMISTRY 8729, 8751 (2014), http://pubs.acs.org/doi/pdf/10.1021/jm402001w (emphasis added) ("The U.S. legislation for the regulation of follow on biological products introduced other terms for *new biological entities* that are eligible for marketing exclusivity." For example, "[a] biological product is defined under section 351(i) of the [Public Health Service Act] as a 'virus, therapeutic serum, toxin, antitoxin, vaccine, blood, blood component or derivative, allergenic product, protein (except any chemically synthesized polypeptide), or analogous product ... applicable to the prevention, treatment or cure of a disease or condition of human beings.").
[42] *Estimated costs for developing a new chemical or biological entity from 1979 to 2012 (in million U.S. dollars)*, STATISTA, https://www.statista.com/statistics/286168/costs-for-developing-a-new-chemical-or-biological-entity/ [hereinafter Estimated Costs of NCEs and NBEs] (Figure pertaining to NCE and NBE development costs) (last visited Oct, 27, 2016); Nordum, *supra* note 33, at fig.1 (Figure pertaining to drug development costs).
[43] Estimated Costs of NCEs and NBEs, *supra* note 42.

Similarly, the price to develop a new drug increased from $179 million in the 1970s, to $2.6 billion in the 2000s and early 2010s.[45] Furthermore, the number of drugs approved per billion dollars of R&D expenditures declines every nine years by 50%.[46]

Patent "evergreening" also keeps the prices of pharmaceuticals high. Evergreening is a strategy where pharmaceutical companies create slightly different variations of older drugs and file for patent protection.[47] Evidence of this phenomenon can be found by comparing the value of pharmaceutical industry patents to those filed by not-for-profit institutions, such as universities.[48] One study found that patents filed by not-for-profit institutions were on average cited more often than pharmaceutical industry patents, which suggests that not-for-profit pharmaceutical patents are more valuable than pharmaceutical industry patents.[49] The comparatively low value of pharmaceutical industry patents indicates that evergreening is a widespread practice.[50]

2. BigPharma M&A, Inefficient FDA Regulations, and the Rising Costs of Generics

Generic drugs account for 88% of prescriptions filled, but they only constitute 28% of pharmaceutical spending.[51] Since generic drugs are so inexpensive, they have saved Americans over $1.68 trillion over the past decade.[52] Their low cost was the result of a large amount of competition amongst many different generic manufacturers.[53] However, 22% of the top selling generics have increased in price faster than inflation and some have

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[44] *Id.*
[45] Nordum, *supra* note 33, at fig.1.
[46] Jack W. Scannell et al., *Diagnosing the decline in pharmaceutical R&D efficiency*, NATURE REVIEWS DRUG DISCOVERY (Mar. 2012), http://www.nature.com/nrd/journal/v11/n3/full/nrd3681.html.
[47] Roger Collier, *Drug Patents: the evergreening problem*, CAN. MED. J. ASS'N (2013), http://www.cmaj.ca/content/185/9/E385.long.
[48] Aaron S. Kesselheim & Jerry Avorn, *SYMPOSIUM: Pharmaceutical Innovation: Law & the Public's Health: Using Patent Data to Assess the Value of Pharmaceutical Innovation*, 37 J.L. MED. & ETHICS 176, 180-81 (2009).
[49] *Id.*
[50] *Id.*
[51] Russell, *supra* note 4.
[52] *Id.*
[53] McCluskey, *supra* note 3; Trefis Team, *Why Are Generic Drug Prices Shooting Up?*, FORBES (Feb. 27, 2015), http://www.forbes.com/sites/greatspeculations/2015/02/27/why-are-generic-drug-prices-shooting-up/.

even increased in price by over 5,000%.[54] This is a cause for concern because the dramatic rise in generic prices coincided with the dramatic overall increase in the price of prescription medication since 2014.[55]

The rise in generic drug prices has much to do with a new strategy amongst generic drug companies called "growth pharma." Growth pharma is a strategy that focuses on merging with or acquiring other drugs companies or parts of other drug companies to gain control over a certain generic market.[56] The success of this strategy has increased its popularity: the first half of 2015 saw $221 billion in deals, which is triple the amount of money spent on M&A in the first half of 2014.[57] The most famous example of growth pharma was the Teva-Allergen merger, which was a $40.5 billion deal that created the world's largest generic drug manufacturer.[58] Moreover, growth pharma is in many ways the response to the increasing difficulty pharmaceutical companies face when trying to develop new drugs:

> "[p]harma companies believe acquisitions are the only way to keep their revenues growing as fast as investors expect—and with today's complex breakthrough medicines, it's often cheaper for a company to acquire the next blockbuster drug than to develop it in-house."[59]

The result of growth pharma has been to reduce competition in the generic drug market.[60] For example, a healthy generic market may normally have 4 or 5 different competing drugs; however, after a series of mergers or acquisitions, there may only be 1 or 2 competing drugs.[61]

The FDA further exacerbates the decrease in generic drug competition because there is a massive backlog for FDA approval of generics, which acts like a bottleneck on generic drug competition.[62] The "median time it takes for the FDA to approve a generic is now 47 months or nearly four years despite the addition of about 1,000 new FDA employees and new user fee

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[54] Mullin, *supra* note 16 (asserting that Daraprim increased in price by over 5000%); Russell, *supra* note 4.
[55] Price Increases Drive Revenue, *supra* note 1.
[56] Wieczner, *supra* note 3; *see* McCluskey, *supra* note 3.
[57] Wieczner, *supra* note 3.
[58] McCluskey, *supra* note 3.
[59] Wieczner, *supra* note 3.
[60] McCluskey, *supra* note 3.
[61] *Id.*
[62] Greene, *supra* note 6.

funds."[63] Moreover, in 2014, the FDA was unable to approve thousands of generic applications from 2013, which did not allow the FDA to review any of the 1,500 applications filed in 2014.[64] Currently, there are 4,036 generic applications that have yet to pass FDA approval.[65]

3. The Cost of Marketing and Sales

Drug marketing is an enormous expense. In 2012 alone, the pharmaceutical industry spent $27 billion on drug promotion.[66] The largest portion, $15 billion, is spent on face-to-face sales and promotional activities for doctors and pharmacy directors.[67] However, the fastest growing portion has been direct-to-consumer advertising (DCA).[68] In 1997, the FDA eased restrictions on how pharmaceutical companies advertised to the public.[69] Since 1997, the amount spent on DCA has quadrupled to $3.1 billion.[70] Not only is DCA an added cost, but it also effectively increases the demand for drugs.[71]

Furthermore, pharmaceutical companies often spend more money on marketing and sales than on R&D: in 2013, ten major pharmaceutical companies spent more money on marketing and sales than on R&D.[72] This includes Johnson & Johnson, who spent $17.7 billion on marketing and sales

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[63] Brennan, *supra* note 5.
[64] Greene, *supra* note 6.
[65] Sydney Lupkin, *FDA Fees On Industry Haven't Fixed Delays In Generic Drug Approvals*, NPR (Sept. 1 2016) http://www.npr.org/sections/health-shots/2016/09/01/492235796/fda-fees-on-industry-havent-fixed-delays-in-generic-drug-approvals.
[66] *Persuading the Prescribers: Pharmaceutical Industry Marketing and its Influence on Physicians and Patients*, THE PEW CHARITABLE TR. (Nov. 11, 2013), http://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2013/11/11/persuading-the-prescribers-pharmaceutical-industry-marketing-and-its-influence-on-physicians-and-patients.
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Id.*
[71] *Id.* ("[DCA has] encouraged one-third of respondents to speak to their doctors about the promoted drug and one-fifth to request the prescription.[15] In one study, doctors were more likely to prescribe a branded antidepressant when asked for it by name than when patients didn't specify which treatment they wanted.[16]").
[72] Ana Swanson, *Big Pharmaceutical Companies are spending far more on marketing than research*, THE WASH. POST (Feb. 11, 2015), https://www.washingtonpost.com/news/wonk/wp/2015/02/11/big-pharmaceutical-companies-are-spending-far-more-on-marketing-than-research/.

but only $8.2 billion on R&D.[73] Another example is Pfizer, who spent $14.6 billion on marketing and sales while only spending $6.6 billion on R&D.[74]

III. RECOMMENDATIONS

A. Bulk-Buying Power

The U.S suffers from a fractured system of buying prescription medications. This system consists of private insurance companies, pharmacy benefit managers (PBM), and pharmaceutical companies.[75] Insurance companies and PBMs negotiate with pharmaceutical companies to set prescription drug prices.[76] After the price is set, PBMs create formularies[77] for the insurance companies;[78] then, insurance companies decide what particular beneficiaries will pay in premiums, copayments, co-insurance, and deductibles.[79] This system, using the power of the free market, is supposed to drive down the price of prescription drugs because of competition between insurance companies, PBMs, and pharmaceutical companies. In reality, Americans pay significantly more than their European counterparts in part because many European systems allow for bulk-buying power.[80]

France, the U.K., and Germany use a public insurance model that covers the vast majority of prescription drug users in their respective countries.[81] For example, Germany's Statutory Health Insurance (SHI) provides 90% of German citizens with health insurance.[82] Comparatively, the largest PBM in 2014, Express Scripts, only had 29% of the U.S. prescription drug market

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[73] *Id.*
[74] *Id.*
[75] Joanna Shepard, *The Fox Guarding the Henhouse: The Regulation of Pharmacy Benefit Managers by a Market Adversary*, 9 N.W. J. L. & Soc. Pol'y 1, 2 (2013).
[76] *Id.*
[77] *Id.* at 5 ("list of preferred drugs for different medical conditions…for which the [health insurance] plan will provide coverage.")
[78] *Id.*
[79] *See id.*
[80] Kounang, *supra* note 8; Paris, *supra* note 8.
[81] Marie Salter, Comment, *Reference Pricing: An Effective Model for the U.S. Pharmaceutical Industry?*, 35 N.W. J. INT'L L. & BUS. 413, 424–426 (2015); Jerry Stanton, Comment, *Lesson for the United States from Foreign Price Controls on Pharmaceuticals*, 14 CONN. J. INT'L L. 149, 162–163 (2000).
[82] Salter, *supra* note 81, at 424–25 .

share.[83] Moreover, CVS health and Optum Rx only had 24% and 22% respectively.[84] Because European public health insurance systems cover such a high percentage of prescription drug consumers, they have the ability to use bulk-buying power.[85] Bulk-buying power works by decreasing the number of buyers for prescription drugs.[86] Therefore, pharmaceutical companies become more sensitive to the price their consumers are willing to pay.[87] In other words, the consumer has significantly more power in France, the U.K., and Germany than in the United States.

It may be very difficult to implement the power of bulk-buying in the United States. To create a system that could use European-style bulk-buying would require the U.S. to switch to a public health system much like many European countries. A more practical solution would be to allow Medicare to negotiate with pharmaceutical companies directly.[88]

B. Longer Patent Terms

The 20 years that American utility patents promise[89] means little when the average effective life for pharmaceutical patents is around 11-12 years[90] — especially because effective terms for pharmaceutical patents are continuing to decrease.[91] However, increasing the amount of time that a drug has on patent may relieve the pressures of short effective terms by allowing pharmaceutical companies, who spend enormous sums on R&D, to spread their R&D costs over more years and consequently decrease their drug prices.[92]

Longer effective terms could also improve innovation because, as effective patent lives increase, so does the amount of time in which profits can be

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[83] *Market share of the top 5 pharmacy benefit managers in the U.S. prescription market in 2014*, STATISTA, https://www.statista.com/statistics/239976/us-prescription-market-share-of-top-pharmacy-benefit-managers/ (last visited Nov. 6, 2016).
[84] *Id.*
[85] *See* Kounang, *supra* note 8.
[86] *Id.*
[87] *Id.*
[88] Tami Luhby, *Here's one fix for high drug prices*, CNN (Sept. 28, 2015), http://money.cnn.com/2015/09/28/news/economy/medicare-drug-prices/index.html ("Medicaid and the Veterans Health Administration…can bargain directly. Medicare pays 83% of a brand-name drug's official price, on average….Medicaid pays 48% and the Veteran Health Administration [pays] 46%.").
[89] 35 U.S.C. § 154(a).
[90] Sarayloo, *supra* note 37, at 59.
[91] Bloom, *supra* note 36.
[92] *Id.*

made. A successful drug can make $3 billion a quarter.[93] That means even a month-long extension on a patent could add hundreds of millions or even billions of dollars to your revenue stream.[94] Adding years to patent terms, therefore, can create a powerful incentive to innovate.

Effective patent terms can be increased simply by allowing patent terms to run from FDA approval instead of filing with the USPTO.[95] To alleviate fears of patents lasting for too long, the USPTO could implement a system where they can evaluate the value of each drug to be patented. Drugs that meet the threshold of patentability but are not remarkable enough to gain the maximum level of protection could receive 15 years of protection from FDA approval.[96] The most valuable and innovative drugs would receive 20 years from FDA approval.[97] This would require the USPTO to make value judgments, which it is already apt to make. The USPTO must resolve whether a new drug is novel and non-obvious, which is essentially a measure of the drug's worth.[98] Simply adding another step, where the USPTO takes the standards it already uses to decide patentability and uses them to decide the patent term, should be an easy decision for the USPTO to make.

C. Using Referencing Pricing and Additional Clinical Benefit to Set Prices for Patented Drugs

The U.S. government should use its considerable negotiating position with pharmaceutical companies in another way: regulating the price of prescription drugs on patent. Many other countries around the world, including France, Germany, and the U.K., regulate the price of prescription drugs directly, which is another reason why their prices are significantly below the prices in the United States.[99] To set the prescription drug prices, these countries use different metrics to decide a prescription drug's value.

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[93] Richard Anderson, *Pharmaceutical industry gets high on fat profits*, BBC (Nov. 6, 2014), http://www.bbc.com/news/business-28212223.
[94] *Id.*
[95] Herper, *supra* note 36.
[96] *See id.*
[97] *See id.*
[98] *See* 35 U.S.C. § 102(a) (2012); *see* 35 U.S.C. § 103 (2012).
[99] Salter, *supra* note 81, at 424–426 ; *Understanding the 2014 Pharmaceutical Price Regulation Scheme*, ABPI 1, 1 (2014), http://www.abpi.org.uk/our-work/policy-parliamentary/Documents/understanding_pprs2014.pdf [hereinafter PPRS].

The two most effective and easily applied methods to the American system are additional clinical benefit and reference pricing.[100]

First, additional clinical benefit should be considered. In Germany, pharmaceutical companies must send data pertaining to new drugs trying to enter the German market to the Federal Joint Committee (FJC).[101] The FJC sets the reimbursement rate of new drugs to the German market by rating the level of "additional clinical benefit" the new drug will provide.[102] For drugs that have a high additional clinical benefit, their reimbursement rate is not subject to reference pricing.[103] However, if the drug has little additional clinical benefit, the reimbursement rate is set by reference pricing.[104] Measuring additional clinical benefit would attack the practice of evergreening patents directly by penalizing incremental patents. Moreover, the PTO is already in a position to decide additional therapeutic benefit because it must already decide the value of patent by inspecting a proposed patent's novelty and non-obviousness.[105]

Second, a scheme of reference pricing must follow the valuation of additional clinical benefit. Reference pricing involves creating a reference group made up of similar drugs and then comparing the prices of drugs within that group to the new drug.[106] Reference groups are set up by comparing active ingredients, pharmacological class, and therapeutic class.[107] After the reference group is created, a reference price must be set.[108] The reference group looks to prices of similar drugs within the country as well as from different countries.[109] The number of countries used for price comparison can be anywhere from four to more than twenty.[110] Then,

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[100] Salter, *supra* note 81, at 415; Sebastian Sieler et al., *AMNOG Revisited*, MCKINSEY & COMPANY (May 2015), http://www.mckinsey.com/industries/pharmaceuticals-and-medical-products/our-insights/amnog-revisited.
[101] Salter, *supra* note 81, at 424–426 ; Sieler, *supra* note 100.
[102] Olga Khazan, *Why Medicine is Cheaper in Germany*, THE ATLANTIC (May 22, 2014), http://www.theatlantic.com/health/archive/2014/05/why-medicine-is-cheaper-in-germany/371418/; Sieler, *supra* note 100.
[103] Salter, *supra* note 81, at 424–426 ; Sieler, *supra* note 100.
[104] Salter, *supra* note 81, at 424-426; Sieler, *supra* note 100.
[105] *See* 35 U.S.C. § 102(a); *see* 35 U.S.C. § 103.
[106] Salter, *supra* note 81, at 417.
[107] *Id.*
[108] *Id.* at 419–20.
[109] *Id.*
[110] Kai Ruggeri & Ellen Nolte, *Pharmaceutical Pricing: The Use of External Reference Pricing*, RAND CORP. 1, 28 (2013), http://www.rand.org/content/dam/rand/pubs/research_reports/RR200/RR240/RAND_RR240.pdf.

reference prices can be set either by "the average of all medicines within a group" or by "the lowest price in [the] group."[111] Averaging would not give the lowest price, but it would negatively affect pharmaceutical innovation the least, which is why it is the better method of price setting.[112]

An interesting feature of the U.K. Pharmaceutical Price Regulation Scheme (PPRS) is that the profit limits they set are flexible.[113] The limit can be increased if new evidence that shows a drug is more valuable than initially thought.[114] The PPRS also reserves the right to decrease the upper limit.[115] This could be applied to reference pricing, either by allowing the price of the drug to increase above the reference price or decrease below the reference price, which would allow flexibility in the system. It could also be a method of removing reference pricing altogether for a drug that has shown extensive additional clinical value.

Another interesting feature of the PPRS is that it does not apply to generic drugs, only brand name drugs.[116] The most effective method to reduce the recent increase in generic prices is to increase competition. Reference prices may interfere with generics and the prices they are set at.[117] Moreover, setting reference prices for patented drugs is a quid pro quo. The government gives the pharmaceutical company a legal monopoly, but the pharmaceutical company promises to keep the prices of their drugs below a certain level.

D. Improving FDA Efficiency

The FDA's sluggish approval rate for new drugs has exacerbated the prescription drug problem. The approval rate has allowed many generics to become the victims of growth pharma by acting as a bottleneck for generic competition.[118] In response, the FDA will begin meeting on October 21, 2016 to "discuss plans for the second iteration of the *Generic Drug User Fee Act (GDUFA II)* under which the FDA says it will begin offering eight-month and ten-month reviews of abbreviated new drug applications (ANDAs) between 2018 and 2022."[119]

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[111] Salter, *supra* note 81, at 419.
[112] *Id.*
[113] PPRS, *supra* note 99, at 6.
[114] *Id.*
[115] *Id.*
[116] *Id.* at 1.
[117] Salter, *supra* note 81, at 420.
[118] Wieczner, *supra* note 3; *see* McCluskey, *supra* note 3.
[119] Brennan, *supra* note 5.

A faster and more efficient approach would be to give shorter review times for possible competitors of generics that suffer from low competition.[120] The FDA is already allowed to "move up in the queue applications for generic drugs that 'could help mitigate or resolve a drug shortage and prevent future shortages."[121] The FDA should equate preventing price hikes caused by monopolistic conditions to its goal of preventing future shortages.[122] If the FDA is not be able to evaluate if a drug is experiencing low competition, then another agency, like Office of the Assistant Secretary for Planning and Evaluation, could aid the FDA in its evaluation.[123] The goal of such a policy should be to approve a number of generics that will compete with generics that have spiked in price because of low competition.[124]

IV. CONCLUSION

The recent increase in prescription drug prices is an incredibly complex issue. The causes of the recent spike are related to increasing R&D costs, decreasing generic competition, decreasing effective patent terms, long FDA approval times, growth pharma, PBMs and private insurance, as well as many other causes. In short, a single policy, regulation, or law will not be able to unravel our current predicament. A myriad of laws and regulations will be necessary to reduce the current dramatic increases in prescription drug price, including but not limited to: allowing Medicare to negotiate directly, increasing patent terms, using reference pricing for patented drugs, and improving the FDA's approval process for generics. Simply put, our prescription drug development and delivery system needs to change.

The societal purpose of the pharmaceutical industry is to provide life-altering medicines to the general public. However, it is beginning to fail its customers by putting the medications they need out of reach. Our regulatory scheme must now be modified to combat the recent price spikes and incentivize the pharmaceutical industry to spend more money and effort on innovative R&D. If these modifications to the U.S. regulatory scheme are implemented, the pharmaceutical industry will continue to innovate while also making life-altering medication accessible to the common man.

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[120] Greene, *supra* note 6.
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] *Id.*

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

CONSOLIDATION IN THE AGRICULTURAL MANUFACTURING INDUSTRY: DOES JOHN DEERE'S PROPOSED BUYOUT OF PRECISION PLANTING VIOLATE SECTION 7 OF THE CLAYTON ACT?

❖ NOTE ❖

*Ryan Harding**

Abstract

In the fall of 2015, John Deere attempted to buy Precision Planting: a specialty manufacturer of precision planting equipment. The government objected to this sale under Section 7 of the Clayton Act. This Note will examine the technology of John Deere and Precision Planting and determine whether the acquisition of Precision Planting by Deere is legal. Finally, this Note will recommend that the government take further action to prevent continued consolidation in the agricultural manufacturing industry.

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I. INTRODUCTION

Since the 1980's, the agricultural manufacturing industry has significantly consolidated.[1] The six largest remaining manufactures based on revenue are John Deere, Case New Holland (CNH), AGCO, Kubota, Claas, and Mahindra, respectively.[2] Because of falling commodity prices and declining sales in agricultural equipment, analysists in the farm industry predict further consolidation.[3] More specifically, analysts predict that the largest remaining manufactures will seek to acquire smaller, specialty manufactures to further increase their market share.[4] Such an acquisition occurred in the fall of 2015 when John Deere attempted to buy Precision Planting: a specialty manufacturer of precision planting equipment.[5]

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[1] Aimee Cope, *2016 Outlook: Machinery Market Ripe for Consolidation*, FARM J. (Dec. 14 2015), http://www.agweb.com/article/2016-outlook-machinery-market-ripe-for-consolidation-naa-aimee-cope/.
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] Steve Stein, *Area Agricultural Service Precision Planting Bought by Monsanto in 2012 Being Sold to John Deere*, PEORIA J. STAR (Nov. 22 2014), http://www.pjstar.com/article/20151122/NEWS/151129863.

However, the government objected to this proposed merger under Section 7 of the Clayton Act.[6]

Part II of this Note will examine the planting technology of John Deere and Precision Planting. This section will also study the eventual purchase of Precision Planting by John Deere and the resulting government action under Section 7 of the Clayton Act to prevent the sale. Part III will analyze whether the purchase of Precision Planting by John Deere violates Section 7 of the Clayton Act. Part IV of this Note will conclude that the purchase of Precision Planting is probably legal. Finally, Part V recommends that the government take further action to prevent continued consolidation of the agricultural manufacturing industry.

II. BACKGROUND INFORMATION

A. The Technology

To analyze the legality of the purchase of Precision Planting by John Deere, it is necessary to describe in detail their planting technology and how this technology compares to the rest of the industry. This description will begin by examining how traditional planters work and then contrasting them with high speed precision planters.

1. Traditional Planter

A planter is a farm implement pulled behind a tractor that automatically plants seeds into the ground.[7] Planters are comprised of two primary components: a toolbar and row units. The toolbar is a large metal implement pulled by the tractor and provides the basic structural framework for the planter.[8]

Row units are attached to the toolbar.[9] Every planter has an even number of row units ranging from two to forty-eight.[10] Essentially, row units

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[6] Jessie Scott, *After Acquisition, Deere and AG Leader Will Sell Precision Planting Products*, SUCCESSFUL FARMING (Oct. 12 2016), http://www.agriculture.com/news/machinery/after-acquisition-deere-and-ag-leader-will-sell-precision-planting-products.
[7] *List of Farm Machinery in Agriculture*, WORLD AGRIC. (2016), http://www.agrotechnomarket.com/2012/02/list-of-farm-machinery-in-agriculture.html.
[8] *See The Anatomy of a Planter*, ILL. FARM GIRL (April 30, 2015), http://www.theillinoisfarmgirl.com/the-anatomy-of-a-planter/.; *see also* The Farmer's Life, *How a Corn Planter Works,* YOUTUBE (Mar. 19, 2011), https://www.youtube.com/watch?v=3M9Xl17_rtQ.
[9] *Id.*
[10] *Id.*

insert seeds into the ground for planting. Each row unit draws seed from a main seed hopper or is individually filled with seed.[11] In a traditional row unit, gravity forces the seeds into a seed meter within the row unit.[12] The seed meter has individual holes, one seed to each hole, which allows for uniform planting.[13] The seed meter continually spins, dropping one seed into the ground at a time.[14]

The row unit also prepares the ground for the planting of seeds.[15] A row cleaner, which is a part of the row unit, moves through the field and pushes stalks, clods of dirt, and other debris out of the way.[16] Gauge wheels regulate how deep the seeds will be planted while metal discs open a narrow trench in the field for the seed meter to drop seeds into.[17] Once the seed is in the ground, a small plastic stick known as a seed firmer presses the seed gently against the ground.[18] Closing wheels then follow and close the trench; which ensures that the seeds are covered in dirt.[19]

2. *High Speed Precision Planter*

High speed precision planters operate in essentially the same way as traditional planters except for how the seeds are delivered to the ground. High speed precision planters use flighted belts to deliver the seed from the row unit to the seed trench rather than a seed meter.[20] Unlike traditional planters which use gravity tubes, these flighted belts do not rely on gravity to deliver the seed into the ground.[21]

Traditional planters, when traveling at speeds greater than five miles per hour, begin to bounce causing seeds to drop at different speeds from the seed meter.[22] This causes irregular spacing and lower yields overall.[23] High speed precision planters solve this problem because the flighted belts deliver the seeds in a uniform fashion, rather than relying on gravity, and increase or

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[11] *See id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *See SpeedTube: Plant 2X Faster*, PRECISION PLANTING (2017), http://www.precisionplanting.com/#products/speedtube/.
[21] *Id.*
[22] *See id.*
[23] *See id.*

decrease the number of seeds planted based on the speed of the planter.[24] This high speed precision planting technology allows for farmers to plant at up to 10 miles per hour; which is twice the speed of traditional planters.[25] This increased speed allows farmers to plant during better growing conditions, farm more acres, and produce higher yielding crops.[26]

B. The Art of the Deal: Precision Planting, Monsanto, John Deere, and the U.S. Department of Justice

Precision Planting is a Delaware corporation headquartered in Tremont, Illinois.[27] Precision Planting employs more than 250 workers, ships products to more than 40 countries including the United States and Canada, and operates a 100,000 square-foot production facility.[28] The company originally developed aftermarket products that were added onto existing planters with the goal of improving planting depth and spacing in order to increase crop yields.[29] More recently, the company began manufacturing precision planting equipment that can be retrofitted to update conventional planters manufactured by John Deere, Kinze Manufacturing, AGCO Corporation, and other agricultural manufactures.[30] These products and services directly compete with John Deere's precision planters because it allows a farmer to upgrade his existing planter at a fraction of the cost of buying a new precision planter from John Deere.[31]

Monsanto is a Delaware corporation headquartered in Saint Louis, Missouri.[32] The company provides agricultural products including seeds, herbicides, and fertilizers. The Climate Corporation is a subsidiary of

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[24] *See id.*
[25] *See* Jessie Scott, *10 Tips for High-Speed Planting*, SUCCESSFUL FARMING (Feb 4, 2015), http://www.agriculture.com/machinery/farm-implements/planters/10-tips-f-highspeed-plting_231-ar47375.
[26] *Id.*
[27] Steve Stein, *Tremont-based Precision Planting Remains One of Area's Most Prominent Agriculture Businesses*, PEORIA J. STAR (Apr. 21, 2016), http://www.pjstar.com/lifestyle/20160421/tremont-based-precision-planting-remains-one-of-areas-most-prominent-agriculture-businesses; Steve Stein, *Progress: Ag Products Maker Precision Planting has Become One of Region's Most Prominent Businesses*, PEORIA J. STAR (Apr. 22, 2015) http://www.pjstar.com/article/20150422/NEWS/150429692.
[28] *Id.*
[29] *Id.*
[30] *See* PRECISION PLANTING *supra* note 20.
[31] *See id.*
[32] *Monsanto Facilities Around the World*, MONSANTO (2017), http://www.monsanto.com/whoweare/pages/our-locations.aspx.

Monsanto.[33] In 2012, the Climate Corporation purchased Precision Planting for $250 million.[34] Monsanto then invested an addition $25 million into Precision Planting.[35]

Deere & Company, more commonly known as John Deere, is a Delaware corporation headquartered in Moline, Illinois.[36] Deere manufactures implements and machinery for the construction, forestry, lawn care, and agricultural industries.[37] Furthermore, Deere is the leading seller of new seed planters in the United States.[38]

John Deere was the first company to develop high speed precision planting equipment.[39] In 2014, Deere released a new planter that utilized the metered delivery system for seed placement into the trench.[40] This allowed farmers to plant at speeds up to 10 miles per hour; double the speed of traditional planters.[41]

Shortly thereafter, Precision Planting released its own high speed planting system that could be retrofitted to an existing traditional planter.[42] This allowed for a farmer to retrofit his existing traditional planter to be just as efficient as the new John Deere planter at a fraction of the cost.[43] Precision Planting then partnered with Case-International Harvester and AGCO, two of Deere's major rivals in the agricultural manufacturing industry, and allowed them to offer Precision Planting technology on their new planters.[44]

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[33] *See Company History*, MONSANTO (2017), http://www.monsanto.com/whoweare/pages/monsanto-history.aspx.
[34] Steve Stein, *Area Agricultural Service Precision Planting Bought by Monsanto in 2012 Being Sold to John Deere*, PEORIA J. STAR (Nov. 22 2014), http://www.pjstar.com/article/20151122/NEWS/151129863.
[35] *Id.*
[36] *See World Headquarters*, JOHN DEERE (2017), https://www.deere.com/en_US/corporate/our_company/fans_visitors/tours_attractions/worldheadquarters.page.
[37] *See History*, JOHN DEERE (2017), https://www.deere.com/en_US/corporate/our_company/about_us/history/history.page?.
[38] *See* Compl. at 4, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[39] *2014 News Releases and Information: John Deere Revolutionizes Seed Delivery with New Row Units for 2015*, JOHN DEERE (Feb. 12, 2014), https://www.deere.com/en_US/corporate/our_company/news_and_media/press_releases/2014/agriculture/2014feb12_exactemerge_planter.page.
[40] *Id.*
[41] *Id.*
[42] Ike Brannon, *When Does Antitrust Activity Stifle Innovation*, 39 REG. 6, 6 (2016).
[43] *See id.*
[44] *Id.*

On November 3, 2015, Deere agreed to purchase Precision Planting for $190 million from Monsanto.[45] On August 31, 2016, the Justice Department sued to stop Deere's acquisition of Precision Planting under Article 7 of the Clayton Act.[46] The government argued that the transaction violated Article 7 of the Clayton Act because the deal would bring together the two largest manufacturers of high speed precision planting products.[47] The government further alleged that this merger would substantially reduce competition and result in higher prices for farmers and consumers.[48]

John Deere responded that the merger would increase innovation and that competition was already intense in the planter market.[49] Deere also proposed to license Precision Planting technology to Ag Leader.[50] Ag Leader, a competitor of Deere, would then be allowed to develop, improve, and sell this technology to other competitors.[51] This deal with Ag Leader, however, was contingent upon the Justice Department confirming the acquisition of Precision Planting by John Deere.[52]

III. ANALYSIS

A. Antitrust Law Generally

Antitrust law in the United States is primarily governed by three statutes: the Sherman Antitrust Act, the Federal Trade Commission Act, and the Clayton Act.[53] The Shearman Act generally proscribes agreements that

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[45] *Id.*
[46] Compl. at 34, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[47] Jessie Scott, *After Acquisition, Deere and AG Leader Will Sell Precision Planting Products*, SUCCESSFUL FARMING (Oct. 12 2016), http://www.agriculture.com/news/machinery/after-acquisition-deere-and-ag-leader-will-sell-precision-planting-products.
[48] *See id.*
[49] *See id.*
[50] *2016 News Releases and Information: Deere Plans to Further Expand Customer Choice in Planter Market*, JOHN DEERE (Oct. 12, 2016), https://www.deere.com/en_US/corporate/our_company/news_and_media/press_releases/2016/corporate/2016oct12-corporaterelease.page.
[51] *Id.*
[52] *Id.*
[53] Arjun Mishra, *History of Antitrust Laws*, JURIST (Dec. 30, 2013), http://www.jurist.org/feature/2013/12/a-history-and-the-main-acts.php (for the history of antitrust legislation *see* Barak Orbach, *The Antitrust Curse of Bigness*, 85 S. CALIF. L. REV. 605 (2012); Richard B. McDermott, *History and Identity of the Relevant Antitrust Statutes*, 5 TULSA L. REV. 265 (1968); Rush H. Limbaugh, *Historic Origins of Anti-Trust Legislation* 18 MO. L. REV. 215 (1953)).

unreasonably restrain trade[54] and organizations that become or attempt to become monopolies.[55] The Federal Trade Commission Act created the Federal Trade Commission and generally prohibits unfair methods of competition or deceptive business practices.[56] The Clayton Act prohibits price discrimination that may substantially lessen competition[57] and exclusive dealing that may tend to lessen competition.[58] Additionally, Section 7 of the Clayton Act proscribes mergers and acquisitions where the effect may substantially lessen competition.[59]

B. Applicable Antitrust Law

For the facts of this case, Section 7 of the Clayton Act is the applicable antitrust law.[60] Section 7 is primarily concerned with mergers and acquisitions that may substantially lessen competition or tend to create a monopoly.[61] Section 7 therefore empowers the Department of Justice to prohibit pending mergers and acquisitions of companies that may reduce competition or to undo completed mergers via forced divestiture of stock, compulsory sharing of technology, or corporate spin offs.[62]

To satisfy Section 7, the government must show a reasonable probability that the proposed transaction would substantially lessen competition in the future.[63] A horizontal merger is a merger that occurs between two competing firms.[64] As mentioned above, Precision Planting and Deere are competitors, so the acquisition of the former by the latter would be a horizontal merger.[65] To satisfy Section 7 in a horizontal merger, the government must identify the relevant product and geographic market.[66] The relevant product market generally includes the products at issue, substitute products, and other

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[54] 15 U.S.C. § 1 (2012).
[55] 15 U.S.C. § 2 (2012).
[56] 15 U.S.C. §§ 41–58 (2012).
[57] 15 U.S.C. § 13 (2012).
[58] 15 U.S.C. § 14 (2012).
[59] 15 U.S.C. § 18 (2012).
[60] *Id.*
[61] *Id.*
[62] WILLIAMS C. HOLMES, INTELLECTUAL PROPERTY AND ANTITRUST LAW § 9:1 (2016).
[63] *Id.*; *see* F.T.C. v. Warner Commc's Inc., 742 F.2d 1156, 1160 (9th Cir. 1984); *see also* HOLMES, *supra* note 62.
[64] *Horizontal Merger*, INVESTOPEDIA (2017), http://www.investopedia.com/terms/h/horizontalmerger.asp.
[65] *Id.*
[66] F.T.C. v. Advocate Health Care Network, 841 F.3d 460, 467 (7th Cir. 2016); *see also* Brown Shoe Co. v. United States., 82 S.Ct. 1502, 1530 (1962).

products that are reasonably interchangeable with the product at issue.[67] The relevant geographic market is where the effect of the merger on competition will be direct and immediate.[68] If the government makes this showing, a presumption of illegality exists.[69]

The burden then shifts to the defendant to rebut this presumption.[70] To rebut the presumption of illegality, the defendant must produce evidence that the evidence offered by the government gives an inaccurate description of the competition in the relevant market.[71] This can be done by showing that barriers to enter the market are low, that both of the merging parties are weak market participants, or that the remaining competition by third parties should remain intense.[72] Lastly, if the defendant rebuts the presumption of illegality, the burden returns to the government to present other evidence sufficient to show a reasonable probability that the transaction would substantially lessen competition.[73]

C. Party Arguments

1. The U.S. Department of Justice

The government alleges that the proposed buyout of Precision Planting by John Deere violates Section 7 of the Clayton Act.[74] The government defines the relevant geographic market as the United States.[75] It defines the relevant product market as high-speed precision planting systems that are factory-installed on new planters and systems that can be retrofitted onto new and used conventional planters.[76] As defined, the government argues that Deere is 44% of the high speed precision planting market and Precision Planting is 42% of the precision planting market.[77] The government concedes that Kinze and Horsch represent 12% and 2% of the high speed planting market, respectively.[78] The government further argues that no

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[67] F.T.C. v. Advocate Health Care Network, 841 F.3d 460, 467 (7th Cir. 2016).
[68] *Id.*; *see also* United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 357 (1963).
[69] *Id.*
[70] *See* Citizens & S. Nat'l Bank, 422 U.S. 86, 120 (1975); *see also* HOLMES, *supra* note 62.
[71] Citizens & S. Nat'l Bank, 422 U.S. at 120.
[72] F.T.C. v. Univ. Health, Inc. 938 F.2d 1206, 1218 (11th Cir. 1991); *See generally* United States v. Citizens & S. Nat'l Bank, 422 U.S. 86 (1975); *see also* HOLMES, *supra* note 62.
[73] F.T.C. v. Univ. Health, Inc. 938 F.2d 1218.
[74] Compl. at 4, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[75] *Id.* at 12.
[76] *Id.*
[77] *Id.* at 13.
[78] *Id.*

reasonably interchangeable substitutes exist in this market because conventional planters, which are both slower and less efficient than high speed precision planting systems, are not effective substitutes for high-speed precision planting systems.[79] Thus, the government argued that a presumption of illegality arose because of the perceived lack of substitute products and the high degree of market concentration.[80]

The government further argued that John Deere could not rebut this presumption of illegality.[81] First, they argued that barriers of entry into the high speed planter market were high since it would take years and large amounts of capital for a company to develop high speed precision planting technology comparable to John Deere or Precision Planting.[82] Furthermore, the government noted that the barriers to entry were especially high since John Deere and Precision Planting owned most of the intellectual property rights required to develop high speed precision planting technology.[83]

Second, the government argued that competition would not remain intense because Kinze and Horsh were not large competitors and constituted a small market share.[84] Additionally, the government argued that Kinze and Horsh did not offer technology that was on par with Deere or Precision Planting.[85] As such, the government requested that the acquisition of Precision Planting by John Deere be permanently enjoined under Section 7 of the Clayton Act.[86]

2. *John Deere*

John Deere responded that the government did not meet their burden of showing that a presumption of illegality existed.[87] First, they denied that the government adequately defined an antitrust product market or geographic market.[88] More specifically, Deere rejected the idea that there is a narrow "market" for high speed precision planters.[89] Rather, they argued that there is only a broad planter market generally; of which Deere does not constitute

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[79] *Id.* at 11.
[80] *Id.* at 18.
[81] *See id.*
[82] *Id.* at 16.
[83] *Id.*
[84] *See id.* at 13.
[85] *Id.* at 12.
[86] *Id.* at 18.
[87] Resp. at 34, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[88] *See id.*
[89] *See id.*

44% of sales because rivals such as Case International Harvester and AGCO would also be included.[90] Deere also argued that so called traditional planters offer an effective substitute to high speed precision planters.[91]

Deere also argued that it could rebut a presumption of illegality if one was found to exist.[92] First, Deere committed to licensing Precision Planting's technologies to a competitor so long as their acquisition of Precision Planting was approved.[93] Such a move, according to Deere, would substantially lessen the barriers to create a high speed precision planter because the intellectual property rights for them were available for purchase.[94] In fact, Deere argued that this arrangement would actually increase competition and choice for American farmers.[95] Deere also argued that the potential for market entry or expansion in this evolving area would prevent any anticompetitive effects.[96]

D. Analysis of Arguments

1. Did the Government Show a Presumption of Illegality?

For the government to show a presumption of illegality, it must define the relevant product market and the relevant geographic market.[97] The government was essentially correct when it determined the whole United States to be the relevant geographic market because the vast majority of states produce soybeans and corn that is planted by planters.[98] However, the issue remains of whether it accurately defined the product market. In determining the relevant product market, courts pay particular attention to (1) evidence of cross-elasticity of demand and (2) reasonably interchangeable products.[99] Although submarkets may exist within a larger market, relevant markets must

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[90] *See id.*
[91] *See id.* at 28.
[92] *Id.* at 34.
[93] *Id.*
[94] *Id.*
[95] *Id.* at 1.
[96] *Id.*
[97] F.T.C. v. Advocate Health Care Network, 841 F.3d 460, 467 (7th Cir. 2016); *see also* Brown Shoe Co. v. United States., 82 S.Ct. 1502, 1530 (1962).
[98] *See* Compl. at 12, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016); Rob Cook, *States That Produce The Most Corn*, BEEF2LIVE (2014), http://beef2live.com/story-states-produce-corn-0-107129 (last visited Feb. 26, 2017); Rob Cook, *Soybeans: Ranking Of Production By State (2012 vs. 2013)*, BEEF2LIVE (2014), http://beef2live.com/story-soybeans-ranking-production-state-2012-vs-2013-0-110116 (last visited Feb. 26, 2017).
[99] PSKS, Inc. v. Leegin Creative Leather Products, Inc., 615 F.3d 412, 412 (5th Cir. 2010).

be drawn "with sufficient breadth" to include the competing products of other companies and recognize competition where it exists.[100]

a. Cross-Elasticity

Cross elasticity of demand measures the responsiveness in the quantity demanded of one good when a change in price takes place in another good.[101] If a decrease in the price of traditional planters causes a considerable number of farmers to purchase traditional planters rather than high speed precision planters, it would be an indication that a high degree of cross elasticity of demand exists between them and that they compete in the same market.[102] Conversely, if a large increase in the price of high speed precision planters does not increase demand for traditional planters, then a low degree of cross elasticity exists between them and they are unlikely to compete in the same market.[103]

As applied to planters, there should be some elasticity between high speed precision planters and traditional planters based on price. This is because, if the price of high speed precision planters increases unreasonably, it is inferable that there will be an increase in the demand for traditional planters because they perform the same function.[104] Additionally, with the current surplus of used farm equipment, it is inferable that there will be an increase in the demand for used planters if the price of new high speed precision planters increases.[105] Further, although planters are a basic necessity for farming, high speed precision planters should be viewed more as a luxury product due to their recent arrival on the market; leading to the conclusion that demand would be elastic.[106] However, because this is a new and developing product line, the necessary information to confirm this analysis is unavailable. Nevertheless, due to the practicality and thriftiness of the American farmer as a self-interested rational economic actor, it is assumable

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[100] Brown Shoe, 370 U.S. at 326.
[101] *See* Matt McMurrer, *Exclusive Gadget: Apple & AT&T Antitrust Litigation and the IPhone Aftermarkets*, 36 J. CORP. L. 495, 498 (2011); *Cross Elasticity of Demand*, INVESTOPEDIA (2017), http://www.investopedia.com/terms/c/cross-elasticity-demand.asp (last visited Feb. 23, 2017).
[102] United States v. Du Pont, 351 U.S. 377, 400 (1956); *see also* Gregory J. Werden, *Demand Elasticities in Antitrust Analysis*, 66 ANTITRUST L.J. 363, 398-401 (1998).
[103] *See id.*
[104] *See generally id.*
[105] *See* Bob Tita, *Deere Profit Tumbles Amid Glut of Used Farm Equipment at Dealers*, WALL ST. J. (Aug. 21, 2015, 2:05 PM), https://www.wsj.com/articles/deere-reports-decline-in-profit-as-sales-tumble-1440158935.
[106] *Cross Elasticity of Demand*, *supra* note 101.

that traditional planters and high speed precision planters are substitute products and that there would be a medium to large amount of cross elasticity between them.[107] However, more research would be needed by agricultural economists as data becomes available to confirm this hypothesis.

b. Traditional Planters and High Speed Precision Planters are Reasonably Interchangeable Products

The crux of this case is deciding the relevant market. The government views precision planters as a unique submarket within the market for all planters.[108] John Deere refutes this and believes that there is no submarket for precision planters and that the government failed to allege any relevant product market for the purposes of this litigation.[109] Rather, they believe there is only one large market that includes both so-called traditional planters and high-speed planters.[110] If the government can prove that precision planters indeed are a submarket, the government can easily meet the presumption of illegality because Deere and Precision Planting constitute 86% of precision planter sales.[111] Conversely, if the government fails to prove that a submarket exists, then a presumption of illegality will not be found because many other companies sell planters generally.[112]

A properly defined relevant market must take into account products which compete with the producer's product and must include reasonably interchangeable substitute products that limit the producer's ability to sustain an increase in price above competitive levels.[113] Interchangeability refers to the use or function of the given product compared to other products.[114] Reasonable interchangeability only requires that the product is roughly equivalent to another product.[115]

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[107] *See* Bob Tita, *supra* note 105.
[108] Compl. at 10-11, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[109] Resp. at 33-34, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[110] *See id.* at 20.
[111] Compl. at 13, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).*See generally* Robert G. Harris and Thomas M. Jorde, *Market Definition in the Merger Guidelines: Implications for Antirust Enforcement*, 71 CALIF. L. REV. 464, 464 (1983).
[112] *See id.*
[113] Lucas Automotive Eng'r, Inc. v. Bridgestone/Firestone, Inc., 275 F.3d 762, 767 (9th Cir. 2001); *see also* JOHN BOURDEAU, 54 AM. JUR. 2D MONOPOLIES AND RESTRAINTS OF TRADE § 164 (2016) .
[114] In re AMR Corp., 527 B.R. 874, 884 (Bankr. S.D. N.Y. 2015); *see also* BOURDEAU, *supra* note 113.
[115] Navarra v. Marlborough Gallery, Inc., 820 F. Supp. 2d 477, 485-86 (S.D. N.Y. 2011); *see also* BOURDEAU, *supra* note 113.

However, within a broad market, a well-defined submarket may exist which may constitute a product market for antitrust purposes.[116] If there is a reasonable probability that a merger would substantially lessen competition in a submarket, Section 7 of the Clayton Act prohibits the merger.[117] The boundaries of such submarket can be determined by examining practical indications such as industry or public recognition of the submarket, the product's peculiar characteristics or uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.[118] However, mere price or grade distinctions are not a proper basis for distinguishing between submarkets.[119]

The government argues that traditional planters are not a reasonably interchangeable substitute to high speed precision planters because they are much slower.[120] To reach the same efficiency, the government argues, would require a traditional planter that is twice as large as a high speed precision planter or purchasing two traditional planters.[121] However, traditional planters perform the exact same function as high speed planters. They only differ slightly in their mechanics, although there is, as a result, a considerable difference in speed and efficiency.[122] Nonetheless, the court should still find that traditional and high speed planters are reasonably interchangeable because they still perform the same function in a reasonable manner. As such, the court should find that the market for planters is large enough to includes traditional planters and high speed planters. If the court so rules, the government would fail to meet their presumption of illegality because Deere and Precision Planting would not constitute an especially large market share.[123]

However, it is still possible that a court could determine that high speed planters are a submarket within the larger planter market for the purposes of product market definition. On the one hand, precision planters wouldn't seem to be a unique submarket because they do not have distinct customers or specialized vendors. Rather, John Deere plans to sell these planters to regular farmers, presumably, through their normal distribution chain.

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[116] Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962).
[117] *Id.*
[118] *Id.*
[119] Haagen-Dazs Comp, Inc. v. Double Rainbow Gourmet Ice Creams, Inc., 691 F.Supp. 1262, 1268 (N.D. Cali 1988); Ron Tonkin Grand Turismo v. Fiat, 637 F.2d 1376, 1379-80 (9th Cir. 1981).
[120] Compl. at 11-12, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[121] *Id.*
[122] *See id.*
[123] *See id.* at 13.

Nonetheless, precision planters do have peculiar characteristics in how they are designed. Moreover, the agriculture industry recognizes precision planters as a unique subtype of planter.[124] Thus, it is possible, although not probable, that a court could determine that high speed precision planters are a submarket within the larger planter market. If the court so determined, the government would meet their presumption of illegality because Deere and Precision Planting constitute 86% of the high speed precision planters sold.[125] Nonetheless, it is still more likely that the court will rule that the government did not meet its burden.

2. *If the Government meets their burden, John Deere will likely rebut the presumption of illegality*

Assuming, for the moment, that the government met its presumption of illegality, John Deere could still rebut this presumption. This can be accomplished by showing that barriers to enter the market are low, that both of the merging parties are weak market participants, or that the remaining competition by third parties should remain intense.[126] Deere and Precision Planting are not weak participants, so the analysis will focus on barriers to entry and the level of remaining competition if this deal were approved.

a. Are Barriers to Entry Low?

The government alleged that entry into the high speed precision planting market would be very high because John Deere and Precision Planting own most of the intellectual property rights to produce high speed planters as they are currently known.[127] Thus, according to the government, a merger between these two competitors would effectively cut off the ability for other companies to develop high speed planters.[128]

Nonetheless, in response to the government's complaint, Deere offered to license Precision Planting's technology to Ag Leader if the government allowed Deere to acquire Precision Planting.[129] This would allow Ag Leader

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[124] *See, e.g.,* Mike Wiles, *How Fast Can We Plant*, FARM EQUIPMENT (Apr. 10, 2015), https://www.farm-equipment.com/articles/11547-how-fast-can-we-plant.
[125] Compl. at 13, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[126] F.T.C. v. Univ. Health, Inc. 938 F.2d 1206, 1218 (11th Cir. 1991); *See generally* United States. v. Citizens & S. Nat'l Bank, 422 U.S. 86 (1975); *see also* HOLMES, *supra* note 62.
[127] Compl. at 11, 13, 16, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).
[128] *See id.*
[129] *See* Jessie Scott, After Acquisition, Deere and AG Leader Will Sell Precision Planting Products, SUCCESSFUL FARMING (Oct. 12, 2016),

to develop its own series of high speed precision planters, and sell aftermarket Precision Planting equipment that can retrofit a traditional planter into a high speed planter to other competitors.[130] These retrofit packages would allow other competitors, such as Case IH or AGCO, to develop high speed planters.[131]

Although this agreement needs to be studied in detail, this agreement to license Precision Planting technology Deere's competitors should ameliorate most of the government's concerns about high barriers of entry into the high speed precision planting market. Additionally, the court should recognize that high speed planters are a relatively new development and that two companies independently invented ways to create them.[132] As such, innovation from a competitor could be just around the corner and it could be too early to tell how high the barriers truly are into the high speed precision planting market.[133] Thus, Deere should be able to show that barriers to enter into the market are not unreasonably high.

b. Competition Will Remain Competitive

Second, assuming the court finds that high speed precision planters are a submarket, Deere can still show that competition will remain competitive within this submarket. First, they have already agreed to license their technology to their competitors.[134] This will prevent Deere from unreasonably increasing its prices, provided that there are no price-fixing components in the licenses.[135]

Additionally, other manufactures are already entering the so-called high speed precision planting market. Case International Harvester has recently unveiled a new, high-speed planter that can reach up to 10 miles per hour.[136] AGCO has just announced that they are introducing a high-speed planter

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http://www.agriculture.com/news/machinery/after-acquisition-deere-and-ag-leader-will-sell-precision-planting-products.

[130] *Id.*

[131] *See id.*

[132] Brannon, *supra* note 42.

[133] *See id.* at 7. Note that this is still assuming that a court found that high speed precision planters constituted a market for antitrust purposes.

[134] *See* Scott, *supra* note 129.

[135] *See generally id.*

[136] *See* Dave Mowitz, *Case IH Unveils New High-Speed Planter*, SUCCESSFUL FARMING (Nov. 23, 2015), http://www.agriculture.com/machinery/farm-implements/planters/case-ih-unveils-new-highspeed-plter_231-ar51246.

that can plant at speeds above 9 miles per hour.[137] Finally, Vaderstad, which has intentions to become a larger player in the United States, has recently developed a high-speed planter than can plant at approximately 10 miles per hour.[138] This does not even include Kinze and Horsch which are already participants in the so-called high speed precision planting market.[139] Therefore, between licensing its intellectual property and the entrance of new competitors, Deere will be able to show that competition in the high speed precision planting market will remain intense. As such, between this high level of competition and the relatively low barriers to entry, Deere should be able to rebut any presumption of illegality.

3. *If Deere Rebuts the Presumption of Illegality, the Government Won't Be Able to Meet Their New Burden*

If Deere rebuts the presumption of illegality, the government can still introduce other evidence sufficient to show a reasonable probability that the transaction would substantially lessen competition.[140] However, if Deere is able to show that competition will increase within the high speed precision planter market and that barriers to entry are reasonable, then it is very unlikely that the government could come back and show that the merger would substantially lessen competition. To that point, the government did not even address this contingency.[141]

IV. CONCLUSION

Overall, Deere has a stronger case and will likely prevail if the matter is decided in court. The government may fail to prove a presumption of illegality because it may have difficulty establishing that high speed precision planters are a submarket. Additionally, even if the government could prove a presumption of illegality, Deere would likely rebut this presumption by their agreement to license their intellectual property to competitors and by

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[137] Ben Potter, *AGCO Introduces New High-Speed Planters* FARM JOURNAL'S AG PRO (Feb. 9, 2017, 6:29 AM), http://www.agprofessional.com/news/new-high-speed-planter-comes-marketplace.

[138] Scott Gavey, *Two New Tempo planters*, GRAINEWS (April 15, 2016), http://www.grainews.ca/2016/04/15/vaderstad-adds-new-models-to-its-high-speed-planter-line/.

[139] *See* Compl. at 13, United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).

[140] F.T.C. v. Univ. Health, Inc. 938 F.2d 1206, 1218 (11th Cir. 1991); *See generally* United States v. Citizens & S. Nat'l Bank, 422 U.S. 86 (1975); *see also* HOLMES, *supra* note 62.

[141] *See* Compl., United States v. Deere & Co., No. 1:16-cv-08515 (N.D. Ill. 2016).

showing that competition in the so called high speed precision planting submarket is already intensifying.

V. RECOMMENDATION

Although the acquisition of Precession Planting by John Deere is probably legal, more aggressive action is still required by the Federal Trade Commission and the U.S. Attorney's Office to prevent further concentration in the agricultural manufacturing sector. Failure to prevent further concentration will likely result in stagnated technological innovation, lower profitability for American farmers, and higher food prices for consumers.

Moreover, although this merger will likely be found to be legal, the actions of the government should still be viewed as a success. Without threatening to block this proposed merger, it is much less likely that Deere would have offered to license Precision Planting's products to their competitors. Thus, even the threat of meritorious litigation can be enough to increase competition or at least stifle potentially anticompetitive effects. As such, the Federal Trade Commission and the U.S. Attorney's Office should continue their strong enforcement of antitrust laws when there is a reasonable probability of antitrust violations.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

TIMING BREXIT RIGHT: THERESA MAY'S GREAT POLITICAL CHALLENGE

❖ NOTE ❖

*Julian D. Jankowski**

Abstract

The Prime Minister of the United Kingdom, Theresa May, in her expressed pursuit for a hard Brexit, faces economic, legal, and political challenges in her endeavors to gain a hard Brexit deal. Each of these challenges individually presents much difficulty, but together, these challenges appear daunting. Nonetheless, these are challenges that can ultimately be overcome, and this Note proposes a way to overcome these challenges, and deliver a final deal to Queen Elizabeth II for royal assent.

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I. INTRODUCTION

Recently, the Prime Minister of the United Kingdom, Theresa May, delivered a speech at Lancaster House in London outlining her broad

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objectives she sought in Britain's departure from the European Union (E.U.), or "Brexit".[1] Her description of the nature of Britain's departure was of particular importance:

> [W]e seek a new and equal partnership – between an independent, self-governing, Global Britain and our friends and allies in the EU. Not partial membership of the European Union, associate membership of the European Union, or anything that leaves us half-in, half-out. We do not seek to hold on to bits of membership as we leave. No, the United Kingdom is leaving the European Union. And my job is to get the right deal for Britain as we do.[2]

This would mean a departure not only from the European Union and its mechanisms of power, but the single market as well: a complete severance of political ties to the E.U..[3]

The Supreme Court of the United Kingdom recently dismissed an appeal made by the Secretary of State for Exiting the European Union.[4] This

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[1] Theresa May, U.K. Prime Minister, The government's negotiating objectives for exiting the EU: PM speech at Lancaster House, London (Jan. 17, 2017), *in* PRIME MINISTER'S OFF. (U.K.), Jan. 17, 2017, https://www.gov.uk/government/speeches/the-governments-negotiating-objectives-for-exiting-the-eu-pm-speech; *see also* Peter Wilding, *Stumbling towards the Brexit: Britain, a Referendum and an Ever-Closer Reckoning*, BLOGACTIV.EU (May 15, 2012), https://blogactiv.eu/blog/2012/05/15/stumbling-towards-the-brexit/, for an early description of a British departure from the E.U., with the moniker, "Brexit". Though this author does not endorse the political conclusions of a Brexit, the article, nonetheless, does give a useful summation of a departure of the U.K. from the E.U. in the familiar, singularly-worded term ("Brexit") commonly known today.

[2] *Id.*

[3] Gavin Barrett, *How Article 127 of the EEA Agreement Could Keep the UK in the Single Market*, LONDON SCH. ECON. EUR. POL. AND POL'Y BLOG (U.K.) (Jan. 4, 2017), http://blogs.lse.ac.uk/europpblog/2017/01/04/how-article-127-eea-agreement-could-keep-the-uk-in-the-single-market/; Stephen Castle & Stephen Erlanger, *British Premier Outlines Path To a Clean Break With the E.U.*, N.Y. TIMES, Jan. 18, 2017, at A9.

[4] R (Miller) v. Secretary of State for Exiting the European Union [2017] UKSC 5 [7], [152] (appeal taken from EWHC (Admin)) (UK), https://www.supremecourt.uk/cases/docs/uksc-2016-0196-judgment.pdf. The court also ruled on whether the parliamentary bodies' assent from Scotland, Wales, and Northern Ireland was required. *See also*, *Id.* at [150], (noting that the devolved governments of Scotland, Wales, and Northern Ireland do not have the power to use their legislatures to block Article 50's invocation). A contrary result regarding the powers of the devolved parliaments would have further complicated Britain's exit from the European Union – perhaps mortally – considering the Scottish National Party's staunch opposition to Brexit, and its control of Scottish Parliament. *See generally*, Peter Geoghegan,

ensures that parliamentary approval is required to invoke the mechanisms for departure from the E.U. outlined in Article 50 of the Treaty of Lisbon (Lisbon Treaty).[5] The pursuit of a hard Brexit, however, requires a departure from the European Economic Area (E.E.A.) as well.[6] The threat of a lawsuit by British Influence, a pro-E.U. think tank, over whether an exit from the E.E.A. under Article 127 of the Agreement on the European Economic Area (E.E.A. Agreement) will also require parliamentary assent adds another issue.[7] It also threatens to bifurcate Brexit into separate departures from both the E.U. bodies and the E.E.A..[8]

For Prime Minister May to attain the Brexit that she seeks, she will need to strike a middle ground in terms of when she completes the Brexit negotiations. Precise timing at every stage will enable the Prime Minister to use best her political power to push the final deal into the arms of Queen Elizabeth II for royal assent.[9] Over-prolonging these negotiations jeopardizes the prospects of any deal and disables any domestic political leverage against opponents in the process. Both extrema loom large in light of the fact that the E.U. did not intend to use Article 50 provisions, particularly in light of political intransience from E.U. bureaucrats.[10] A plot within the House of Lords to modify a final deal that erects a hard Brexit makes timing concerns more urgent.[11]

Scottish Nationalist Fury at 'Arrogant' May Government, POLITICO EUR. (Oct. 5, 2016, 5:23 AM), http://www.politico.eu/article/scottish-nationalist-fury-at-arrogant-may-government-snp-brexit-conservatives-european-union/.

[5] R (Miller), [2017] UKSC 5 at [152].

[6] Barrett, *supra* note 3.

[7] James Tapsfield, *Is Brexit EVER Going to Happen? Theresa May Faces Fresh Legal Battle over Whether MPs Must Approve Leaving Single Market As well As EU*, DAILY MAIL ONLINE (U.K.) (Nov. 29, 2016), http://www.dailymail.co.uk/news/article-3977774/Is-Brexit-going-happen-Theresa-faces-fresh-legal-battle-MPs-approve-leaving-single-market-EU.html.

[8] *Id.*

[9] Royal assent is the British equivalent of the President of the United States signing a bill into law. However, unlike the practice of the American counterpart, royal assent is, in practice, a formality in the modern day. *See generally* Lucinda Maer & Oonagh Gay, *The Royal Prerogative*, HOUSE OF COMMONS LIBR. 4-5 (Dec. 30, 2009), www.parliament.uk/briefing-papers/SN03861.pdf, for further details.

[10] Crispian Balmer, *Father of EU Divorce Clause Demands Tough Stance on British Exit*, REUTERS (July 21, 2016, 3:19 PM), http://www.reuters.com/article/us-britain-eu-amato-idUSKCN1012Q8; Katrine Bussey, *Article 50 diplomat predicts 'one in three' chance of no Brexit deal*, INDEP. (U.K.) (Jan. 19, 2017), http://www.independent.co.uk/news/uk/politics/brexit-article-50-diplomat-lord-kerr-no-deal-a7534611.html.

[11] *See generally* Duncan Geddes, *Mandelson Urges Peers to Alter Exit Deal*, SUNDAY TIMES (U.K.) (Feb. 19, 2017), http://www.thetimes.co.uk/edition/news/lords-must-fight-

Part II of this Note provides background and analysis into issues surrounding Brexit. Specifically, it delves into problems caused by the relevant treaty provisions, economic issues, and political realities. Part III concludes by noting that although Prime Minister May has a struggle ahead, a favorable Brexit deal is possible.

II. BACKGROUND & ANALYSIS

Section A of this part outlines the legal and timing complications brought by Article 50 of the Lisbon Treaty, and Article 127 of the E.E.A. Agreement. That section also provides a way to harmonize the two provisions. Section B illustrates the economic and time constraint conditions that the U.K. will need to address in the course of making a deal to exit the E.U. and proposes a way to leverage this into a good deal. Section C accounts for what would and could occur in the course of making a deal and offers a path through Parliament, particularly the House of Lords.

A. Article 50 & Article 127

Under the terms of Article 50 of the Lisbon Treaty, the member state's withdrawal must be in accordance with its constitutional requirements.[12] Because of the ruling from the Supreme Court, this would require parliamentary approval.[13] The treaty also notes the overall negotiation process between parties, and requires that the European Parliament and a qualified majority of the Union of the Council approve the deal.[14] A qualified majority here requires 72% of remaining voting members from at least 65% of the population.[15] There are also strict time limits that accompany the negotiation process:

back-on-brexit-says-mandelson-07tvw29r6?CMP=Sprkr-_-3-_-thesundaytimes-_-News-_-Unspecified-_-Statement-_-Unspecified-_-TWITTER&linkId=34657333.

[12] The Treaty of Lisbon amending the Treaty Establishing the European Union and the Treaty Establishing the European Community, including the Protocols and Annexes, and Final Acts with Declarations, Dec. 13 2007, Bel.-Bulg.-Czech-Den.-Ger.-Est.-Ir.-Greece-Spain-Fr.-It.-Cyprus-Lat.-Lith.-Lux.-Hung.-Malta-Neth.-Austria-Pol.-Port.-Rom.-Slov.-Slovk.-Fin.-Swed.-U.K., art. 49A, GR. BRIT. T.S. No. 7 (2010) (Cm. 7901) [hereinafter Treaty of Lisbon]. Note that Article 49A in this treaty is commonly termed Article 50. *See* Tapsfield, *supra* note 7.

[13] R (Miller), [2017] UKSC 5 at [152].

[14] Treaty of Lisbon, *supra* note 12.

[15] Alan Renwick, *What Happens if We Vote for Brexit?*, THE CONST. UNIT BLOG (U.K.) (Jan. 19, 2016), https://constitution-unit.com/2016/01/19/what-happens-if-we-vote-for-brexit/.

> [European Union Membership] shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification… unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.[16]

Article 50 allows a unanimous vote by the European Council to extend the time limitation but this is unlikely because of an unwillingness by E.U. leaders to concede more than apparently necessary.[17] The treaty provides the two-year constraint, through which serious trade and legal considerations in the negotiations are bound.[18]

Theresa May's political goal – to sever all political ties with the European Union and its affiliates – requires an exit from the E.E.A..[19] The terms of withdrawal from the E.E.A. under Article 127 the Agreement on the European Economic Area, in contrast to the Article 50 provisions, are more relaxed:

> Each Contracting Party may withdraw from this Agreement provided it gives at least twelve months' notice in writing to the other Contracting Parties. Immediately after the notification of the intended withdrawal, the other Contracting Parties shall convene a diplomatic conference in order to envisage the necessary modifications to bring to the Agreement.[20]

Because these E.E.A. Agreement terms can be harmonized to the Treaty of Lisbon's withdrawal timetable, it would be helpful to trigger both withdrawal provisions simultaneously.[21] But even when the two withdrawal processes are triggered in tandem, the pressures imposed by Article 50 time limitations give

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[16] Treaty of Lisbon, *supra* note 12.
[17] Bussey, *supra* note 10; *What is Article 50 of the Lisbon Treaty - and Is It Irrevocable?*, WK. (U.K.) (Nov. 3, 2016), http://www.theweek.co.uk/brexit/72965/what-is-article-50-of-the-lisbon-treaty-and-is-it-irrevocable.
[18] Treaty of Lisbon, *supra* note 12; Bussey, *supra* note 10.
[19] May, *supra* note 1.
[20] Agreement on the European Economic Area with Final Act and Declarations, May 2 1992, E.E.C.-E.C.S.C.-Belg.-Den.-Ger.-Greece-Spain-Fr.-Ir.-It.-Lux.-Neth.-Port.-U.K.-Austria-Fin.-Ice.-Liech.-Nor.-Swed.-Switz., art. 127, GR. BRIT. T.S. No. 26 (1995) (Cm. 2847) [hereinafter E.E.A. Agreement].
[21] Treaty of Lisbon, *supra* note 12; E.E.A. Agreement, *supra* note 20.

the E.U. a procedural advantage.[22] Fortunately, the United Kingdom can use its economic position as a fulcrum to gain favorable terms in a deal.[23] But this requires an acute awareness of the time constraints imposed by the withdrawal provisions of the Lisbon Treaty and the E.E.A. Agreement.[24]

B. Dealing with the European Union

Economic problems from excessive inflation are noted to arise from physical money leaving a nation through trade deficits.[25] The U.K. had a total trade deficit of £13.2 billion as of November 2016, and has had an overall trade deficit every month since June 2015.[26] £8.7 billion of this trade deficit came from the E.U..[27] Within the E.U. in that same time, the U.K.'s trade deficit was £2.85 billion with Germany, £1.33 billion with the Netherlands, and £443 million with France.[28] Economic numbers suggest that a reduction of exports from 2013 on and a growing trade deficit with the E.U. are key contributors.[29] Further, Britain's shrinking market with the E.U., and a growing market outside the E.U. make the trade deficit with the E.U. a more pressing concern.[30] Thus, the overall health of the British economy within the E.U. leaves little to be envied.

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[22] Renwick, *supra* note 15.
[23] *Id.*
[24] Treaty of Lisbon, *supra* note 12; E.E.A. Agreement, *supra* note 20.
[25] *See* Kurt Williamsen, *So I'm Told Trade Deficits Are Good*, NEW AM. (Mar. 15, 2015), https://www.thenewamerican.com/economy/economics/item/20341-so-i-m-told-trade-deficits-are-good (arguing in brief that there is a link to trade deficits and inflation, and that there is an influence by trade deficits, upon inflation, though not the only factor, and not without the possibility of inflation inducing trade deficits); *but c.f.* Capital Flows, *Two Cheers For A Big U.S. Trade Deficit*, FORBES (Sep. 18, 2011, 6:33 PM), http://www.forbes.com/sites/realspin/2011/09/18/two-cheers-for-a-big-u-s-trade-deficit/#613917131aab (arguing that trade deficits are beneficial to the economy because of cheaper goods, which leads, according to this line of thought, to more jobs, and a healthier, more robust economy).
[26] H.M. REVENUE & CUSTOMS (U.K.), UK OVERSEAS TRADE STAT. NOV. 2016 1 (2017) [hereinafter U.K. Trade Statistics], https://www.uktradeinfo.com/Statistics/OTS%20Releases/OTS_Release_1116.pdf.
[27] *Id.* at 3.
[28] *Id.* at 4, 8.
[29] *Id.* at 2–3.
[30] James Burton, *EU Exports Are a Mere 12% of British Economy: Trade Figures Show Focus on Europe Has Steadily Dropped in Past Five Years*, DAILY MAIL (U.K.) (July 29, 2016, 8:57 P.M.), http://www.dailymail.co.uk/news/article-3715547/EU-exports-mere-12-British-economy-Trade-figures-focus-Europe-steadily-dropped-past-five-years.html.

Brexit presents itself as an antidote to these chronic economic woes. The U.K. imported £42.5 billion worth of goods for the month of November.[31] Of these, £5.2 billion were spent on mechanical appliances, and £4.81 billion on motor vehicles.[32] These are goods that play a key role in Germany's prosperous economy.[33] The U.K.'s vote to leave the E.U. has caused a decline in German exports, and capital investment, as well as a downgrade in Germany's economic prospects.[34]

Britain's economic opportunity in Brexit poses as an economic specter for the German Chancellor, Angela Merkel. Merkel's economic success provides her with substantial political gravitas.[35] Merkel's successes at home produced her power abroad, and particularly in the E.U..[36] However, Merkel's poor handling of the migrant crisis in Europe has caused a weakening of her political clout at home.[37] It has also caused a loss of influence among E.U. nations on the migrant crisis issue.[38] Merkel has a direct interest in handling Britain's exit from the E.U. in a way that minimizes the negative impact on Germany, if only to cling to power.[39] This will require that Merkel reach a bilateral agreement with the U.K. that preserves the corpus of German trade

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[31] U.K. Trade Statistics, *supra* note 26, at 10.
[32] *Id.*
[33] Nina Adam, *Brexit Vote Brings Germany-U.K. Trade Relationship Into Question*, WALL ST. J. (June 28, 2016, 1:38 P.M.), http://www.wsj.com/articles/brexit-vote-brings-germany-u-k-trade-relationship-into-question-1467134712; George Packer, *The Quiet German*, NEW YORKER (Dec. 1, 2014), http://www.newyorker.com/magazine/2014/12/01/quiet-german.
[34] *See generally* Adam, *supra* note 33; *German exports fall in July after global demand weakens*, B.B.C. NEWS (U.K.) (Sept. 9, 2016), http://www.bbc.com/news/business-37316827; Guy Chazan, *UK's Brexit Vote to Dampen German Economic Growth – Think Tank*, FIN. TIMES (U.K.) (Sept. 8, 2016), https://www.ft.com/content/56f0afca-100d-32f1-b816-7b885fec767a.
[35] Packer, *supra* note 33.
[36] *See generally id.*; Alison Smale & Steven Erlanger, *Election of Trump Leaves Merkel as the Liberal West's Last Defender*, N.Y. TIMES, Nov. 13, 2016, at A8; Adrian Bridge, *A Conversation with Angela Merkel: Remembering Her Rise to Power*, TELEGRAPH (U.K.) (Sept. 20, 2013, 11:40 AM), http://www.telegraph.co.uk/news/worldnews/europe/germany/10322798/A-conversation-with-Angela-Merkel-remembering-her-rise-to-power.html; Faisal Islam, *Baton of Global Leadership Passes from US to Germany*, SKY NEWS (U.K.) (Nov. 18, 2016, 8:06 AM), http://news.sky.com/story/has-baton-of-global-leadership-passed-from-us-to-germany-10661050.
[37] Staff, *Is the Merkel Era Coming to an End?*, SPIEGEL ONLINE (Ger.) (Sept. 9, 2016, 6:10 PM), http://www.spiegel.de/international/germany/refugee-policy-sees-waning-of-power-for-merkel-a-1111668.html.
[38] *Id.*
[39] *Id.*

with the U.K., and use her significant European influence to reach a multinational agreement.[40] Prime Minister May can this path to leverage the best possible deal with the E.U..

C. Gaining Parliamentary Assent

In order for Britain to leave the E.U., Parliament must approve the exit deal reached by Theresa May. The House of Commons is unlikely to pose any threat to parliamentary assent, since that would be contrary to what the British public as a whole want.[41] But the 203 Labour members of the House of Lords (also called peers) and 102 Liberal Democrat peers imply innate resistance, considering that 403 peers is a majority.[42] All a unified Labour-Liberal Democrat coalition would need is 98 votes.[43] This combined with a plot to organize resistance to a hard Brexit deal makes resistance more likely in the upper chamber.[44] This is why Theresa May's timing as to when she concludes exit negotiations will become important; it will determine how effective her range of powers will be.

The relevant statutes only permit the House of Lords to delay non-monetary bills passed by the House of Commons for no more than one year.[45] Beyond this point, such a bill bypasses the House of Lords, and is given to the monarch for royal assent consideration.[46] If the Prime Minister strikes a deal with the E.U., and its affiliated parties, no more than one year after Article 50 is invoked, then the House of Lords is no issue. The

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[40] U.K. Trade Statistics, *supra* note 26, at 10; Adam, *supra* note 33; Packer, *supra* note 33.
[41] Katrin Bennhold, *'Brexit' Ruling Exposes Cracks in an Old System*, N.Y. TIMES, Jan. 25, 2017, at A4, A6.
[42] *Lords by Party, Type of Peerage and Gender*, U.K. PARLIAMENT, http://www.parliament.uk/mps-lords-and-offices/lords/composition-of-the-lords/ (last visited Feb. 24, 2017) (noting that 203 members of the House of Lords are Labour, 102, Liberal Democrat, compared with 253 Conservative, 178 Crossbencher, and 29 Non-affiliated, 26 Bishops, and 14 Other, which makes 805 members, and 403 needed for a majority); Rob Merrick, *Brexit: Lib Dems to Fight on for EU Single Market Membership after Labour Accused of Dropping the Issue*, INDEP. (U.K.) (Jan. 25, 2017), http://www.independent.co.uk/news/uk/politics/brexit-latest-news-eu-single-market-membership-liberal-democrats-tim-farron-labour-tariff-free-a7544791.html.
[43] *Id.*
[44] *Id.*; Geddes, *supra* note 11.
[45] Parliament Act, 1911, 1 & 2 Geo. 5 c. 13, § 2 (U.K.), http://www.legislation.gov.uk/ukpga/1911/13/pdfs/ukpga_19110013_en.pdf; Parliament Act, 1949, 12, 13 & 14 Geo. 6 c. 103, § 1 (U.K.), http://www.legislation.gov.uk/ukpga/1949/103/pdfs/ukpga_19490103_en.pdf.
[46] *Id.*

Commons could just pass the deal each time the upper house rejects it, and the on the third time the Commons passes the deal, it would go straight to Her Majesty, Elizabeth II.[47] This would make the House of Lords practically irrelevant in Brexit.

But if a deal were struck after that one-year duration, the House of Lords would have the ability to delay the bill to beyond the two-year provision set out in Article 50.[48] This would effectively allow the House of Lords to stop any deal from reaching the Queen. If this is Theresa May's reality, the Prime Minister will need to use her political and governmental leverage over the House of Lords, to facilitate the deal's passage. This is best used if she leaves ample time for proper leverage usage. If the deal is struck too close to the two-year mark, Theresa May's ability to gather the necessary votes in the upper chamber will become very difficult if not impossible.

Politically, it is entirely possible in theory for Theresa May to push a deal through with only Conservative, and Crossbencher peers to form a majority in the upper chamber.[49] But if Prime Minister May is unable to cobble together enough Crossbencher support, Theresa May must gain Labour support; the Liberal Democrats will likely oppose a deal.[50]

Labour Party weakness nationally provides a path for Theresa May to pressure Labour peers into supporting a final deal.[51] The organization of the Labour Party in the House of Commons plunged itself into disarray in the months immediately following the referendum, from which it has not recovered.[52] This has caused the Labour Party to loose support in the

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[47] *Id.*

[48] *Id.*; Treaty of Lisbon, *supra* note 12.

[49] *Lords by Party, Type of Peerage and Gender*, *supra* note 42 (combining all the Conservatives and Crossbenchers would bring the support of the deal without anyone else to 431, which is beyond the 403 votes needed, assuming all of the peer members are present).

[50] *Id.*; Merrick, *supra* note 42.

[51] Laura Hughes & Kate McCann, *Jeremy Corbyn Backs Down on Vow to Force Labour MPs to Vote in Favour of Brexit*, TELEGRAPH (U.K.) (Jan. 19, 2017, 10:22 PM), http://www.telegraph.co.uk/news/2017/01/19/labourmps-will-forced-vote-favour-triggering-article-50-says/.

[52] *See* Hughes & McCann, *supra* note 51 (Jeremy Corbyn changed his public stance on whether he would require the Members of Parliament to vote for the Article 50 invocation, and Labour Party members close to the situation said that they did not know what the party positon on the Brexit vote was, implying that the Labour Party had not fully recovered from the leadership chaos a few months ago); Heather Stewart & Rowena Mason, *Labour Leadership: Jeremy Corbyn Wins Convincing Victory over Owen Smith*, GUARDIAN (U.K.) (Sept. 24, 2016, 1:14 PM), https://www.theguardian.com/politics/2016/sep/24/labour-leadership-jeremy-corbyn-wins-landslide-victory-party (Jeremy Corbyn continues his leadership of the Labour Party with his

national polls.[53] From this, Theresa May can argue effectively that the Labour Party has no mandate to block the policy.[54] But Theresa May must

win against Owen Smith, and with a greater percentage of the voting body of the Labour Party than his first victory in 2015); Andrew Grice, *Labour Leadership Election: Angela Eagle Pulls out of Contest to Allow Owen Smith Straight Run at Jeremy Corbyn*, INDEP. (U.K.) (July 19, 2016), http://www.independent.co.uk/news/uk/politics/angela-eagle-pulls-out-labour-leadership-election-owen-smith-jeremy-corbyn-a7145021.html (Angela Eagle, the former Shadow Business Secretary withdrew from the leadership race, and endorsed Owen Smith, after he received more support from Members of Parliament and Members of European Parliament than Eagle); *Labour Leadership: Owen Smith to Enter Contest*, B.B.C. NEWS (U.K.) (July 13, 2016), http://www.bbc.com/news/uk-politics-36780715 (Owen Smith, the former Shadow Work & Pensions Secretary entered the leadership race against Corbyn, and another previous entrant, Angela Eagle); *Labour MPs Pass No-Confidence Motion in Jeremy Corbyn*, B.B.C. NEWS (U.K.) (June 28, 2016), http://www.bbc.com/news/uk-politics-36647458 (vote of no confidence against Corbyn passes 172-40, in which Corbyn said was against the Labour Party constitution, repeated his call for an opponent to challenge him, and announced that he was working to replace the shadow cabinet ministers that resigned); Gordon Rayner, *Labour Meltdown (Continued): 47 Resignations, but Jeremy Corbyn Fights on*, TELEGRAPH (U.K.) (June 27, 2016, 9:34 PM), http://www.telegraph.co.uk/news/2016/06/27/labour-meltdown-continued-44-resignations-but-jeremy-corbyn-figh/ (nearly four dozen members of the Shadow Cabinet resigned, and the Labour Members of Parliament called a vote of no confidence against Corbyn's leadership, but Corbyn refused to resign despite this, and challenged opponents of his leadership to stand against him in the next leadership election); Daniel Boffey et al., *Labour in Crisis: Shadow Ministers Resign in Protests against Corbyn*, GUARDIAN: OBSERVER (U.K.) (June 26, 2016, 6:14 AM), https://www.theguardian.com/politics/2016/jun/26/hilary-benn-revolt-jeremy-corbyn (Jeremy Corbyn, the Labour Party Leader sacked his Shadow Foreign Secretary, Hilary Benn after Benn made a coup attempt against Corbyn, which triggered a mass resignation of Labour Shadow Cabinet Members).

[53] *See Voter Intention Tracker (GB) From 2015 General Election-Present*, YOUGOV (U.K.), https://yougov.co.uk/publicopinion/archive/?page=1&category=political-trackers (follow "YouGov Tracker Voting Intention 2015 to Present" hyperlink under the 'Label' column) (last visited Feb. 24, 2017) [hereinafter *Voter Intention Tracker*] (showing that Labour had a three-point lead over the Conservatives on Apr. 28-29, 2016 – YouGov's last poll before the referendum – which turned to an eleven-point Conservative lead over Labour after the referendum on July 17-18, 2016, and that the Conservative's lead over Labour is seventeen points in the most recent General Election Preference poll conducted, on Jan. 17-18, 2017); Damian Gayle et al., *Labour Struggling to Build Voter Support, Poll Shows*, GUARDIAN (U.K.) (Jan. 14, 2017, 11:35 AM), https://www.theguardian.com/politics/2017/jan/14/labour-struggling-build-voter-support-poll-theresa-may-jeremy-corbyn?utm_source=dlvr.it&utm_medium=twitter (noting that an Optimum/Observer poll put Labour at an eight-point deficit against the Conservatives in a General Election, and put Corbyn's net approval rating at negative twenty-seven percent); Matt Singh, *ICM/Guardian (and something interesting within it…)*, NUMBER CRUNCHER POL. (U.K.) (Jan. 23, 2017), https://www.ncpolitics.uk/2017/01/icmguardian-poll-something-interesting-within.html/ (showing that an I.C.M./Guardian poll conducted from Jan. 20-22, 2017 showed the

also argue that she has a sufficient electoral mandate to advance the deal.[55] Though Labour members of the House of Lords would be insulated from an electoral backlash, electoral pressures based on party loyalty give a motive to allow a deal.[56] This is a tool Theresa May can use to advance a deal in the House of Lords.

Theresa May's other option – her governmental leverage – is to appoint members to the House of Lords that would favor an exit from the E.U. before the vote on the final deal.[57] In modern practice, it is the Prime Minister that appoints the members; the monarch accedes to the Prime Minister's appointment wishes.[58] Naturally the Prime Minister would have to appoint enough new lords to push the final deal through the House of Lords.[59] Brexit's uniqueness and a looming, organized, gathering opposition within the upper house provides a justification to Theresa May to counter

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Conservative lead over Labour in a hypothetical General Election was sixteen points, and that the share of persons preferring Labour dropped six points since Apr. 2016).

[54] *Id.*

[55] Sam Coates, *Most Voters Back PM's Plan…but Doubt It Will Work*, TIMES (London) (Jan. 19, 2017, 12:01 A.M.), http://www.thetimes.co.uk/article/most-voters-back-pm-s-plan-but-doubt-it-will-work-vfwnzccn9 (A YouGov/Times poll in the week leading up to Jan. 19, 2017 showed a majority of fifty-five percent liked the ideas Theresa May put forth in her speech on Jan. 17, 2017, a forty-seven percent plurality that had confidence in the Prime Minister's negotiating ability, compared with thirty-eight percent that did not, and forty-eight percent believed that no deal was better than a bad deal, compared with seventeen percent who believed the contrary (the fact that a majority believed that the E.U. would not agree to her terms is irrelevant – this paper addresses precisely how Theresa May could get an E.U. deal)); Gayle et al., *supra* note 53 (An Optimum/Observer poll conducted from Jan. 10-12, 2017, showed that a forty-one percent plurality preferred closing the U.K.'s borders with other E.U. nations over continuing in the single market, compared with thirty-two percent who preferred staying in the single market to closing the U.K.'s borders to E.U. nations); *Voter Intention Tracker*, *supra* note 53 (According to various YouGov polls, Conservative voter share increased from thirty percent on Apr. 25-26, 2016 to forty-two percent on Jan. 17-18, 2017, compared to Labour's voter share dropping from thirty-three percent to twenty-five percent over that same respective period).

[56] *How Members Are Appointed*, U.K. PARLIAMENT, http://www.parliament.uk/business/lords/whos-in-the-house-of-lords/members-and-their-roles/how-members-are-appointed/#jump-link-1 (last visited Feb. 24, 2017).

[57] *Id.*

[58] *Id.*; *see also Cameron Announces 26 New Tory Peers in Dissolution Honours*, B.B.C. NEWS (U.K.) (Aug. 27, 2015), http://www.bbc.com/news/uk-politics-34072201.

[59] *See Lords by Party, Type of Peerage and Gender*, *supra* note 42 (given that 203 members of the House of Lords are Labour, 178 are Crossbencher, and 102 are Liberal Democrat, if these members form a block that opposes a final deal with the E.U., it is foreseeable that Theresa May would appoint as many as three-hundred new peers to clear such a hypothetical blockade posed by Labour, Liberal Democrat and Crossbench members).

any opposition to such an appointment.[60] And it is certainly within Theresa May's powers to create such new peers.[61] Prime Minister May could also use the threat of appointing more lords as an extra political weapon to ensure final passage of a deal with the E.U. among the existing peers in the House of Lords. However, both the threat of, and actual appointment of more lords will require ample time for vetting. Therefore, these critical time constraints require that enough time between the final deal with the E.U. and the two-year provision in Article 50 is provided.[62]

III. CONCLUSION

Thus, in order for Theresa May to obtain the exit deal she seeks, she will need to time each stage of the Brexit process precisely. She must not allow negotiations with the E.U. and its affiliates to prolong so far that no deal is made, or that a deal is made so close to the Article 50 timing provisions that no deal can go through Parliament.[63] Theresa May also must take care that Parliament – and the House of Lords particularly – does not obstruct the deal to the point where it is effectively killed before being ratified, provided the need presents itself. Thus, although Prime Minister May must tread difficult terrain to reach her goal of a hard Brexit, she has the ability to do just this, and should use these means at her disposal to make such a deal a reality.

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[60] Geddes, *supra* note 11; *see also Cameron Announces 26 New Tory Peers in Dissolution Honours*, *supra* note 58, (David Cameron, the former Prime Minister of the U.K., faced political criticism in his appointment of only twenty-six new members of the House of Lords).
[61] *How Members Are Appointed*, *supra* note 56; *Cameron Announces 26 New Tory Peers in Dissolution Honours*, *supra* note 58.
[62] Treaty of Lisbon, *supra* note 12.
[63] *Id.*

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

DISCLOSURE DILEMMA: IS DISCLOSURE TO THE GOVERNMENT ENOUGH TO INVOKE THE FALSE CLAIMS ACT'S PUBLIC DISCLOSURE BAR?

❖ NOTE ❖

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Abstract

The federal government has a significant financial interest in the $3 trillion dollar health care industry. Due to limited administrative resources, the government's biggest allies in the fight against health care fraud are individual whistleblowers who are able to file lawsuits under the False Claims Act's qui tam provisions and share in the recovery. The Act contains a public disclosure bar to prevent parasitic suits by opportunistic whistleblowers. This Note analyzes two contrasting decisions from the Sixth and Seventh Circuits interpreting who qualifies as the "public." In both cases, the court was asked to determine whether a health care provider's self-disclosure of misconduct to the federal government was sufficiently public to bar future suits. Ultimately, this Note argues that the Seventh Circuit's interpretation is more persuasive and closer to striking the proper balance between incentivizing whistleblowers and inhibiting opportunism.

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I. INTRODUCTION

The economic impact of the health care industry is immense. In 2014, the United States spent $3 trillion on health care.[1] What makes the industry even more distinctive, however, is that the states and federal government pay for a considerable portion of consumer costs.[2] Naturally, the federal government's direct financial interest in the $3 trillion industry has led to substantial legislation, regulation, and monitoring of the health care industry and the actors in it.[3] One major source of economic loss is health care fraud.[4] The Department of Justice ("DOJ") estimates that costs to the United States due to health care fraud may total $100 billion a year.[5]

Despite the DOJ's concern that "health care fraud schemes continue to grow in complexity and seriousness," the government's efforts have been fruitful.[6] For the 2014 fiscal year, the DOJ obtained a record $5.69 billion in settlements and judgments from civil cases involving fraud and false claims against the government.[7] Of that amount, $2.3 billion involved false claims against federal health care programs, including Medicare and Medicaid.[8] Since the founding of the interagency Health Care Fraud Prevention and Enforcement Action Team,[9] the government has recovered $14.5 billion in

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[1] *See Health Expenditures*, CTRS. FOR DISEASE CONTROL (Oct. 7, 2016), http://www.cdc.gov/nchs/fastats/health-expenditures.htm.
[2] *See* Carolyn V. Metnick, *The Jurisdictional Bar Provision: Who Is an Appropriate Relator?*, 17 ANNALS HEALTH L. 101, 101 (2008) (describing the health care industry and the U.S. Department of Health and Human Services' increasing operating budget).
[3] *See* False Claims Act, 31 U.S.C. §§ 3729-3733 (2000).
[4] *See* Metnick, *supra* note 2.
[5] *Health Care Fraud Unit*, U.S. DEP'T OF JUST. (Feb. 3, 2017), http://www.justice.gov/criminal-fraud/health-care-fraud-unit.
[6] *Id.*
[7] *See Justice Department Recovers Nearly $6 Billion from False Claims Act Cases in Fiscal Year 2014*, Press Release, Office of Pub. Affairs, U.S. DEP'T OF JUST. (Nov. 20, 2014), http://www.justice.gov/opa/pr/justice-department-recovers-nearly-6-billion-false-claims-act-cases-fiscal-year-2014 ("The pharmaceutical industry accounted for a substantial part of the $2.3 billion in health care fraud recoveries for the 2014 fiscal year. Global health care giant Johnson & Johnson . . . paid $1.1 billion to resolve False Claims Act claims.").
[8] *Id.*
[9] In 2009, Attorney General Eric Holder and Health and Human Services Secretary Kathleen Sebelius announced the creation of the interagency task force. *See supra* note 7.

federal health care dollars through the False Claims Act.[10] Due to limited administrative resources, the government's biggest allies in the fight against health care fraud are individual whistleblowers who are able to file suits under the False Claims Act's *qui tam* provisions.[11]

One of the most stringent restrictions on *qui tam* whistleblowers is the public disclosure bar[12] enacted as part of the 1986 amendments.[13] Congress amended the public disclosure bar in 2010 but left open the issue of how to treat self-disclosure of misconduct to the federal government.[14] Along with Congress, the Supreme Court has not taken up this latter question. Recently, the Sixth Circuit tackled this issue and sided with the view held by a dominant majority of circuit courts.[15] Although the Seventh Circuit currently stands on an island,[16] this Note argues that its interpretation is more persuasive and closer to striking the proper balance between incentivizing whistleblowers and inhibiting opportunism.

This Note proceeds in four Parts: Part I provides a background of the False Claims Act and the recent Sixth Circuit decision; Part II analyzes the reasoning of the Sixth Circuit, compares it with the interpretation adopted by the Seventh Circuit, and observes some implications of the 2010 amendments to the public disclosure bar; Part III recommends that the Seventh Circuit's minority view should be adopted as the better approach; Part IV concludes and observes how the decisions will impact health care providers and other businesses.

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[10] *Id.*

[11] "Recoveries in *qui tam* cases during fiscal year 2014 totaled nearly $3 billion, with whistleblowers receiving $435 million." *See supra* note 7 (observing that most false claims actions are filed by whistleblowers, with *qui tam* filings exceeding 700 for 2014).

[12] The public disclosure bar before 2010 provided:

> No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.

31 U.S.C. § 3730(e)(4)(A) (2000).

[13] *Id.*; *see* Chris S. Stewart, *Resourceful Relators: The Rise of Qui Tam Suits Under the False Claims Act Based on Information Obtained in Civil Litigation*, 89 TEX. L. REV. 169, 175 (2011) (observing that the public disclosure bar has posed the greatest deterrent to relators in FCA suits).

[14] *See infra* note 37.

[15] *See infra* Part II.A.

[16] *See infra* Part III.

II. BACKGROUND

A. The False Claims Act

The False Claims Act ("FCA") originally dates back to 1863, enacted during the Civil War to combat fraud and extortion in war procurement contracts.[17] In its modern version, the FCA creates liability for "any person who knowingly submits a false money claim to the government; uses a false statement to induce the government to pay a false claim; conspires to defraud the government into paying a false claim, or uses a false statement to reduce an obligation to pay money to the government."[18] Violators face the possibility of criminal liability and harsh monetary penalties—with fines ranging from $5,500 to $11,000 per false claim, along with treble the amount of any damages that the government proves it actually sustained.[19]

Even in its original form, the FCA contained *qui tam* provisions, allowing private citizens, eventually dubbed "relators" or "whistleblowers," to bring suit on behalf of the federal government and share in the monetary recovery.[20] The *qui tam* provisions were designed to create an incentive for whistleblowers to assist government enforcement of the FCA.[21] Congress occasionally amends these provisions to achieve "the golden mean between adequate incentives for whistle-blowing insiders with genuinely valuable information and discouragement of opportunistic [parasitic] plaintiffs who

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[17] *See* United States *ex rel.* Springfield Terminal Ry. Co. v. Quinn, 14 F.3d 645, 649 (D.C. Cir. 1994) (recounting the legislative history of the False Claims Act to its 1986 version).
[18] Violations of the Federal Anti-Kickback Statute, 42 U.S.C. § 1320a-7b(g) (2012), and Stark Law, 42 U.S.C. § 1395nn, often form the basis of FCA suits. United States *ex rel.* Drakeford v. Tuomey, 792 F.3d 364 (4th Cir. 2015) (upholding a judgment of more than $237 million against a health care provider for entering into improper compensation arrangements with physicians in violations of the Stark Law—resulting in submission of over 21,000 false claims to Medicare); *see* United States *ex rel.* Hutcheson v. Blackstone Med., Inc., 647 F.3d 377 (1st Cir. 2011) (reversing dismissal of a relator's FCA suit which premised a health care provider's liability on its false certification of compliance with the federal Anti-Kickback statute). *See* David Freeman Engstrom, *Private Enforcement's Pathways: Lessons from Qui Tam Litigation*, 114 COLUM. L. REV. 1913, 1943 (2014).
[19] *The False Claims Act: A Primer*, U.S. DEP'T OF JUST. (Apr. 22, 2011), http://www.justice.gov/civil/docs_forms/C-FRAUDS_FCA_Primer.pdf (explaining that civil penalty amounts are adjusted from time to time and currently stand at $5,500 to $11,000).
[20] *Id.*
[21] *Id.*; *see also* Kamal Al-Salihi, *Keeping It Simple: Finding Falsity Under the False Claims Act*, 36 WHITTIER L. REV. 431 (2015) ("The government's ever increasing reliance on private contractors, in conjunction with the general expansion of the administrative state, exposes numerous contracting relationships to potential False Claims Act (FCA) liability.").

have no significant information to contribute of their own."[22] The 1986 amendments incorporated several new rights and benefits, but also significant restrictions, for relators.[23] New benefits for relators included a higher ceiling reward of up to thirty percent of the recovery, or up to twenty percent if the government takes over the suit.[24] New restrictions require relators to provide a complaint and all material evidence to the government prior to filing suit—[25]the government then has sixty days to review and investigate the case to decide whether it would wish to intervene.[26] Furthermore, those who are not the first person to file a suit based on the facts of the underlying pending action are barred from proceeding.[27]

Congress also included a public disclosure bar as part of the 1986 amendments.[28] However, Congress placed an exception to the bar if the relator satisfies the statutory criteria as an "original source" of the information.[29] This latter exception served to remedy a frequent deterrent to relators—dismissal of suits brought on the basis of knowledge already known to the government.[30] Yet, as one court observed, the public disclosure bar's language has led to extensive litigation and confusion as to "which cases

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[22] United States *ex rel.* Springfield Terminal Ry. Co. v. Quinn, 14 F.3d 645, 649 (D.C. Cir. 1994); *see* Engstrom, *supra* note 18, at 1951 (collecting data and rejecting the widespread notion that "qui tam litigation is in the midst of an inefficient 'explosion' of enforcement effort.").

[23] *See* J. Morgan Phelps, *The False Claims Act's Public Disclosure Bar: Defining the Line Between Parasitic and Beneficial*, 49 CATH. U. L. REV. 247, 256 (1999).

[24] *Id.* In fiscal year 2014, *qui tam* relators received $435 million in rewards for filing false claims actions. *See supra* note 7.

[25] *See* Phelps, *supra* note 23 (outlining requirements relators must meet in order to bring a suit).

[26] 31 U.S.C. § 3730(b)(4) (2000). As a practical matter, the government often receives an extension to investigate and decide whether to intervene or pursue the action through an administrative vehicle. *See* Stewart, *supra* note 13, at 171.

[27] 31 U.S.C. § 3730(b)(5) (2012).

[28] *See supra* note 13.

[29] The pre-2010 Act defines an original source as: "an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this section which is based on the information." 31 U.S.C. § 3730(e)(4) (2000).

[30] *See* Stewart, *supra* note 14, at 184 (discussing the defects of the 1943 amendments and criticizing a Seventh Circuit decision in which a *qui tam* plaintiff was denied relief after reporting a fraud to the government, as required by the 1943 amendments, because "its own disclosure put enough information in the federal government's hands to trigger the jurisdictional bar").

Congress intended to bar."[31] Partly in response to this judicial confusion, in 2010 Congress amended the public disclosure bar as part of its bill on health care reform.[32] Courts and commentators have noted that the 2010 Amendments[33] "made significant headway in further increasing the availability of qui tam relief."[34] Expanding incentives for relators to assist the government in detecting and reporting health care fraud was seemingly a natural result of the national recession "that ballooned the ranks of the uninsured" and amidst "reports of rampant health care frauds that were robbing millions of dollars from federal health programs."[35] Although the

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[31] *See* United States *ex rel.* Findley v. FPC-Boron Employees' Club, 105 F.3d 675, 681 (D.C. Cir. 1997) ("Predictably, these jurisdictional provisions too have led to extensive litigation and to circuit splits concerning the meaning of the words 'based upon,' 'public disclosure,' 'allegations or transactions,' 'original source,' 'direct and independent knowledge' and 'information.' ").

[32] *See* the Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

[33] The public disclosure bar currently reads:

> (4)(A) The court shall dismiss an action or claim under this section, unless opposed by the Government, if substantially the same allegations or transactions as alleged in the action or claim were publicly disclosed--
> (i) in a Federal criminal, civil, or administrative hearing in which the Government or its agent is a party;
> (ii) in a congressional, Government Accountability Office, or other Federal report, hearing, audit, or investigation; or
> (iii) from the news media,
> unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.

31 U.S.C. § 3730 (2010).

[34] *See* United States *ex rel.* May v. Purdue Pharma L.P., 737 F.3d 908, 917 (4th Cir. 2013) *cert. denied*, 135 S. Ct. 2376 (2015) ("The 2010 amendments thus substantially narrowed the class of disclosures that can trigger the public-disclosure bar."); Beverly Cohen, *Kaboom! The Explosion of Qui Tam False Claims Under the Health Reform Law*, 116 PENN ST. L. REV. 77, 77–78 (2011) (observing that the amendments have "enormously broadened the ability of relators to commence quit tam lawsuits" by increasing the sources of public information relators may utilize and eliminating the stringent "direct knowledge" requirement to qualify as an "original source."); Stewart, *supra* note 14, at 178 ("[T]he 2010 FCA amendments made significant headway in further increasing the availability of *qui tam* relief, especially for suits based on information obtained in civil litigation.").

[35] Cohen, *supra* note 32, at 77.

2010 Amendments clarified the law on a variety of circuit splits,[36] they raised new issues of interpretation and left important questions unresolved.[37]

Despite the *qui tam* provisions, cooperation and voluntary disclosure of misconduct by health care providers is crucial in assisting the government and sparing its resources. The Office of the Inspector General of the Department of Health and Human Services has implemented a Provider Self-Disclosure Protocol—incentivizing voluntary disclosures by lowering damages multiples, favoring against permissive exclusion from federal healthcare programs, and granting a presumption against mandatory Corporate Integrity Agreements.[38] On the criminal side, "the DOJ has increasingly entered into deferred prosecution agreements and nonprosecution agreements with corporate defendants" in exchange for provider implementation of compliance and rehabilitation programs.[39] Strict self-disclosure requirements[40] and a high likelihood that some payment will have to be made to the government has driven most health care providers to opt against voluntary disclosure.[41] Even more, providers can face substantial FCA liability despite voluntary disclosure and monetary reimbursement.[42]

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[36] *See, e.g.*, Leveski v. ITT Educ. Servs., Inc., 719 F.3d 818, 829 n.1 (7th Cir. 2013) ("The current version of 31 U.S.C. § 3730(e)(4), which went into effect on March 23, 2010, expressly incorporates the 'substantially similar' standard previously used by our circuit and most other circuits under the prior version of the statute.").

[37] Courts have gone through rigorous statutory interpretation and split on the issue of whether the new version of the FCA's public disclosure bar continues to be jurisdictional or presents grounds for dismissal for failure to state a claim. *Compare* United States *ex rel.* Osheroff v. Humana Inc., 776 F.3d 805, 810 (11th Cir. 2015) ("We conclude that the amended § 3730(e)(4) creates grounds for dismissal for failure to state a claim rather than for lack of jurisdiction."); United States *ex rel.* May v. Purdue Pharma L.P., 737 F.3d 908, 916 (4th Cir. 2013) ("In our view, these changes make it clear that the public-disclosure bar is no longer a jurisdiction-removing provision."); *with* United States *ex rel.* Beauchamp v. Academi Training Ctr., Inc., 933 F. Supp. 2d 825, 839 (E.D. Va. 2013) ("The relators argue that the FCA's public disclosure bar has been rendered non-jurisdictional by the 2010 amendment because Congress has not made clear that the public disclosure bar is jurisdictional. This argument fails.").

[38] *See* David Farber, *Agency Costs and the False Claims Act,* 83 FORDHAM L. REV. 219, 232 (2014).

[39] *Id.* at 236.

[40] *See* 31 U.S.C. § 3729(a)(2) (2012) (allowing the court to reduce damages only if a disclosure is made within 30 days of discovering the misconduct).

[41] *See* Faber, *supra* note 36, at 244 ("[T]he best advice for the least visible offenders must continue to be 'when in doubt—wait it out.' ").

[42] *See* United States v. Chattanooga-Hamilton Cty. Hosp. Auth., 782 F.3d 260, 263 (6th Cir.) *cert. denied sub nom.* Chattanooga-Hamilton Cty. Hosp. Auth. v. United States *ex rel.* Whipple, 136 S. Ct. 218 (2015).

B. The Sixth Circuit Decision

The U.S. Court of Appeals for the Sixth Circuit decided *United States v. Chattanooga-Hamilton Cty. Hosp. Auth.* ("*Whipple*") in February 2015.[43] The relator in that case, Robert Whipple, alleged that defendant Chattanooga–Hamilton Hospital Authority[44] ("Erlanger") violated the False Claims Act[45] by knowingly submitting four categories of false or fraudulent claims for reimbursement to federally funded healthcare programs.[46] During a six-month period in early 2006, Whipple worked at Erlanger as a Revenue Cycle Consultant on assignment from ACS Healthcare Solutions,[47] and ultimately as Erlanger's Interim Director of Care Management.[48] Whipple testified that during his brief tenure at Erlanger, he identified the alleged fraud by analyzing past billing data, reviewing patient records, and observing operations in each of the revenue cycle departments.[49] Furthermore, Whipple claimed direct knowledge of the fraudulent practices through his supervision of patient admissions, planning discharges, and reviewing the submission of claims for payment.[50] In October 2010, Whipple disclosed his *qui tam* claims to the United States.[51] His complaint was filed under seal in March 2011 and the government declined to intervene.[52]

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[43] *See generally id.*
[44] D/b/a Erlanger Medical Center and Erlanger Health System. *Id.* at 262.
[45] Whipple also alleged that Erlanger violated Tennessee, North Carolina, and Georgia statutes—these claims were dismissed by the district court under each state's parallel public disclosure bar and not raised on appeal. *Id.* at 262 n.1.
[46] The healthcare programs at issue included Medicare, Medicaid, and Tricare/Champus. *Id.* at 262.
[47] ACS was retained by Erlanger consequent to an unrelated investigation in late 2005, which resulted in Erlanger agreeing to pay $40 million to the Department of Health and Human Services and abide by a Corporate Integrity Agreement ("CIA"). *Id.* at 268 n.2. CIAs, although costly to healthcare providers by imposing additional compliance reforms and continuous monitoring of compliance efforts, are a common prerequisite to settlement of FCA claims with the government and often entered into by providers due to threat of exclusion from the Medicare and Medicaid programs. *See* Sharon Finegan, *The False Claims Act and Corporate Criminal Liability: Qui Tam Actions, Corporate Integrity Agreements and the Overlap of Criminal and Civil Law*, 111 PENN ST. L. REV. 625, 651 (2007).
[48] United States v. Chattanooga-Hamilton Cty. Hosp. Auth. (*Whipple*), 782 F.3d 260, 263 (6th Cir. 2015).
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*

Whipple did not know, however, that an anonymous tip to the government in April 2006 resulted in an extensive administrative audit and investigation into Erlanger's billing practices.[53] The United States Department of Health and Human Services ("HHS"), Office of Inspector General ("OIG"), referred the complaint for review by AdvanceMed Corporation on behalf of the government.[54] Consequently, AdvanceMed identified ninety problematic inpatient claims from the period of July 2005 through May 2006, and in November 2006 requested additional records and information from Erlanger.[55] AdvanceMed's audit identified evidence of upcoding[56] along with four sources of error and possible overpayments—these findings were ultimately communicated directly to the OIG's Office of Investigations through a fraud case referral in July 2007.[57] In February 2008, OIG opened an administrative investigation into whether the behavior identified by AdvanceMed violated criminal law.[58] Thereafter, an OIG's Office of Counsel to the Inspector General ("OCIG") special agent notified Erlanger that it was under OIG review.[59]

Erlanger retained Deloitte Financial Advisory Services, LLP, to perform a broader internal investigation and audit of one-day hospital stays from October 2005 through December 2007.[60] Deloitte's audit found that Erlanger had improperly billed for inpatient and outpatient services.[61] On May 29, 2008, Erlanger presented the results of the audit to the OIG special agent, along with explanations and estimates of the amount of overpayments.[62] In June 2008, after OIG's consultation with the United

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[53] *Id.*

[54] AdvanceMed is the "Medicare Part A Program Safeguard Contractor for Tennessee hired to perform 'benefit integrity activities aimed to reduce fraud, waste, and abuse in the Medicare program.' " *Id.* at 266.

[55] *Id.*

[56] The term "upcoding" refers to a frequent form of Medicare fraud where a provider bills for "medical services or equipment designated under a code that is more expensive than what a patient actually needed or was provided." *See* United States *ex rel.* Bledsoe v. Cmty. Health Sys., Inc., 501 F.3d 493, 497 n.2 (6th Cir. 2007).

[57] United States v. Chattanooga-Hamilton Cty. Hosp. Auth. (*Whipple*), 782 F.3d 260, 267 (6th Cir. 2015). Additionally, AdvanceMed observed that Erlanger could be in violation of the 2005 CIA. *Id.*

[58] *Id.*

[59] *Id.*

[60] *Id.*

[61] *Id.* Erlanger had improperly billed for inpatient services "without a physician order, without a basis for a change in status, or without documentation to support the level of care and for observation services after outpatient same-day surgeries." *Id.*

[62] *Id.*

State Attorney's Office for the Eastern District of Tennessee, both the Civil and Criminal Divisions declined to prosecute Erlanger.[63] OCIG closed its portion of the investigation in February 2009.[64] OIG then referred the investigation to AdvanceMed, ultimately resulting in Erlanger's voluntary refund check of $477,140.42 to the government, after which the investigation was administratively closed.[65]

Erlanger moved to dismiss the complaint on several grounds, including for lack of subject matter jurisdiction under Federal Rule of Civil Procedure 12(b)(1).[66] The U.S. District Court for the Middle District of Tennessee denied the motion without prejudice, but after limited discovery granted Erlanger's motion for partial summary judgment, treating it as a factual attack to subject matter jurisdiction, and dismissed the three categories of FCA claims at issue as jurisdictionally barred.[67]

Whipple appealed, and the Sixth Circuit reversed and remanded the case.[68] The court applied the pre-2010 public disclosure bar,[69] considering: (1) "whether there has been any public disclosure of fraud [through one of the specified channels]" and (2) "whether the allegations in the instant case are 'based upon' the previously disclosed fraud."[70] In elaborating on the second prong, the court stated that a public disclosure is sufficient to reveal fraud if it puts "the government on notice of the likelihood of related fraudulent activity."[71] The court reasoned that although the government's audit and investigation disclosed facts from which fraud could be inferred thus satisfying the second prong, whether there was a public disclosure was a

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[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.* As previously noted, the 1986 version of the public disclosure bar is clearly jurisdictional. *See* Rockwell Int'l Corp. v. United States, 549 U.S. 457, 467–70 (2007).
[67] The district found that Whipple did not satisfy the public disclosure exception as an original source under the pre or post-2010 version of the statute, reasoning that the alleged misconduct occurred before Whipple worked at Erlanger and was discovered through secondhand sources. *See* Whipple v. Chattanooga-Hamilton Cty. Hosp. Auth., No. 3-11-0206, 2013 WL 4510801, at *8 (M.D. Tenn. Aug. 26, 2013).
[68] *Whipple*, 782 F.3d at 270.
[69] The public-disclosure bar was amended on March 23, 2010—after Whipple's alleged misconduct but before he filed his complaint. *Id.* at 264 n.3 (citing the Patient Protection and Affordable Care Act (PPACA), Publ. L. 111–148, § 10104(j)(2), 124 Stat. 119, 901–02 (2010)). Whipple did not properly raise the issue of whether the post-2010 amendments applied to his claims, thus waiving it on appeal. *Id.*
[70] *Id.* at 265–66 (citing United States *ex rel.* Poteet v. Medtronic, Inc., 552 F.3d 503, 511 (6th Cir. 2009)).
[71] *Id.* at 266 (citing *Poteet*, 552 F.3d at 512).

separate inquiry.[72] The Sixth Circuit tackled the "public disclosure" inquiry guided by the Supreme Court's cautioning "against interpreting the public disclosure bar in a way inconsistent with a plain reading of its text."[73]

Erlanger urged the Sixth Circuit to adopt the Seventh Circuit's interpretation of the term "public disclosure" in *U.S. ex rel. Mathews v. Bank of Farmington*,[74] to include "the disclosure of an alleged false claim to a competent public official who has managerial responsibility for that very claim."[75] The court explained that "based on one definition of 'public,'" the Seventh Circuit held "a disclosure to the public official responsible for the claim effectuates the purpose of disclosure to the public at large."[76] However, the court observed that all of the other circuits[77] to address the Seventh Circuit's interpretation did not adopt its reasoning, instead requiring "some affirmative act of disclosure to the public outside the government."[78] Specifically, the court characterized the First Circuits' case of *United States ex rel. Rost v. Pfizer, Inc.*,[79] as "the leading case involving disclosure of fraud to the government."[80] In *Rost*, the First Circuit rejected the Seventh Circuit's interpretation and held that "[t]he mere fact that the disclosures are contained in government files someplace, or even that the government is conducting an investigation behind the scenes, does not itself constitute public disclosure."[81]

Not surprisingly, the Sixth Circuit declined to follow *Bank of Farmington*'s interpretation.[82] Citing *Rost*, the court reasoned that if a disclosure to the government in an audit or investigation was by itself sufficient to trigger the public-disclosure bar, "the term 'public' would be superfluous."[83] In addition, equating "government" with "public" would be inconsistent with the other uses of the term "government" in the False

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[72] *Id.*
[73] *Id.* (citing Schindler Elevator Corp. v. United States *ex rel.* Kirk, 563 U.S. 401, 409 (2011)).
[74] 166 F.3d 853 (7th Cir. 1999), *overruled on other grounds*, Glaser v. Wound Care Consultants, Inc., 570 F.3d 907 (7th Cir. 2009).
[75] *Whipple*, 782 F.3d at 267 (citing United States *ex rel.* Mathews v. Bank of Farmington, 166 F.3d 853, 861 (7th Cir. 1999)).
[76] *Id.* at 267–68.
[77] The court cited cases from the First, Fourth, Ninth, Tenth, and D.C. Circuits. *Id.* at 268.
[78] *Id.*
[79] 507 F.3d 720, 728–30 (1st Cir. 2007).
[80] *Whipple*, 782 F.3d at 268.
[81] *Id.*
[82] *Id.*
[83] *Id.*

Claims Act.[84] In a footnote, the court suggested that its holding was also consistent with Sixth Circuit precedent in the context of Freedom of Information Act documents—requiring both a request and receipt of documents from the government before holding that information has been publicly disclosed.[85] Therefore the court held that Erlanger's disclosure of information through the administrative audit and investigation was not enough to trigger the public disclosure bar.[86]

The Sixth Circuit also rejected Erlanger's alternative argument—that disclosures to either AdvanceMed or Deloitte constituted prior public disclosures outside the government to parties who were "strangers to the fraud."[87] The court observed that the employees deemed "strangers to the fraud" in *Doe* "were under no obligation to keep the information confidential when they learned of the fraud."[88] As to AdvanceMed, the court reasoned that it was at all times acting on behalf of the government and under an obligation to keep any disclosures confidential.[89] Similarly, Deloitte was under some obligation to keep the internal investigation confidential and did not release any information into the public domain.[90]

By ultimately holding that Whipple's allegations were not publicly disclosed, the court did not have to reach the issue of whether Whipple satisfied the original source exception to the public-disclosure bar.[91] The

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[84] *Id.*

[85] *Id.* at 268 n.8; *see* United States v. A.D. Roe Co., 186 F.3d 717, 723 (6th Cir. 1999) ("It would be extreme to hold that all information for which someone might *potentially* make a FOIA request is 'publicly disclosed.'") (emphasis added).

[86] *Whipple*, 782 F.3d at 269.

[87] *Id.* (finding innocent employees were "strangers to the fraud" (citing United States *ex rel.* Doe v. John Doe Corp., 960 F.2d 318, 323 (2d Cir. 1992))). During execution of a search warrant in *Doe*, a government investigator informed the defendant's employees of fraudulent allegations against the company. *See* United States *ex rel.* Doe v. John Doe Corp., 960 F.2d 318, 323 (2d Cir. 1992).

[88] *Whipple*, 782 F.3d at 269. Other circuits have declined to adopt the *Doe* court's treatment of company employees as members of the public for purposes of the public disclosure bar—sharply criticizing its reasoning and implications. *See* United States *ex rel.* Schumer v. Hughes Aircraft Co., 63 F.3d 1512, 1518 (9th Cir. 1995) *vacated*, 520 U.S. 939 (1997) (vacated on other grounds) ("We decline to adopt the rule of *Doe* for application in this circuit. At one level, the *Doe* court's treatment of company employees as members of the public is unrealistic.").

[89] *Whipple*, 782 F.3d at 269.

[90] *Id.* at 270.

[91] "If both [public disclosure] requirements are satisfied, the relator's suit may nonetheless proceed if he qualifies as an "original source.' " *Id.* at 264.

Sixth Circuit denied a rehearing en banc,[92] and the Supreme Court subsequently denied Erlanger's petition for writ of certiorari.[93]

III. ANALYSIS

A. All Against One

The Sixth Circuit's endorsement of a narrow interpretation of "public disclosure" in *Whipple* aligns it with a dominant majority view held by five other circuit courts.[94] Currently the Seventh Circuit remains as the only circuit court to hold that "disclosure of information to a competent public official [with managerial responsibility for the very claims being made] about an alleged false claim against the government . . . [is a] public disclosure."[95] District courts within the remaining circuits—the Second, Third, Fifth, Eighth and Eleventh—are split on the Seventh Circuit's interpretation.[96] Although the Seventh Circuit has not yet wavered from *Bank of Farmington*, it may capitalize on the opportunity to do so given the weight of authority disagreeing with its interpretation.[97] Quite possibly, the Supreme Court denied review for this reason.

In *Whipple*, the Sixth Circuit's analysis seemed to stay true to the Supreme Court's guidance of interpreting the public disclosure bar consistent with its plain meaning.[98] The court also appeared to follow its Freedom of

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[92] *See generally id.*

[93] Chattanooga-Hamilton Cty. Hosp. Auth. v. United States ex rel. Whipple, 136 S. Ct. 218 (2015).

[94] United States *ex rel.* Wilson v. Graham Cnty. Soil & Water Conservation Dist., 777 F.3d 691 (4th Cir. Feb. 3, 2015); United States *ex rel.* Oliver v. Philip Morris USA Inc., 763 F.3d 36 (D.C. Cir. 2014); United States *ex rel.* Meyer v. Horizon Health Corp., 565 F.3d 1195 (9th Cir. 2009); United States *ex rel.* Maxwell v. Kerr-McGee Oil & Gas Corp., 540 F.3d 1180 (10th Cir. 2008); *see* United States *ex rel.* Rost v. Pfizer, Inc., 507 F.3d 720 (1st Cir. 2007).

[95] *See* United States v. Bank of Farmington, 166 F.3d 853, 861 (7th Cir. 1999).

[96] *See, e.g.*, United States *ex rel.* Whitten v. Cmty. Health Sys., Inc., 575 F. Supp. 2d 1367, 1381 (S.D. Ga. 2008) (rejecting the Seventh Circuit's interpretation); United States *ex rel.* Cosens v. Yale-New Haven Hosp., 233 F. Supp. 2d 319, 327 (D. Conn. 2002) (applying the Seventh Circuit's holding).

[97] *See* Cause of Action v. Chicago Transit Auth., 815 F.3d 267, 277 (7th Cir.), *cert. denied sub nom.* United States, *ex rel.* Cause of Action v. Chicago Transit Auth., 137 S. Ct. 205, (2016) ("There is significant force in the position of the other circuits . . . . However, we need not address squarely the correctness of Bank of Farmington today . . . .").

[98] United States v. Chattanooga-Hamilton Cty. Hosp. Auth., 782 F.3d 260, 266 (6th Cir. 2015).

Information Act precedent, requiring actual rather potential public disclosures to trigger the bar.[99] Primarily relying on the First Circuit's decision in *Rost*—the court reasoned that the plain meaning of the public disclosure bar required disclosure outside the government.[100] In *Rost*, the First Circuit sided with the United States in rejecting a finding of public disclosure—reasoning that the term "public" had to be given independent meaning, but could not be defined as the "government."[101] In support, the First Circuit looked to Black's Law Dictionary, citing its definition of public as: "1. Relating or belonging to an entire community, state or nation . . . 2. Open or available for all to use, share, or enjoy."[102] The court also noted that although the FCA itself uses the term "government" in other provisions, at no point does the statute equate government with public.[103] As such, if Congress had wished to equate the two terms, "it easily could have done so."[104]

But the Seventh Circuit's decision in *Bank of Farmington*, which the district court relied upon, also claimed to give the term "public disclosure" its plain meaning.[105] The Seventh Circuit went beyond the text and explored the statute's purpose, legislative history,[106] and policy implications to establish a sliding scale for finding a public disclosure.[107] It premised the inquiry on how "open" a disclosure is, and to what public official it is made.[108] The court noted that the 1986 amendments sought "to encourage whistleblowing and disclosure of fraud," but also to resolve the tension between incentivizing disclosure and preventing parasitic lawsuits.[109] To that end, the court

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[99] *Id.* at 266–67.
[100] *Id.* at 268–69.
[101] United States *ex rel.* Rost v. Pfizer, Inc., 507 F.3d 720, 729 (1st Cir. 2007) ("As the United States, in opposing Pfizer's reading, notes, the ordinary understanding of the term 'public' means 'something apart from the government itself.' ").
[102] *Id.*
[103] *Id.* ("'[O]riginal source' means an individual who . . . has voluntarily provided the information *to the Government.* ") (emphasis in original).
[104] *Id.*
[105] *See* United States v. Bank of Farmington, 166 F.3d 853, 860 (7th Cir. 1999) ("The interpretation of 'public disclosure' adopted there [the Third Circuit] runs contrary to the plain meaning of the words.").
[106] *Id.* (citing Cooper v. Blue Cross & Blue Shield of Fla., Inc., 19 F.3d 562, 565 (11th Cir. 1994).
[107] *Bank of Farmington*, 166 F.3d at 862 n.6 (7th Cir. 1999) ("The degree to which a disclosure is thus open to all or is likely to give notice to a responsible official is in general a factual question for the district court.").
[108] *Id.* at 860–62.
[109] *Id.* at 858.

observed "the point of public disclosure of a false claim against the government is to bring it to the attention of the authorities, not merely to educate and enlighten the public at large about the dangers of misappropriation of their tax money."[110] Accordingly, the court reasoned that a disclosure to a public official with direct responsibility for a health care claim, such as the OIG or the U.S. Attorney's office would effectuate the purpose of the FCA and achieve the intended balance.[111]

The disclosure at issue in *Whipple* was clearly made to several public officials with direct responsibility for the claim—OIG and the U.S. Attorney's Office—eventually reaching an administrative resolution without an FCA lawsuit by the government.[112] Under *Bank of Farmington*, there is little doubt that the disclosure was "public."

As stated in *Poteet*,[113] the "public" inquiry may not even be a separate analysis. Instead, Congress may have considered the statutory list of disclosures as inherently "public."[114] Disclosures through litigation, reports, hearings, and audits can be classified as presumptively public, while news media is public by definition.[115] This argument counteracts *Whipple* and *Rost*'s reasoning that the term "public" would be superfluous if equated with "government."[116] Rather, it can be argued that—by the statute's plain text—Congress was defining disclosures through government investigations as fundamentally "public" in nature. Taking that to its logical conclusion, the real dispute would center on whether there was an actual government "investigation" of the alleged misconduct. This interpretation supports *Bank of Farmington*, since the likelihood of a government investigation would certainly be premised on the information reaching a responsible public official. It also grounds the Seventh Circuit's holding in the statute's plain text.

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[110] *Id.*
[111] *See id.*
[112] United States v. Chattanooga-Hamilton Cty. Hosp. Auth., 782 F.3d 260, 266-67 (6th Cir. 2015).
[113] United States *ex rel.* Poteet v. Medtronic, Inc., 552 F.3d 503, 511 (6th Cir. 2009) ("To determine whether § 3730(e)(4)(A)'s jurisdictional bar applies, a court must consider first whether there has been any public disclosure of fraud, and second whether the allegations in the instant case are 'based upon' the previously disclosed fraud.").
[114] Jason C. Lynch, Brian T. McLaughlin and Andy Liu, *Recent Developments Under FCA's Public Disclosure Bar: What is 'Public,' Anyway?*, BLOOMBERG BNA FEDERAL CONTRACTS REPORT Vol. 103, No. 13 (Apr. 7, 2015), *available at* https://www.crowell.com/files/Recent-Developments-Under-FCAs-Public-Disclosure-Bar-What-is-Public-Anyway.pdf.
[115] *Id.*
[116] *Whipple*, 782 F.3d at 268.

Another permutation of the issue raised by *Whipple* is whether disclosure from one government employee to another is "public." Courts have predominantly held that it is not.[117] Similarly, as the Sixth Circuit reasoned, disclosures made to a private company hired to perform services on behalf of the government are not made to an "outsider" to the investigation since the company has a strong incentive to keep the information confidential.[118] In *Whipple*, AdvanceMed was clearly acting on behalf of the government and the court was correct to hold that any disclosures were not "public."

The analysis with respect to Deloitte is a little more complicated. The Sixth Circuit seemed to embrace *Doe* – treating the Deloitte auditors as employees of Erlanger who are "members of the public" and to whom a "public disclosure" could have been made.[119] Other circuits have failed to embrace *Doe*'s holding, reasoning that it runs contrary to the purpose of the FCA.[120] Although Deloitte knew nothing about the fraudulent scheme and the auditors were not potential witnesses, it would appear they had an obligation and incentive to keep the information confidential because Erlanger was paying for their services.[121] Unfortunately, the Sixth Circuit cited no factual support—such as a confidentiality clause in Deloitte's engagement agreement—apart from the fact that Deloitte did not release any information into the "public domain."[122]

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[117] *See* United States *ex rel.* Ramseyer v. Century Healthcare Corp., 90 F.3d 1514 (10th Cir. 1996) (holding that disclosure from one government employee to another does not constitute "public" disclosure); United States *ex rel.* Schumer v. Hughes Aircraft Co., 63 F.3d 1512 (9th Cir. 1995) *vacated*, 520 U.S. 939 (1997) (same); United States *ex rel.* Hagood v. Sonoma County Water Agency, 929 F.2d 1416 (9th Cir. 1991) (same).

[118] *See* United States v. Chattanooga-Hamilton Cty. Hosp. Auth., 782 F.3d 260, 269 (6th Cir. 2015) (observing that the government contractor in *Berg* "was not an 'outsider' to the investigation, but rather was acting on behalf of the government and had an incentive to keep confidential the information learned during its audit" (citing Berg v. Honeywell Int'l, Inc., 502 F. App'x 674, 676 (9th Cir. 2012))).

[119] *Id.*

[120] *See* United States *ex rel.* Schumer v. Hughes Aircraft Co., 63 F.3d 1512, 1518 (9th Cir. 1995); *see also* United States *ex rel.* Doe v. John Doe Corp., 960 F.2d 318, 325 (2d Cir. 1992) (Walker, J., dissenting) (reasoning that innocent employees are not "members of the public" because they have "no incentive to further reveal what they have learned"). The court in *Schumer* sharply criticized *Doe* for being "unrealistic." *See Schumer*, 63 F.3d at 158. Distinguishing innocent employees from random members of the public, the court reasoned that innocent employees have a strong economic incentive to protect their employer from allegations of fraud, as such "revelation of information to an employee does not trigger the potential corrective actions presented by other forms of disclosure." *Id.*

[121] *Whipple*, 782 F.3d at 269.

[122] *Id.*

The district court in *Whipple* was sympathetic to Erlanger's argument that "the information was publicly disclosed to more than just the government through investigations . . . conducted by the government, consultants, attorneys and contractors."[123] In its analysis, the district court noted that OIG allowed Erlanger to engage independent auditors, subsequently identifying a letter to OIG stating that "at least ten of Defendant's employees were interviewed by attorneys and auditors regarding the allegations."[124] Notably, the Sixth Circuit's opinion made no mention of the employees that were interviewed. Under Doe, it would appear that (at least some) of the employees could be "strangers to the fraud" with no incentive to keep the information confidential. Perhaps the factual record before the Sixth Circuit was insufficient to make any such determination or the employees were only generally aware of the allegations.

B. Impact of the 2010 Public Disclosure Bar

Since *Whipple* applied the unequivocally jurisdictional pre-2010 version of the public disclosure bar, the decision is not an accurate depiction of how a court would apply the prevailing interpretation[125] of the 2010 non-jurisdictional version. The consequences of a move to a non-jurisdictional bar are significant—including a stark contrast in the evidence that a court may consider when ruling on a motion, and a shift of the party who must bear the burden of persuasion.

In addressing the question of public disclosure through the standard of review for challenges to jurisdiction, courts can consider evidence outside the pleadings.[126] The district court in *Whipple* did just that, initially denying Erlanger's motion without prejudice in order to allow discovery and develop

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[123] Whipple v. Chattanooga-Hamilton Cty. Hosp. Auth., No. 3-11-0206, 2013 WL 4510801, at *4 (M.D. Tenn. Aug. 26, 2013).
[124] *Id.*
[125] The two circuits that have addressed the question, the Fourth and Eleventh, have both held that the public disclosure bar now creates grounds for dismissal for failure to state a claim. *See* United States *ex rel.* Osheroff v. Humana Inc., 776 F.3d 805, 810 (11th Cir. 2015) ("We conclude that the amended § 3730(e)(4) creates grounds for dismissal for failure to state a claim rather than for lack of jurisdiction."); United States *ex rel.* May v. Purdue Pharma L.P., 737 F.3d 908, 916 (4th Cir. 2013) ("In our view, these changes make it clear that the public-disclosure bar is no longer a jurisdiction-removing provision.").
[126] *See* Hamm v. United States, 483 F.3d 135, 137 (2d Cir. 2007) ("In resolving the question of jurisdiction, the district court can refer to evidence outside the pleadings . . . .").

a more thorough factual record.[127] In contrast, a motion to dismiss for failure to state a claim under Rule 12(b)(6) requires the court to accept the relator's allegations as true and solely consider matters outside the pleadings that qualify as judicially noticeable public disclosures.[128] Defendants that rely on declarations or affidavits to prevail will only be able to utilize such evidence on motions for summary judgment, which carry a much higher burden and require significantly more time, effort, and money.[129] Unlike a defense raised under (12)(b)(6), challenges to subject matter jurisdiction cannot be waived or procedurally barred.[130]

Furthermore, relators will no longer have to carry the burden of persuasion on the issue of public disclosure.[131] This burden shift will certainly lead to more relators surviving challenges under the public disclosure bar, especially when coupled with the limited universe of relevant judicially noticeable documents. Also pertinent is the government's new ability to oppose dismissal.[132] Practitioners have only speculated on how the government may be given an opportunity to oppose dismissal, and much remains to be resolved.[133] However, it is certain that this new provision can only bode well for relators and decrease the number of cases dismissed on the basis of public disclosure.

IV. RECOMMENDATION

Common sense dictates that the Sixth Circuit did not reach the right result. For health care providers, the facts in *Whipple* made it the ideal case to go up on appeal. Upon discovering that it was under investigation for

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[127] Whipple v. Chattanooga-Hamilton Cty. Hosp. Auth., No. 3-11-0206, 2013 WL 4510801, at *1 (M.D. Tenn. Aug. 26, 2013).

[128] *See* Staehr v. Hartford Fin. Servs. Group, Inc., 547 F.3d 406, 425 (2d Cir. 2008) (taking judicial notice of "the *fact* that press coverage, prior lawsuits, or regulatory filings contained certain information, without regard to the truth of their contents").

[129] *See* FED. R. CIV. P. 56.

[130] United States v. Cotton, 535 U.S. 625, 630 (2002) (observing that subject matter jurisdiction cannot be forfeited or waived because it involves a court's power to hear a case).

[131] *See* Ping Chen *ex rel.* United States v. EMSL Analytical, Inc., 966 F. Supp. 2d 282, 294 (S.D.N.Y. 2013) ("[T]he Court is not permitted, as it would be on a motion challenging its jurisdiction, to refer to evidence outside the pleadings, nor does the burden rest with Plaintiff . . . .").

[132] *See* 31 U.S.C. § 3730(e)(4)(A) (2012).

[133] *See* Robert T. Rhoad & Jason C. Lynch, *New Questions Regarding the Jurisdictionality of the FCA's Public Disclosure Bar: Potential Hurdles and Increased Costs In Defending Against Parasitic Qui Tam Actions*, 55 THE GOV'T CONTRACTOR 1, 1 (2013).

potential fraudulent billing practices, Erlanger promptly retained an auditor, disclosed the findings to the government, and voluntarily repaid close to $500,000.[134] Although the government was compensated for its losses, and prospective fraudulent conduct was averted, Erlanger continues to incur substantial legal fees in defending an FCA suit. Yet under *Whipple* and in almost all other circuits, such is the state of the law today.

True, the now extinct government knowledge bar was discarded for a reason—proving too restrictive and "resulting in under-enforcement of the FCA."[135] A return to that standard would be far astray from the "golden mean."[136] But that is not an accurate characterization of *Bank of Farmington*. The Seventh Circuit was careful to craft a narrow government knowledge bar based on the information reaching the proper official who could then take action to investigate the fraudulent conduct. In this scenario, there appears to be "little need for assistance by a qui tam relator unless the relator is an original source."[137] Rewarding relators under these circumstances who are not an original source does nothing to further the FCA's purpose of combatting fraud. In contrast, the Seventh Circuit's interpretation would greatly incentivize providers to voluntarily disclose misconduct and resolve fraudulent claims without the need to burden the federal judicial system.

Whipple will have significant implications for a large portion of U.S. providers, bringing some certainty to a previously unresolved question. Many health care providers operate within the Sixth Circuit's jurisdiction—Nashville, Tennessee, has been described as the "health care industry capital."[138] Now, most health care providers faced with a problematic internal audit or government investigation are in a precarious position—given the weight of authority, including *Whipple*, to hold that voluntary disclosure or a prior government investigation alone will not trigger the public disclosure

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[134] *See* United States v. Chattanooga-Hamilton Cty. Hosp. Auth., 782 F.3d 260, 267 (6th Cir. 2015).

[135] *See* United States *ex rel.* Rost v. Pfizer, Inc., 507 F.3d 720, 729 (1st Cir. 2007) ("With the 1986 amendments, Congress deliberately removed a previous provision that barred jurisdiction whenever the government had knowledge of the allegations or transactions in the relator's complaint.").

[136] *See* United States *ex rel.* Springfield Terminal Ry. Co. v. Quinn, 14 F.3d 645, 649 (D.C. Cir. 1994).

[137] *See* Beverly Cohen, *Trouble at the Source: The Debates over the Public Disclosure Provisions of the False Claims Act's Original Source Rule*, 60 MERCER L. REV. 701, 748 (2009) (discussing the pros and cons of the Seventh Circuit's interpretation).

[138] There are nearly 400 health care companies that have operations in Nashville and work on a multistate, national or international basis, of which sixteen are publicly traded. *See Nashville: The Health Care Industry Capital*, NASHVILLE HEALTH CARE COUNCIL (Nov. 26, 2015, 6:20 PM), http://healthcarecouncil.com/nashville-health-care-industry/.

bar. Public companies in particular will face an enhanced calculus. In-house counsel, officers, and directors will have to factor in effects on stock prices, potential securities suits, and necessary filings with the U.S. Securities and Exchange Commission.[139]

On the one hand, a provider may choose to discretely self-disclose problematic conduct to the government in hopes of lower damages and earning credibility towards favorable exercise of prosecutorial discretion. This avenue also avoids public relations concerns and limits public exposure of news and documents to opportunistic relators.

On the other hand, a discrete resolution lacks the protection of the public disclosure bar and leaves the door open to *qui tam* suits. A potential solution to this latter dilemma is a provider's proactive public disclosure—through a press release or otherwise—of a pending investigation or discovery of problematic conduct. However, it is not clear what news medium, format, or level of detail is sufficient for a "public" disclosure.[140] Additionally, the law remains unclear as to whether disclosure to employees or outside auditors such as Deloitte in *Whipple*—even if made without an explicit or implicit expectation of confidentiality—are sufficient for a public disclosure.[141] Voluntary public self-disclosures also carry the risk of opening a Pandora's box of potential relators, with distinct possibilities that they possess independent information from what is publicly disclosed, or that they qualify as an original source.

Even providers in the Seventh Circuit—which has appellate jurisdiction over the federal courts in Illinois, Indiana, and Wisconsin—must remain

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[139] *See* Jay A. Brozost & A. Jeff Ifrah, *I Tell Them, I Tell Them Not: Deciding When and How to Disclose False Claims Act Lawsuits to Shareholders*, ACC DOCKET, Vol. 26, No. 1, 52 (2008) ("You can disclose a lawsuit that may expose your company to millions of dollars in damages at the risk of going to prison, or you can hold on to the information and quite possibly face SEC-related liability. Neither option is attractive for in-house counsel."); *see also* Reuben A. Guttman et al., *The Interplay Between the False Claims Act, Securities Fraud, and ERISA*, 39 FALSE CL. ACT AND QUI TAM Q. REV. 20 (2005) ("Where a publicly traded company reports revenue that is based on dollars that were generated through unlawful conduct, as in the case of revenues based on 'false claims,' then potentially an action may exist under the federal securities laws if that conduct causes injury to shareholders who purchased stock at inflated prices.").

[140] *See* United States ex rel. White v. Gentiva Health Servs., Inc., No. 3:10-CV-394-PLR-CCS, 2014 WL 2893223, at *1 (E.D. Tenn. June 25, 2014) (dismissing some FCA allegations relating to a fraudulent billing scheme for unnecessary home health services because they were publicly disclosed in a *Wall Street Journal* article—but permitting other allegations because they were not discussed with the requisite specificity to put the government on notice of possible fraudulent activity).

[141] *See supra* Part II.

vigilant of legislative and judicial trends narrowing the scope of the public disclosure bar. Since *Bank of Farmington* remains the controlling precedent, relators in that jurisdiction will be reluctant to bring cases arising out of information that was possibly disclosed to the government via audits, investigations, or even a provider's self-disclosure. But even in the Seventh Circuit, defendants will have to bear the burden of persuasion on the issue of public disclosure.

V. CONCLUSION

In conclusion, the Seventh Circuit's interpretation of the public disclosure bar strikes the proper balance in the fight against fraud and should be given greater effect. But as a practical matter there are many additional deterrents to *qui tam* suits apart from the letter of the law. Relators and their counsel often face skilled defense attorneys and health care providers with very deep pockets. FCA cases generally run on for several years, and due to the amount of money at stake often, like *Whipple*, end up on appeal. Regardless of the outcome, their co-workers often ostracize relators and employers are extremely reluctant to hire former whistleblowers. Recognition of these practical realities may be an underlying explanation for congressional amendments and narrowing judicial interpretation of the public disclosure bar in order to adequately incentivize whistleblowing.

Ultimately, the Sixth Circuit's decision foreshadows darker days ahead for health care providers and other companies who do business with the government. Coupled with the ostensible shift toward a non-jurisdictional bar, these companies will face a much greater risk of liability. This may signal substantial investments in stringent compliance and monitoring programs to prevent potential misconduct on the front-end.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

LACK OF LEGAL DUTY TO FILL VACANCIES ON THE UNITED STATES EXPORT-IMPORT BANK'S BOARD OF DIRECTORS MAY DESTROY EX-IM BANK

❖ NOTE ❖

*Michal Nowicki**

Abstract

This Note examines whether the President of the United States has a statutory duty to nominate candidates to fill vacancies on the United States Export-Import Bank's five-person Board of Directors. With only two of the five seats occupied, Ex-Im Bank's Board of Directors cannot currently approve the financing of large export credit transactions, because at least three board members must be present to establish quorum for conducting official business. As a result, the Bank's power is severely limited. Although this Note argues that President Trump is not legally obligated to fill Ex-Im Bank board vacancies, it offers an argument the Bank's supporters can use to persuade President Trump to restore the agency to its full potential.

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I. INTRODUCTION

The acquisition of airplanes and aircraft parts can be expensive. For example, the Boeing 787 Dreamliner costs $206.80 million.[1] As a result, airlines and aircraft leasing companies often rely on export financing to fund aviation equipment. The United States Export-Import Bank (Ex-Im Bank) plays a prominent role in such financing. However, Ex-Im Bank's continued existence is in jeopardy due to opposition from fiscal conservatives, think tanks such as the Cato Institute and the Heritage Foundation, political advocacy organizations like the Club for Growth, and even some U.S. airlines.[2] Although Congress recently extended its charter through September 30, 2019,[3] the Bank may not issue loans and guarantees exceeding $10 million without the approval of its board of directors.[4] Unfortunately for the Bank's customers, its board of directors cannot currently approve such transactions because it presently consists of only two members: one too few to satisfy the three-member quorum requirement.[5]

This Note examines whether the President of the United States has a statutory duty to nominate qualified candidates to fill the three vacant seats on Ex-Im Bank's five-person board of directors. Additionally, this Note attempts to answer whether legal action may be taken against the President for failing to designate a nominee with the devious purpose of hindering the Bank's operations. Part II provides historical background on Ex-Im Bank, as well as a summary of the unsatisfied quorum requirement and its impact on the financing of large export credit transactions. Part III analyzes the statutory framework for filling Board vacancies through the lens of the President's constitutional appointment power. Part IV recommends that Ex-IM supporters urge the Trump Administration to restore the Bank to its full potential by appealing to President Trump's plan to bring jobs back to the United States. This Note argues that, although there is no judicial guidance as to whether federal politicians must fill Ex-Im Bank Board vacancies when

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[1] *Boeing All Models, Complete Aircraft List Price*, AIRCRAFTCOMPARE.COM, https://www.aircraftcompare.com/manufacture-aircraft/Boeing/1 (last visited Feb. 23, 2017).

[2] *See generally* Alan N. Hernandez, *Reauthorization of the U.S. Export-Import Bank and the Role It Plays in the Aviation Industry*, 25 AIR & SPACE LAW., 4, 4–5 (summarizing the main arguments against reauthorization and describing efforts to limit the Bank's power).

[3] Export-Import Reform and Reauthorization Act of 2015 § 54001(a), 12 U.S.C. § 635f (2012).

[4] Ryan McCrimmon, *Conservative Group Wants Ryan to Block Ex-Im Bank Reset*, CQ ROLL CALL 2016 WL 44115544 (2016).

[5] *Id.*

Congress reauthorizes the Bank, the plain language of the Export-Import Bank Act of 1945 establishes that the President of the United States is not legally obligated to nominate candidates to fill such vacancies.

II. BACKGROUND

A. Ex-Im Bank

Ex-Im Bank, an independent federal agency,[6] is the official export credit agency of the United States.[7] The Bank provides direct loans, export credit and working capital guarantees, and export credit insurance, backed by the full faith and credit of the U.S. government, to finance U.S. exports.[8] It was established in 1934 by President Franklin D. Roosevelt as the Export-Import Bank of Washington (EIBW), pursuant to an executive order.[9] It was created to finance American trade with the Soviet Union.[10] EIBW later merged with the Second Export-Import Bank of Washington D.C, initially to finance trade with Cuba.[11] The combined organization became an independent federal agency upon the enactment of the Export-Import Bank Act of 1945.[12] Two years later, it was reincorporated under a renewable federal charter and obtained its current name in 1968.[13]

Ex-Im Bank has been instrumental in export financing both before and after World War II.[14] Its major transactions prior to WWII included a $22 million loan to China for the Burma Road and the financing of the Pan American Highway.[15] After WWII, it provided $2 billion to help rebuild Europe under the Marshall Plan, and $100 million to the newly recognized state of Israel.[16]

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[6] Export-Import Bank Act of 1945 § 3, 12 U.S.C. § 635a(a) (2012).
[7] Hernandez, *supra* note 2, at 4.
[8] *Id.*
[9] Exec. Order No. 6581, 12 C.F.R. § 401 (1934), *reprinted as amended in* 12 U.S.C. § 635 (2012).
[10] Hernandez, *supra* note 2, at 4.
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*

B. The Quorum Problem

As noted above, Ex-Im Bank may finance transactions exceeding $10 million only with the approval of its Board of Directors.[17] When all seats are occupied, the Board consists of five members: the Bank's President, who serves as chairman, its Vice President, who serves as Vice Chairman, and three additional officers appointed by the U.S. President and confirmed by the Senate.[18] The Board may conduct official business only in the presence of at least three members.[19] Currently, however, only two of the five board seats are occupied,[20] making approval of large loans impossible.

The lack of quorum on the Ex-Im Bank's Board of Directors may significantly impact the American economy. Specifically, large transactions account for approximately 75% of the Bank's $20 billion in annual loans and financial guarantees.[21] With such transactions on hold, major beneficiaries of the Bank's programs, such as Boeing and General Electric, might transfer some of their operations overseas.[22] The likely result of such a move is an increase in domestic unemployment.[23] According to CNBC, the Bank supported roughly 165,000 jobs in 2014 – when it still exercised full lending power – compared with only 52,000 jobs in fiscal 2016.[24]

III. DUTY TO FILL BOARD VACANCIES

Although most Republican Congressmen supported the last two Ex-Im Bank reauthorizations,[25] then President-elect Donald Trump dismissed the agency on his campaign trail as "'featherbedding' for politicians and huge

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[17] *See supra* Part I.
[18] 12 U.S.C. § 635a(c)(1).
[19] *Id.* § 635a(c)(6).
[20] McCrimmon, *supra* note 4.
[21] *Id.*
[22] *Id.*
[23] *See* John Engler, *Business Leaders Urge House Vote to Reauthorize the Export-Import Bank of the United States*, BUS. ROUNDTABLE (Oct. 27, 2015), http://businessroundtable.org/resources/business-leaders-urge-house-vote-reauthorize-the-export-import-bank-the-united-states (arguing that Ex-Im Bank financing "plays a critical role in supporting the U.S. economy and jobs").
[24] Clay Dillow, *Will Trump's Administration Spell Doom for the Export-Import Bank?*, CNBC.COM (Dec. 7, 2016, 1:26 PM), http://www.cnbc.com/2016/12/07/will-trumps-administration-spell-doom-for-the-export-import-bank.html.
[25] Hernandez, *supra* note 2, at 5 (2012 reauthorization); Fred P. Hochberg, *Ex-Im Bank Reauthorization Information*, EXIM.GOV (Dec. 4, 2015), http://www.exim.gov/reauthorization (2015 reauthorization).

companies that don't need the help."[26] Moreover, he already started fulfilling some of his campaign promises the first business day after his inauguration by stifling the previous Administration's efforts to enter the Trans-Pacific Partnership, ordering a hiring freeze for most federal agencies, and blocking foreign aid for organizations that perform or encourage abortions.[27] Thus, while public pressure often compels politicians to change their attitudes, these events suggest that President Trump embraces governmental fiscal restraint. Hence, he will likely appoint Ex-Im Board members only if he is legally obligated to do so.

Unfortunately, President Trump likely has no statutory or constitutional obligation to fill the Banks vacancies, so supporters will need to seek out alternative avenues for fulfilling their mission. The Export-Import Bank Act provides, in pertinent part, "There shall be a Board of Directors of the Bank consisting of the President of the Export-Import Bank of the United States, who shall serve as Chairman, the First Vice President who shall serve as Vice Chairman, and three additional persons appointed by the President of the United States by and with the advice and consent of the Senate."[28] In interpreting the meaning of a statute, courts first consider "'its language, giving the words used their ordinary meaning,'"[29] unless a "literal reading . . . would 'compel an odd result.'"[30] They resort to extrinsic evidence, such as legislative history, only when the statute is ambiguous.[31] "The plainness or ambiguity of statutory language is determined by reference to the language itself, [its] specific context . . . , and the broader context of the statute as a whole."[32]

While courts and legal scholars have not addressed whether politicians may be sanctioned for a bad-faith dereliction of nomination powers with respect to filling the Ex-Im Bank's Board of Directors, the U.S. Constitution provides:

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[26] Tom Howell, Jr., *Donald Trump May Deal Death Blow to Ex-Im Bank*, WASH. TIMES (Dec. 26, 2016), http://www.washingtontimes.com/news/2016/dec/26/donald-trump-may-deal-death-blow-to-ex-im-bank/#content.

[27] Elise Viebeck, *Trump's First 100 Days: Delivering on Campaign Promises*, WASH. POST (Jan. 23, 2017), https://www.washingtonpost.com/news/powerpost/wp/2017/01/23/trumps-first-100-days-delivering-on-campaign-promises/?utm_term=.a11f3acf32e7.

[28] 12 U.S.C. § 635a(c)(1) (2012).

[29] Lawson v. FMR, L.L.C., 134 S. Ct. 1158, 1165 (2014) (quoting Moskal v. United States, 498 U.S. 103, 108 (1990)).

[30] Pub. Citizen v. U.S. Dep't of Justice, 491 U.S. 440, 454 (1989) (internal citation omitted).

[31] Oklahoma v. New Mexico, 501 U.S. 221, 236 n.5 (1991).

[32] Robinson v. Shell Oil Co., 519 U.S. 337, 341 (1997).

> [The President] shall have *Power*, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur; and he shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law . . . ."[33]

The President's Article II appointment power is, thus, discretionary.[34] The key word in Article II, Section 2, Clause 2 is "power." While duties must be fulfilled, powers may, but need not, be utilized. The U.S. Constitution delegates specific powers to each government branch so that no single branch dominates the others. [35] This system of checks and balances is one of the cornerstones of American democracy.[36] That being said, the plain language of the Constitution conclusively establishes that the President has appointment "powers," not "duties."[37] If the framers had intended otherwise, the checks and balances system would be weaker. The lack of judicial precedent to the contrary confirms this conclusion.

Supporters of full restoration of Ex-Im Bank's powers may raise several objections to this analysis. First, they may argue that the President is legally obligated to fill Ex-Im Board vacancies because unlike in the Constitution,[38] the word "power" is absent from the analogous provision of the Export-Import Bank Act.[39] They may further contend, based on the structure of Clause 2,[40] that the President's appointment power is confined to entering into treaties on behalf of the United States, and that the Constitution creates a duty to nominate officers such as judges and ambassadors.[41] Finally, as a last resort,

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[33] U.S. CONST. art. II, § 2, cl. 2 (emphasis added); *see also* Matthew Madden, *Anticipated Judicial Vacancies and the Power to Nominate*, 93 VA. L. REV. 1135 (2007) (consistently characterizing the presidential appointment privilege as a "power," not a "duty").
[34] Marbury v. Madison, 1 Cranch 137 (1803).
[35] *See, e.g.*, U.S. CONST. art. II, § 2, cl. 2 (requiring Senate to confirm presidential appointments to prevent the President from acting arbitrarily).
[36] Perez v. Mortg. Bankers Ass'n, 135 S. Ct. 1199, 1215–17 (2015); Desirae L. Wells, *National Security Letters: Why Reform Is Necessary*, 2012 CARDOZO L. REV. DE NOVO 216, 236 (2012).
[37] U.S. CONST. art. II, § 2, cl. 2.
[38] *Id.*
[39] 12 U.S.C. § 635a(c)(1) (2012).
[40] U.S. CONST. art. II, § 2, cl. 2.
[41] *Id.*

they may claim that presidential inaction undermines the rule of law.[42] At the height of the confirmation stalemate following the 1996 presidential election, Massachusetts Senator Edward Kennedy summarized the problem as follows:

> In Congress today, . . . there is increasing talk of stricter scrutiny of judicial nominees. Fair scrutiny makes sense. But it is painfully evident with each passing month that the scrutiny they have in mind is passing all reasonable bounds of service to justice - and turning into obstruction of justice . . . What we are witnessing today is a direct assault on the President's constitutional power to nominate and appoint judges. Deliberate efforts are being made in Congress to undermine the judicial independence that is at the heart of the rule of law. Advice and consent in the Senate is becoming abuse and dissent.[43]

All of the above counterarguments, if raised in litigation, will probably fail. The first argument is unconvincing because the statute merely authorizes the appointment of directors without even implying that such appointments are necessary.[44] The second potential argument is the strongest, as entry into treaties is distinguishable from filling vacant political offices in that requiring the President to enter into unfavorable treaties could trigger adverse political consequences for Americans, whereas imposing a duty to fill vacant positions promotes political stability. Nevertheless, Congress chose to limit the Bank's spending authority,[45] precisely to reduce government spending.[46] Thus, President Trump's expected failure to nominate candidates for the vacant seats is lawful consistent with likely congressional intent to block taxpayer funding for large export transactions. Lastly, the third possible argument is ineffective because while judicial vacancies must be filled to preserve our system of separation of powers and checks and balances, the Trump Administration's decision to stifle large export transactions might actually strengthen the rule of law by promoting respect for legislative intent.

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[42] *Cf.* Stephan O. Kline, *The Topsy-Turvy World of Judicial Confirmations in the Era of Hatch and Lott*, 103 DICK. L. REV. 247, 333 (1999) (raising this argument in the context of judicial activism in the U.S. Senate).
[43] *Id.*
[44] § 635a(c)(1).
[45] McCrimmon, *supra* note 4.
[46] *See* Hernandez, *supra* note 2, at 5 (referring to the 2012 reauthorization bill as a "compromise bill" between the Bank's supporters and fiscally conservative opponents).

IV. RECOMMENDATION

Since President Trump is not legally required to nominate candidates for the vacant seats on the Ex-Im Bank's Board of Directors, the Bank's defenders should urge him to act by arguing that restoration of the Bank's full powers will create more American jobs. In his seven-step plan for bringing jobs back to the United States, the President calls for, among other measures, stricter enforcement of international trade agreements and more rigorous application of tariffs against U.S. trade partners engaged in unlawful trade practices.[47] His ultimate goal is to provide assurances that countries like China stop taking advantage of Americans.[48] Reviving the Bank's Board furthers these objectives while simultaneously promoting friendly relations with foreign countries.

V. CONCLUSION

Although Congress recently reauthorized Ex-Im Bank through September 30, 2019[49] despite opposition from right-wing groups and politicians,[50] the Bank cannot function properly because its Board of Directors has too many vacant seats to approve funding for large transactions. The fact that the U.S. President is not legally required to propose candidates for the vacant position further complicates the matter, as President Trump's hostility towards the Bank on his campaign trail [51] suggests that he will not support the agency. Nonetheless, there is hope for Ex-Im supporters in the argument that resurrecting the Board will advance Trump's mission of restoring U.S. jobs: an argument Ex-Im supporters should pursue vigorously.

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[47] Henry Fernandez, *Trump's 7 Steps to Bring Back U.S. Jobs*, FOX BUS. (June 28, 2016), http://www.foxbusiness.com/politics/2016/06/28/trumps-7-steps-to-bring-back-u-s-jobs.html.
[48] *Id.*
[49] 12 U.S.C. § 635f (2012).
[50] *See supra* text accompanying note 2.
[51] Howell, *supra* note 26.

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ILLINOIS BUSINESS LAW JOURNAL

KEEPING AN AI ON TECHNOLOGICAL ADVANCES IN BUSINESS LAW

❖ NOTE ❖

*Elizabeth Rice**

Abstract

This Note explores the role that artificial intelligence plays in the legal world today and the ways in which it may affect the legal profession in the future. Artificial intelligence programs are being used in a variety of ways to streamline legal research, contracts analysis, and many other tedious and time-consuming legal processes. As this technology develops, many lawyers are concerned that these efficient programs will begin to replace lawyers, especially at the lower level of big law firms, while others welcome the benefits that this technology will bring to law firms. This Note touches on competing views concerning the implications of the use of artificial intelligence in the legal field, and how the implementation of these programs will ultimately benefit the profession as a whole.

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I. INTRODUCTION

Artificial intelligence (AI) is a developing area at the forefront of technological advancement. The evolution of artificial intelligence has led to its expansion into many different industries, including the legal field.[1] The idea of artificial intelligence tools geared to help streamline legal practice is relatively recent, but these tools will no doubt become more prevalent within the industry.[2] In an ideal world, these tools would aid legal professionals in a business law setting and would save time and money by completing menial tasks that waste the better part of a lawyer's time but cannot be billed to clients.[3] Legal professionals worry, however, that the rise in use of artificial intelligence tools in legal practice will make lawyers' jobs obsolete, especially in business law.[4] Nonetheless, it is more likely, that artificial intelligence tools will become effective aids for attorneys practicing business law, rather than their replacements.[5] In order to analyze this issue, it is necessary to have a basic understanding of artificial intelligence. Part I of this note will be a general overview of what artificial intelligence is and what forms it can take. Part II will take a closer look at the current applications of artificial intelligence in business law, as well as what may be possible in the future as this technology continues to advance. Finally, Part III will explore the impact of artificial intelligence on the field of business law as a whole and what changes its continued use may bring to the legal profession.

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[1] David Schatsky et al., *Demystifying Artificial Intelligence*, DELOITTE UNIVERSITY PRESS (Nov. 04, 2014), https://dupress.deloitte.com/dup-us-en/focus/cognitive-technologies/what-is-cognitive-technology.html#endnote-5.

[2] Julie Sobowale, *How Artificial Intelligence is Transforming the Legal Profession*, A.B.A. J. (Apr. 01, 2016, 12:10 AM), http://www.abajournal.com/magazine/article/how_artificial_intelligence_is_transforming_the_legal_profession.

[3] Jane Croft, *Artificial Intelligence Disrupting the Business of Law*, FIN. TIMES (Oct. 05, 2016), https://www.ft.com/content/5d96dd72-83eb-11e6-8897-2359a58ac7a5.

[4] Greg Wildisen, *Is Artificial Intelligence the Key to Unlocking Innovation in your Law Firm?*, LEGAL WK. (Dec. 12, 2015), http://www.legalweek.com/sites/legalweek/2015/11/12/is-artificial-intelligence-the-key-to-unlocking-innovation-in-your-law-firm/?slreturn=20170006101501.

[5] Schatsky et al. *supra* note 1.

II. AN INTRODUCTION TO ARTIFICIAL INTELLIGENCE

For many, the term "artificial intelligence" conjures to mind an image of a human-like robot with the capability of rational thought, such as Ava from the movie Ex Machina.[6] Others may think of an intelligent computer system with a mind of its own, such as Hal from 2001 A Space Odyssey.[7] What many don't realize is that artificial intelligence can also refer to simpler pieces of technology. For example, the voice recognition software on many smartphones falls under the category of artificially intelligent programming. An article published in Deloitte University Press provides that "[a] useful definition of artificial intelligence is the theory and development of computer systems able to perform tasks that normally require human intelligence."[8]

We are many years away from creating artificial intelligence with convincingly human characteristics, but our technology does allow us to create artificial intelligence that is capable of solving problems in a more efficient way than humans might be able to do un-aided. Artificial intelligence can fall into two different categories: hard and soft artificial intelligence.[9] Hard artificial intelligence refers to machines and programs that are capable of thinking and reasoning like humans.[10] Soft artificial intelligence is more relevant for use in the legal field, and refers to machines and programs that are able to do work that would traditionally be done by humans.[11] "Cognitive computing" is the name of the mechanism that enables machines to learn and complete tasks like humans.[12] As these machines tackle massive data sets, they seek out information that their programming instructs them to find.[13] In addition to doing what it has been taught by its programmers, a machine capable of cognitive computing also identifies patterns within the data and uses those patterns to create new solutions within the data.[14] These solutions are, in turn, used in the next data set and the next.[15] In essence, these machines are teaching themselves to be better at what they are programmed to do simply by doing it. After the initial learning process, artificial intelligence does not have to be retrained for each assignment, and it is capable of adapting its knowledge to

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[6] EX MACHINA (Film 4 & DNA Films 2015).
[7] 2001 A SPACE ODYSSEY (Metro-Goldwyn-Mayer 1968).
[8] Schatsky et al., *supra* note 1.
[9] Sobowale, *supra* note 2.
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] Schatsky et al., *supra* note 1.
[14] Sobowale, *supra* note 2.
[15] *Id.*

new situations.[16] The way that artificial intelligence learns through cognitive computing is similar to the way that human beings learn and become better at tasks. This ability is combined with the computational and analytical power that these machines and programs also possess, making for incredible efficiency.[17]

III. ARTIFICIAL INTELLIGENCE IN THE LEGAL WORLD

Because artificially intelligent programs are able to complete tasks that are traditionally performed by human beings, but at a more efficient rate, the main use of artificial intelligence in today's legal world is in areas that tend to be very time consuming and tedious for lawyers.[18] Of the artificial intelligence programs in use today, one of the most well-known is IBM's Watson.[19] Watson is an open cognitive computing platform that has been put to a variety of uses. Some of Watson's users' most notable achievements include beating the two best players on the gameshow *Jeopardy!* in 2011, splicing together the first artificial-intelligence-made trailer for a horror film, and helping to diagnose cancer patients through analysis of over 600,000 medical evidence reports, 1.5 million patient records and patient trials, as well as the text of medical journals.[20] Watson's ability to take on many diverse tasks makes it one of the most easily-harnessed artificially intelligent programs on the market. Watson's knowledge and ability continues to grow as its programing is put to new tests. IBM predicted that Watson would be able to pass the bar exam by 2016, a remarkable feat for a person, let alone a computer.[21] Watson has been applied to the legal field in the form of ROSS, a program that uses Watson's question-and-answer technology to answer legal questions in plain language.[22]

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[16] *Id.*
[17] Schatsky et al., *supra* note 1.
[18] Michael Mills, *Using AI In Law Practice: It's Practical Now*, LAW PRACTICE, July 2016, at 48.
[19] IBM WATSON, https://www.ibm.com/watson/ (last visited Feb. 23, 2017).
[20] Carl Benedikt Frey & Michael A. Osborne, *The Future of Employment: How Susceptible are Jobs to Computerisation?*, OXFORD MARTIN PROGRAMME ON TECH. AND EMP. 19 (2013), http://www.oxfordmartin.ox.ac.uk/downloads/academic/future-of-employment.pdf; Schatsky et al., *supra* note 1; Morgan (20th Century Fox 2016).
[21] Michael Mills, *Artificial Intelligence in Law: The State of Play in 2016*, THOMSON REUTERS LEGAL EXECUTIVE INST. (2016), http://www.neotalogic.com/wp-content/uploads/2016/04/Artificial-Intelligence-in-Law-The-State-of-Play-2016.pdf.
[22] Jim Kelly, *Artificial Intelligence and The Law: What to Expect*, ANEWDOMAIN (Nov. 04, 2016), http://anewdomain.net/2016/11/04/artificial-intelligence-and-the-law-what-to-expect/.

Recently, ROSS has been applied to legal research in bankruptcy law.[23] ROSS has had its successes, winning a finalist spot in IBM's Cognitive Computing Competition and signing on several large business law firms as clients, including Baker Hostetler.[24] A test of ROSS's operations has reported that the program is capable of taking care of some of the more time-consuming tasks that lawyers deal with, in order to make their practice more efficient.[25] Thomson Reuters announced in October 2015 that they planned to collaborate with IBM through the use of Watson.[26] Although no specific information was released publicly about Thomson Reuters' plans for Watson, one can only imagine how a platform like Watson could revolutionize the way that Thomson Reuters' customers are able to find and access data through their many databases for businesses and professionals. Thomson Reuters runs Westlaw, a popular legal database, and hinted at a summit in February 2016 that a beta version of Watson for legal research might be available in the near future.[27]

While IBM's Watson might be the most well-known example of artificial intelligence at work in the legal field, other companies have developed artificial intelligence tools that are being used in today's legal market. Beagle, an artificial intelligence tool made to read contracts, is being developed to make transactional law easier and more efficient for lawyers.[28] Beagle is designed to read a contract and pull out key information that a lawyer may need, but also to learn over time what sorts of information its user tends to look for and to build off of the patterns it recognizes. Beagle essentially teaches itself over time to read contracts in a way that is tailored toward the parties using it.[29] Another example of artificial intelligence advances in the legal field is eBrevia, a company that has made it its goal to make lawyers' lives better by eliminating drudge work.[30] In 2012, eBrevia launched their Diligence Accelerator Program, which aims to streamline legal due diligence.[31] eBrevia's programs work by analyzing documents that users upload to their server and extracting

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[23] Mills, *supra* note 21.
[24] *Id.*; Kelly, *supra* note 22.
[25] Kelly, *supra* note 22.
[26] *Thomson Reuters and IBM Collaborate to Deliver Watson Cognitive Computing Technology*, THOMSON REUTERS (Oct. 08, 2015), http://thomsonreuters.com/en/press-releases/2015/october/thomson-reuters-ibm-collaborate-to-deliver-watson-cognitive-computing-technology.html.
[27] Mills, *supra* note 21.
[28] BEAGLE.AI (last visited Feb. 23, 2017).
[29] Kelly, *supra* note 22.
[30] Sobowale, *supra* note 2.
[31] *Id.*

legal information from them, using the legal concepts it had been taught by its programmers.[32] This method of getting information from documents enables the program to gather information from databases efficiently, cutting costs by cutting the hours a firm would have to bill an associate for such work. As law firms feel pressure to keep clients happy by lowering legal costs, eBrevia's programs help to further that objective.[33]

Smart Apps are another genre of artificial intelligence technology being put into use at business law firms. These applications are capable of addressing legal questions by analyzing content that users upload or by accessing information stored in databases.[34] Smart Apps give clients immediate answers to their legal problems, and are relatively user-friendly.[35] One example of a Smart App at use in the business law world is Foley & Lardner's FCPA App, which allows the firm's business clients to ask the app payment questions anywhere, at any time.[36] Using this Smart App, Foley & Lardner has been able to expand their network of business clients further into the Fortune 500.[37] These are just some examples of different artificial intelligence programs that are emerging in the legal market, and no doubt many more are in development.

IV. How the Use of Artificial Intelligence May Affect Legal Jobs and Practice

The increasing use of artificial intelligence in the legal field brings up many questions. How will the streamlining of tedious legal work affect the number of attorneys a firm employs? Will the use of artificial intelligence lead to a decrease in hiring because there is less work to go around, or an increase due to a larger demand for legal work as technology makes legal costs more affordable? Authorities are split.

The Big Law model organizes firms into a pyramid hierarchy. On the bottom, associates and junior associates do the bulk of the "grunt work," including time-consuming research and due diligence.[38] On the top, a small group of partners bring in clients and assign tasks to the employees below

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[32] *Id.*
[33] *Id.*
[34] Wildisen, *supra* note 4.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] Misa Han, *Boutique Law Firms Adopting 'Inverse Pyramid' Structure*, FIN. REV. (Dec. 18, 2016, 3:28 PM), http://www.afr.com/business/legal/boutique-law-firms-adopting-inverse-pyramid-structure-20161124-gswpum.

them.[39] The advent and implementation of artificial intelligence has the potential to reform this pyramid structure into something more diamond-shaped.[40] This diamond-shaped structure would have less junior associates at the bottom performing tedious tasks, and more mid-level associates interacting with clients and performing more meaningful and analytically fulfilling tasks.[41] On the one hand, the rise of technology in the legal field has caused firms to create new jobs to keep up with the times. Firms are inventing new positions and putting lawyers in charge of research and development, or hiring technology experts to implement artificial intelligence at their firms.[42]

On the other hand, increased automation and streamlining of work normally allocated to the bottom of the pyramid could result in a decreased need for lower-level associates as the work that would traditionally be theirs is given to artificial intelligence programs to complete. Already, artificial intelligence is pulling work away from legal professionals in certain business settings. Over 60 million disputes between eBay sellers annually are now settled by "online dispute resolution services" rather than by the legal system, which is three times the number of cases filed in the United States court system each year.[43] If the trend of replacing legal counsel with artificial intelligence continues, one can imagine that this will eventually cause an upset in the legal market. Firms will have to adapt, and lower-level associates may get the short end of the stick as artificial intelligence programs are able to complete more and more of the tasks that these attorneys would normally be assigned. Michio Kaku, a professor of theoretical physics, predicts that "[t]he job market of the future will consist of those jobs that robots cannot perform."[44] Even if the move towards artificial intelligence in business settings and firms doesn't result in a loss of jobs, it is likely that the legal industry will have to make big changes to keep up with the growth of technology.

Many experts argue that, rather than replacing lawyers, artificial intelligence will free lawyers from simple but time-consuming work and allow

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[39] *Id.*
[40] Sobowale, *supra* note 2.
[41] *Id.*
[42] Croft, *supra* note 3.
[43] Richard Susskind & Daniel Susskind, *Technology Will Replace Many Doctors, Lawyers, and Other Professionals*, HARV. BUS. REV. (Oct. 11, 2016), https://hbr.org/2016/10/robots-will-replace-doctors-lawyers-and-other-professionals.
[44] Mark A. Cohen, *How Artificial Intelligence Will Transform the Delivery of Legal Services*, FORBES (Sep. 06, 2016, 7:48 AM), http://www.forbes.com/sites/markcohen1/2016/09/06/artificial-intelligence-and-legal-delivery/#3119a7fa2647.

them to focus more on higher-value tasks.[45] One of the biggest sources of dissatisfaction among attorneys is with the amount of tedious work that they must complete. With artificial intelligence eliminating some of this work, lawyers will have more time to devote to clients and to perform more meaningful, intellectually challenging tasks.[46] For example, the CEO of ROSS has estimated that the program has the potential to save lawyers about 30% of their time by helping to answer legal problems quickly and efficiently.[47] In this way, artificial intelligence tools can lend a helping hand and increase work-satisfaction in business law firms. Lawyers who learn to use this new technology may find that they will become valuable assets at their firms as this technology becomes more common. Artificial intelligence does not work by itself, after all. Even the smartest artificially intelligent technology still needs a human operator to tell it what to look for and to feed it tasks.[48] Even if the absence of time-consuming tasks means that there will be less need for attorneys on the lower level of the business law pyramid, the rise of artificial intelligence will open up new jobs and new areas of law practice that we can only speculate about today.[49]

Using the automated systems of artificial intelligence tools might save lawyers' time and help to make rote and menial tasks more efficient, but it is difficult to imagine artificial intelligence replacing lawyers completely.[50] When a client goes to a law firm for representation, they expect low-cost and accurate work, but they are also seeking guidance and a personal touch. Client-relations are a very important part of the legal profession, especially in a business law setting, where clients may be entrusting the future of their business to their lawyers.[51] The law is a customer service profession designed to help clients, even where business and corporations are concerned. In this era of technology,

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[45] Croft, *supra* note 3.
[46] Sobowale, *supra* note 2.
[47] Joshua Mirwis, *Artificial Intelligence and the Legal Profession*, LAWCAREERS.NET (June 21, 2016), http://www.lawcareers.net/Information/BurningQuestion/Olswang-LLP-Artificial-Intelligence-and-the-legal-profession.
[48] *Id.*
[49] Jeff Bennion, *Are Robots Going to Take Our Legal Jobs?*, ABOVE THE LAW (June 21, 2016, 2:02 PM), http://abovethelaw.com/2016/06/are-robots-going-to-take-our-legal-jobs/?rf=1.
[50] *Id.*
[51] Jennifer Smuts, *Relationship Development in Today's Law Firm*, LAW PRACTICE TODAY (Aug. 14, 2015), http://www.lawpracticetoday.org/article/relationship-deve;opment-in-todays-law-firm/.

we humans still feel uneasy entrusting important matters to machines.[52] Until artificial intelligence has improved in accuracy and evolved to the point where clients feel comfortable utilizing it in place of a human lawyer, it is difficult to imagine these machines and programs replacing human beings in the legal workforce. Lawyers can rest assured that most legal jobs, especially those that involve working with clients, are safe for now.[53] The legal world is slow to change.[54] Even at firms with extensive artificially intelligent technology, it seems that human lawyers will still be as valuable tomorrow as they are today. Artificial intelligence is still very limited, and while these programs and applications are only able to perform simple time consuming tasks, we will still need lawyers to boldly go where these machines cannot.[55]

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[52] Jason Baldridge, *Machine Learning and Human Bias: An Uneasy Pair*, TECHCRUNCH (Aug. 2, 2015), https://techcrunch.com/2015/08/02/machine-learning-and-human-bias-an-uneasy-pair/.
[53] AlexK2009, *The Impact of Artificial Intelligence on Jobs in the Legal and Software Sectors*, SOAPBOXIE (Dec. 14, 2016), https://soapboxie.com/misc/The-Impact-of-Artificial-Intelligence-on-jobs-in-the-Legal-and-Software-Sectors.
[54] Sobowale, *supra* note 2.
[55] Kelly, *supra* note 22.

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ILLINOIS BUSINESS LAW JOURNAL

THE SHARING ECONOMY: AIRBNB'S DISCRIMINATION PROBLEM

❖ NOTE ❖

*Jason Shultz**

Abstract

Racial discrimination is a systemic issue deeply rooted in American society. One company within the sharing economy cannot possibly change the behavior of the individual hosts that are essentially landlords. This Note examines how Airbnb hopes to achieve an inclusive community for its users, how the new policies will affect hosts and guests, as well as Airbnb as a corporation, and how the traditional Fair Housing Act applies to Airbnb's hosts. Finally, this analysis will illustrate how Airbnb's new focus on inclusion will impact the sharing economy as a whole. Airbnb needs to work with the government to change the current exceptions that allow certain landlords to discriminate against classes of people. These changes include both eliminating the exceptions and reclassifying how landlords are treated under government regulations. By working with lawmakers and other sharing economy companies, Airbnb can make a large impact fighting discrimination in American society.

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*J.D. Candidate, Class of 2019, University of Illinois College of Law. I would like to thank the editors of the *Illinois Business Law Journal*, especially Steven Wittenberg and Jacob Mezei for their feedback and insights to this note. I would also like to thank my family for their encouragement, love and support.

I. INTRODUCTION

Airbnb is changing the way it conducts operations to address discrimination of guests and hosts. In November of 2016, Airbnb brought in Laura Murphy, a consultant who has spent her career fighting for the protection and advancement of civil rights in the United States.[1] Airbnb hired Laura Murphy to assess its practices and find areas that it could improve in order to lay the foundation for change.[2] With the help of Laura Murphy, Airbnb completed a "comprehensive examination of how Airbnb has fought discrimination in the past, where these efforts fell short, and how they can be improved in the future."[3] Following the examination, Airbnb implemented a new antidiscrimination policy that immediately effected guests and hosts, as well as Airbnb's employees.[4] As Airbnb takes on the challenge of reducing and eliminating discrimination in its property rentals, change must happen in the housing laws, especially the Fair Housing Act, to address discrimination industry wide. Airbnb will need to continue evolving its policies so their hosts operate as independent businesses and work together with other leaders in the sharing economy to eliminate laws that protect discrimination.

Part II of this note provides background on what led up to Airbnb's new discrimination policy and what it has done to address complaints of discrimination. Part III describes the effects of Airbnb's changes and the broader impact to the sharing economy. Part IV concludes with what Airbnb must do to advance their fight against discrimination.

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[1] Laura W. Murphy, *Airbnb's Work to Fight Discrimination and Build Inclusion*, AIRBNB 1, 3 (2016), http://blog.airbnb.com/wp-content/uploads/2016/09/REPORT_Airbnbs-Work-to-Fight-Discrimination-and-Build-Inclusion.pdf?3c10be.
[2] *Id.*
[3] *Id.* at 10.
[4] *See id.*

II. BACKGROUND

Airbnb has received negative attention for hosts discriminating against people making reservations.[5] Several widely publicized stories of hosts denying reservations to guests with African American-sounding names forced Airbnb to act and hire prominent civil rights advocates to change their policies.[6] These lawsuits, including an attempted class action, were brought by individuals who suffered discrimination.[7] The new policies focus on changing both the internal culture and behavior of the hosts and guests.[8]

Airbnb's original antidiscrimination policy mainly addressed explicit discrimination and did little to address implicit discrimination.[9] Although, the company did have an antidiscrimination policy in place, it was not prioritized, and as a result, many discrimination claims were ignored by Airbnb's customer service team.[10]

The new Airbnb policies include both changes for the hosts and the guests. Now users must acknowledge the inclusive policies to navigate the website and either list a place or to make a reservation.[11] This updated policy is part of Airbnb's focus on creating a community that is free from discrimination. This goal is clear and represented prominently by their new policies on almost every page of their website.[12] The new policy also requires hosts to accept all reservations except when permitted to reject a reservation by law.[13] Under the

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[5] Elaine Glusac, *As Airbnb Grows, So Do Claims of Discrimination*, N.Y. TIMES (June 21, 2016), https://www.nytimes.com/2016/06/26/travel/airbnb-discrimination-lawsuit.html?_r=0.

[6] Katie Benner, *Airbnb Adopts Rules to Fight Discrimination by Its Hosts*, N.Y. TIMES (Sep. 8, 2016), http://www.nytimes.com/2016/09/09/technology/airbnb-anti-discrimination-rules.html?_r=1.

[7] *Id.*

[8] Laura W. Murphy, *Airbnb's Work to Fight Discrimination and Build Inclusion*, AIRBNB 1, 10 (2016), http://blog.airbnb.com/wp-content/uploads/2016/09/REPORT_Airbnbs-Work-to-Fight-Discrimination-and-Build-Inclusion.pdf?3c10be.

[9] *Id.* at 3.

[10] *Id.* at 16.

[11] *Id.* at 19.

[12] *See*, AIRBNB, https://www.airbnb.com/ (last visited Feb. 19, 2017).

[13] *Airbnb's Nondiscrimination Policy: Our Commitment to Inclusion and Respect*, AIRBNB.COM, https://www.airbnb.com/help/article/1405/airbnb-s-nondiscrimination-policy--our-commitment-to-inclusion-and-respect?topic=533 (last visited Feb. 19, 2017).

new policy, when a host rejects a guest, that reservation date is no longer available for any reservations unless the original party was rejected lawfully.[14] Also, guests who experience discrimination will now have more booking options through the Airbnb customer service team. Airbnb will now guarantee a reservation at another host site, or find a suitable alternative accommodation.[15]

Discrimination is hard to prove because hosts are free to deny reservations for a variety of reasons. Discrimination in housing is also found in traditional purchase or lease housing markets. The U.S. Department of Housing and Urban Development released a study in 2012 highlighting the discrimination in the traditional real estate market. Minorities are shown and informed of fewer listings than white customers.[16] This type of discrimination is also found in jury selection in American courts. Lawyers are not permitted to reject a juror for only demographic reasons.[17] Lawyers can challenge juror discrimination through a batson challenge, requiring the attorney to justify why a juror was removed from the juror pool.[18] Unlike the procedures designed to provide a remedy for juror discrimination, policies at Airbnb have made it difficult for guests to get the same sort of protection as potential jurors.[19] The experience of African American guests was brought to national attention by a Harvard study that showed it was much harder for a person with an African American sounding name to book a reservation.[20] Both studies illustrate a deep societal problem with discrimination. As a response to the negative national attention, Airbnb implemented its new antidiscrimination policies.[21]

III. ANALYSIS

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[14] Murphy, *supra* note 8, at 20.
[15] *Id.* at 21.
[16] Margery Austin Turner et al., *Housing Discrimination Against Racial and Ethnic Minorities 2012*, U.S. DEP'T OF HOUS. AND URBAN DEV. 1 (2013), https://www.huduser.gov/portal/Publications/pdf/HUD-514_HDS2012_execsumm.pdf.
[17] Adam Liptak, *Supreme Court Finds Racial Bias in Jury Selection for Death Penalty Case*, N.Y. TIMES (May 23, 2016), https://www.nytimes.com/2016/05/24/us/supreme-court-black-jurors-death-penalty-georgia.html.
[18] Batson v. Kentucky, 476 U.S. 79, 84 (1986).
[19] Murphy, *supra* note 8, at 16.
[20] Benjamin Edelman, Michael Luca, & Dan Svirsky, *Racial Discrimination in the Sharing Economy: Evidence from a Field Experiment*, AM. ECON. J. 1, 1 http://www.benedelman.org/publications/airbnb-guest-discrimination-2016-09-16.pdf (forthcoming).
[21] Murphy, *supra* note 8, at 13.

This section analyzes how Airbnb's antidiscrimination policy begins with internal changes and what is required to create large national change. Part A of the analysis examines Airbnb's new antidiscrimination policy effects on guests and hosts. Part B explores the impact on Airbnb as a corporation. Part C incorporates how the FHA Rules and exemptions apply to Airbnb as a sharing economy business. Part D concludes with how this new focus of inclusion will impact the sharing economy as a whole. Finally, this Note argues that Airbnb's antidiscrimination policy reform is only a beginning to the goals it hopes to achieve.

A. Effects for Guests and Hosts

The new policy has a limited effect on the hosts, but added several important resources for guests.[22] Two changes that hosts will experience are additional trainings to combat discrimination and limitations to book their rental once they have denied a guest for the same timeframe.[23] The trainings focus on implicit bias, along with other diversity training.[24] However, hosts are still able to reject guests for a variety of reasons, Airbnb merely encourages the hosts to accept as many guests as possible.[25] It will likely have a larger impact on the experience for both guests and hosts if Airbnb makes the new trainings mandatory for the hosts. The changes for the guests include a streamlined system for complaints of discrimination, as well as an open-door policy that guarantees them a place to stay should they experience discrimination during the booking process or their stay.[26] For all users, an agreement to their new inclusive policy is required before one can use the Airbnb platform.[27]

These changes are likely to have a minimal impact for guests and hosts. The most obvious consequence is the inclusive policy that guests and hosts are required to acknowledge to proceed into the reservation portion of the site.[28] This acknowledgement manages expectations for all users as to what type of community they are joining. One may not and probably should not feel like they are joining a community when booking at a standard hotel. However, sense of community is an important part of the sharing economy. The host is

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[22] *Id.*
[23] *Id.* at 11.
[24] *Id.* at 22.
[25] *Airbnb's Nondiscrimination Policy: Our Commitment to Inclusion and Respect*, AIRBNB.COM, https://www.airbnb.com/help/article/1405/airbnb-s-nondiscrimination-policy--our-commitment-to-inclusion-and-respect?topic=533 (last visited Feb. 19, 2017).
[26] Murphy, *supra* note 8, at 22.
[27] *Id.*
[28] *Id.* at 19.

putting up their home and welcoming a stranger to stay with them. Without the community feel, this idea is intimidating. It would seem an easy fix to discrimination to stop using pictures of the users. However, it would be intimidating to go to a strange house and not have confidence that the person claiming to be the host is actually the host. The same benefits apply to hosts so they have a picture of the guest before they welcome a stranger into their home. Therefore, Airbnb did not stop using pictures for both hosts and guests.[29]

B. Effect on Airbnb as a Corporation

There have been several instances of discrimination for Airbnb users and Airbnb believes fighting this discrimination is fundamental to its misson.[30] It has been highlighted for the discriminatory practices of hosts as well as its confusing system to handle complaints.[31] Airbnb is also addressing diversity within its team to make it a stronger company.[32] In their most current report, 9.64% of its staff come from a diverse background.[33] With the new policy it is looking to increase this number to 11% by the end of 2017.[34] Airbnb will also be measuring diversity hires as part of a performance assessment for its recruiting team.[35]

Airbnb has not identified one clear solution, but has implemented several changes to address the issue brought to light by the 2016 report.[36] Airbnb states it will need to address individual biases to fix the root cause of the problem.[37] However, the reality is that racial bias is a major social issue that it will not be able to fix through a new antidiscrimination policy. Regardless, Airbnb has taken significant steps to address racial bias within its organization, and with the hosts.[38] Airbnb is trying to both instill a new culture that focuses on diversity and inclusion at a company-level along with giving all guests and hosts the ability to make reservations without experiencing discrimination.[39]

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[29] Murphy, *supra* note 8, at 23.
[30] *Id.* at 10.
[31] *Id.* at 16.
[32] *Id.* at 12.
[33] *Id.* at 24.
[34] *Id.*
[35] *Id.*
[36] *Id.* at 19.
[37] *Id.* at 4.
[38] *See generally, id.*
[39] *See id.*

Airbnb has taken the additional step of creating a permanent full-time team to fight bias and promote diversity.[40] It has also reduced the use of user photos, especially for guests looking to book a stay.[41] This has an immediate impact for a lot of people, but the initial complaints were for people that had an African-American sounding name.[42] This seems to be a quick attempt to address a problem, but it is not a long-term solution.

Airbnb markets its platform as the forum to rent out unused space to supplement income.[43] This is a great concept as it allows an alternative place to stay and can be beneficial to both hosts and guests. Airbnb was ranked the best company of 2014 on Inc.com, and both hosts and guests find the ease of use preferable over traditional lodging.[44] This alternative lodging benefits areas with insufficient hospitality supply to meet consumer demand. Airbnb is focusing on increasing the number of hosts in the communities that have gone underserved by the traditional lodging options.[45] As a result of this policy shift, Airbnb reported a significant growth in the number of hosts in the underserved areas of New York. This growth rate has exceeded the growth rate for the other parts of the city.[46]

C. FHA Rules and Exceptions

Discrimination in the housing industry has been a target of lawmakers for many years. The Fair Housing Act's purpose is to provide fair housing throughout the United States.[47] For traditional landlords, the Act made it unlawful to refuse to rent or sell based on based on: race, color, religion, sex, family status, or national origin.[48] This rule applies to all housing except for places that meet the Mrs. Murphy exemption.[49] There is another protection under the Civil Rights Act of 1866. This statute provides that all citizens of the United States will have equal rights enjoyed by white citizens with regards

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[40] *Id.* at 24.
[41] *Id.* at 23.
[42] Benjamin Edelman, *supra* note 19.
[43] AIRBNB NEWSROOM: ABOUT US, https://press.atairbnb.com/about-us/ (last visited Feb. 19, 2017).
[44] Burt Helm, *Airbnb is Inc.'s 2014 Company of the Year,* INC., http://www.inc.com/magazine/201412/burt-helm/airbnb-company-of-the-year-2014.html (last visited Feb. 19, 2017).
[45] Murphy, *supra* note 8, at 25.
[46] *Id.*
[47] 42 U.S.C. § 3601 (2012).
[48] *Id.* at § 3604.
[49] *Id.* at § 3603.

to the purchase of lease of real and personal property.[50] This statute has been applied independently of the Fair Housing Act to find landlords liable for discrimination when they would have been protected under the Mrs. Murphy exception.[51]

Under the FHA, there is an exemption to protect landlords who live in the home that they rent.[52] This exemption is known as the Mrs. Murphy rule and was created to protect an old widow that rented out four or less rooms.[53] This law could be used by the hosts that meet the requirements to selectively choose the guests that they desire. They could not market that they were only seeking certain guests, but it would allow them to block certain guests that attempt to make reservations. This law also does not allow for the use of a real estate broker to help locate tenants. There is no precedent which Airbnb has been implicated as a real estate broker, however, it does fit the general description given in the statute.[54] The statute has been applied to include companies that are in the business of rental dwellings, even if the business is not a real estate broker.[55] This would create liability for hosts as they would lose the protection from the Mrs. Murphy exemption for the use of Airbnb's marketing platform.

D. Sharing Economy as a Whole

The broker relationship has created a new problem that is not found in traditional landlord-tenant models. Airbnb's employees are not the ones who decide which specific guest a host will accept or reject.[56] The hosts in Airbnb are directly liable for discrimination issues, but not necessarily Airbnb.[57] Guests may want to sue Airbnb to both push further change and collect larger damages. Hosts are treated as independent contractors which limits the liability for Airbnb.[58] It is difficult for customers to sue the brokerage companies for the actions of the hosts or drivers. Typical companies are liable for the actions of their employees through the doctrine of respondeat superior.[59] Employers assume the liability for their employees' action when they are acting within

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[50] 42 U.S.C. § 1982 (2012).
[51] Johnson v. Zaremba, 381 F. Supp. 165, 167–68 (N.D. Ill. 1973).
[52] 42 U.S.C. § 3603(b).
[53] *Id.*
[54] *Id.*
[55] Singleton v. Gendason, 545 F.2d 1224, 1227 (9th Cir. 1976).
[56] *Terms of Service*, AIRBNB.COM, https://www.airbnb.com/terms (last visited Feb. 19, 2017).
[57] *Id.*
[58] *Id.*
[59] RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006).

their scope of employment. However, respondeat superior does not apply to employers when the liability comes from an independent contractor.[60] Airbnb's hosts are independent contractors, and not actual employees of the company they want to sue.[61]

Airbnb is not the only company in the sharing economy facing this challenge. Almost all companies in the sharing economy must address the issues of implicit bias and how to limit discrimination at the host, or driver level in the case of Uber and Lyft. Both Uber and Lyft, similar to Airbnb, allow car owners to earn money by giving rides to customers who join the respective platform communitites.[62] In the past, this type of relationship was virtually non-existent. As we break away from the typical employee-employer relationship, companies need to figure out how to maintain the same type of customer service that consumers can find at traditional hotels. To accomplish this vision, the hosts must believe in inclusivity and welcome all guests, not just the ones that they want. The right to exclude individuals based on race is surrendered when landlords and hosts choose to start a business.

The sharing economy relies on platforms, such as Airbnb, to facilitate sales.[63] These platforms are becoming common and all have faced similar discrimination problems. Uber has faced many problems for the behavior of their drivers. For instance, Uber has faced problems with drivers harassing their passengers, or not taking passengers to their destination directly.[64] This presents challenges for the platforms as both the passengers and the public blame the platform equally with the tortfeaser. Fighting discrimination needs to be a focus for all companies in the sharing economy. Employees of these companies should be representative of the community they both serve and have created. The sharing economy needs to come to terms with the fact that each host or driver is operating his or her own business.

IV. RECOMMENDATION

Airbnb needs to work with the government to update laws that protect discriminatory practices. Even if the hosts are treated as small business, there are still exemptions such as the Mrs. Murphy rule that allow discrimination in

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[60] RESTATEMENT (THIRD) OF TORTS § 57 (2010).
[61] *Terms of Service*, *supra* note 55; *Terms of Use*, UBER.COM, https://www.uber.com/legal/terms/us/ (last visited Feb. 19, 2017).
[62] *See generally,* UBER, https://www.uber.com/ (last visited Feb. 19, 2017); LYFT, https://www.lyft.com/ (last visited Feb. 19, 2017).
[63] *Terms of Service*, *supra* note 55.
[64] Aimee Picchi, *The Rising Safety Issues that Could Throttle Uber,* CBS MONEYWATCH (Dec. 11, 2014, 3:36 PM), http://www.cbsnews.com/news/the-rising-safety-issues-that-could-throttle-uber/.

real property transactions. Stopping the exemptions that allow for discrimination at the federal level will help enforce the terms and conditions that hosts of Airbnb must follow.

Airbnb needs to work with the other leaders in the sharing economy to address discrimination in this modern marketplace. The ideal resolution is for hosts to switch their mindset to improve the sharing economy, but this solution cannot be practically implemented top-down by Airbnb. One roadblock is the fact that for many people, it is difficult to operate a business that involves welcoming strangers into one's home. Additionally, and more obviously, racism and discrimination are deeply-rooted in American society and will take time to uproot.[65] Airbnb alone cannot remedy centuries of overt hate or subtle discrimination. Hosts should not be able to restrict the types of guests who can enter their properties when they choose to list their property for rent. Airbnb has made a good start to focus on diversity and inclusion, but it must do more, especially if it wants to be a model for the other brokers of the sharing economy.

Hosts are deciding to start a business with the help of a partner who facilitates the booking of their residence. By choosing to start a de facto small business, hosts must recognize that their personal beliefs cannot impact the decisions they make regarding who can stay at their property. Unfortunately, people still face discrimination and there is nothing to stop a homeowner from denying entrance to their home because of the color of someone's skin. However, when a decision is made to get paid for opening one's house to another, the host can no longer dictate who can and cannot stay based on the color of their skin.

Airbnb has shown that big steps must be taken to address the discriminatory practices between the direct contact parties of the hosts and guests. Without hosts undergoing mandatory training before they can welcome guests, only minor changes will be made and progress will be slow. However, if Airbnb truly shows its commitment and focus at the host level first, then it will be a role model for many industries. Within all industries, diversity and inclusion can be a tough area if it isn't the focus for all levels of employees and the people involved with the community. But for the companies that choose

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[65] *See Obama: Racism 'Deeply Rooted' in America*, NBC NEWS (Dec. 8, 2014), http://www.nbcnews.com/politics/barack-obama/obama-racism-deeply-rooted-america-n264256; Glenn C. Loury, *An American Tragedy: The Legacy of Slavery Lingers in Our Cities' Ghettos*, BROOKINGS (Mar. 1, 1998), https://www.brookings.edu/articles/an-american-tragedy-the-legacy-of-slavery-lingers-in-our-cities-ghettos/.

to make diversity and inclusion a priority, they can see vast benefits, not only with community engagement but also to their bottom line.[66]

However, the new policy may not be enough for many users. Airbnb's range of action to prevent hosts from discriminating against their guests is limited. As the broker, Airbnb is in the best position take steps to prevent all their customers from discrimination. The best solution would be to mandate anti-discrimination training for all hosts. With its focus on changing from the inside out, it is likely that the most promising progress will come about organically. Unfortunately, Airbnb does not give much immediate change for the guests facing discrimination. These changes have only begun to streamline the complaint process and provide more anti-discrimination training.

Despite the changes that Airbnb has implemented, there is still more to be done to stop discrimination in the Airbnb system and the sharing economy as a whole. There will be an immediate impact for the employees, but the change will be slow to reach the hosts. Airbnb operates solely as a platform for guests and hosts; it does not own or operate any properties.[67] The goal is to prevent the hosts and property owners from engaging in discriminatory practices. Companies that operate in the housing market need to come together to repeal the Mrs. Murphy exemption. Airbnb can also do more to require hosts to adhere to commercial landlord-tenant laws by treating the hosts as small business owners instead of independent contractors.

V. CONCLUSION

Airbnb has taken a big step to address discrimination problems that have recently made headlines.[68] It recruited civil rights advocates to form a strategic plan to create a new antidiscrimination policy and to foster an inclusive policy.[69] The discrimination problem is not unique to Airbnb and is something many companies in the sharing economy have addressed. To further address discrimination, the laws that exempt certain landlords to still turn guests away based on race must be repealed. All landlords must be held to the same standard that large commercial landlords follow. Without laws prohibiting discrimination for the new type of landlord that Airbnb has created, their

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[66] *See* Ruchika Tulshyan, *Racially Diverse Companies Outperform Industry Norms by 35%*, FORBES (Jan. 30, 2015), http://www.forbes.com/sites/ruchikatulshyan/2015/01/30/racially-diverse-companies-outperform-industry-norms-by-30/.
[67] *Terms of Service*, *supra* note 55.
[68] Sam Levin, *Airbnb Adopts New Rules in Effort to Fight Racial Discrimination by Hosts,* THE GUARDIAN (Sep. 8, 2016, 10:26 AM), https://www.theguardian.com/technology/2016/sep/08/airbnb-discrimination-policy-changes-racial-discrimination.
[69] Murphy, *supra* note 8, at 6.

policies will not have a significant impact. Discrimination is a significant problem for the sharing economy and one that Airbnb will not be able to change alone. Racial bias is an issue that everyone must acknowledge and address individually. If sharing economy leaders can start conversations to identify these biases, they may catalyze change in sharing economy host behavior.

VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

IS A 3-D PRINTED OBJECT A PRODUCT?

❖ NOTE ❖

*Joe Yeoman**

Abstract

This Note argues that a 3-D printed object and its design file should be considered products, and thus potential defendants be held strictly liable for any defects. Based on the growing popularity of home-based 3-D printing, the potential harms that will arise from defective objects requires that action be taken now to define these objects and their design files as products. Currently, the American Law Institute (ALI) and their persuasive Restatements do not completely cover home-based 3-D printing. This Note examines what the ALI can do when releasing a new version of their Restatement of Torts. Additionally, this Note proposes a solution that will balance the need to help injured parties, while protecting innocent hobbyists.

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I. INTRODUCTION

Loading a .357 Magnum bullet into the plastic gun, cocking back the rubber bands, and squeezing the trigger, the tension in the rubber bands

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releases and drives a roofing nail into the bullet.[1] The bullet does exactly what it was designed to do. It fires.[2] The barrel of the plastic gun splits down the middle.[3] The YouTube Reviewer was lucky. In this case, the gun barrel slightly snaps.[4] At 9 minutes and 31 seconds into the video, it can be seen that the barrel of the gun has been split down the middle, half way down the entire barrel length.[5] In the future, he may not be so lucky.

If this was a normal gun that had exploded in his hands, the Reviewer would likely have a prima facie case for strict liability against the gun manufacturer and designer. The purpose of strict liability in products liability cases is "to be that the seller, by marketing his product for use and consumption, has undertaken and assumed a special responsibility toward any member of the consuming public who may be injured by it . . . ."[6] With strict liability, the potential plaintiff "is entitled to the maximum of protection" by accidental injuries caused to him or her by a defective product.[7] The first step he would need to show is that the gun is a "product."[8] A product can be defined as ". . . tangible personal property distributed commercially for use or consumption."[9] In terms of distributed commercially, the consumer would have purchased it from a dealer, who in turn purchased it from a distributor, who in turn purchased it from a manufacturer. Most likely, a court would agree that the hypothetical gun is a product, and then the plaintiff would move on to other strict liability arguments. But this is no ordinary firearm.

The novel thing about the gun in the YouTube video: it was printed from the comfort of the Reviewer's own garage.[10] The Reviewer was able to go on GitHub and download a computer-aided design (CAD) file from James R Patrick.[11] From there, he used a home-based 3-dimensional (3-D) printer to print out each piece of the gun.[12] By adding a rubber band and a roofing nail,

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[1] Guy in a garage, *Songbird 3D Printed Piston*, YOUTUBE (Sep. 1, 2016), https://www.youtube.com/watch?v=1jFjtE7bzeU [hereinafter YouTube Reviewer].
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] RESTATEMENT (SECOND) OF TORTS § 402A cmt. b (AM. LAW. INST. 1965).
[7] *Id.*
[8] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 19 (AM. LAW. INST. 1998).
[9] *Id.*
[10] *See* YouTube Reviewer, *supra* note 1.
[11] James R. Patrick, *PM422 Songbird .22LR Pistol*, GITHUB, https://github.com/maduce/fosscad-repo/tree/master/Firearms/PM422_Songbird_22lr_Pistol_v2.1-JamesRPatrick (last visited Jan. 13, 2017).
[12] *See id.*

the Reviewer, with the help of James R Patrick's design, was able to manufacture a working, single-shot pistol.[13] In this case, the Reviewer was his own distribution chain. The design was digital and never in tangible form. In the classic sense, the 3-D printed gun is not a "product." But if the classic definition of product always ruled, then any item printed on a personal 3-D printer would not be a product, even though it is a tangible object. Such a definition would bar all strict liability claims from going any further in court.

Strict liability "does not depend on proof of negligence or intent to do harm but that is based instead on a duty to compensate the harms proximately caused by the activity or behavior subject to the liability rule."[14] Defective products can be considered under the theory of strict liability.[15] As the Second Restatement of Torts (R2d (Torts))states: "One who sells any product in a defective condition unreasonably dangerous to the user . . . ."[16] Under traditional products liability, a product goes through a distribution chain before it reaches a consumer.[17] This is also echoed in the Third Restatement of Torts (R3d (Torts)): "One engaged in the business of selling or otherwise distributing products who sells or distributes a defective product is subject to liability for harm to persons or property caused by the defect."[18] This means that for strict liability, a basic threshold that a plaintiff will need to pass is if the digital file or software used to produce the 3-D printed objected is, itself, a product or not. Currently, there is no clear-cut answer here. Some commentators have suggested that courts have already laid the groundwork for a digital file to be considered a product.[19] However, there are no court cases that explicitly define a digital file used in home-based 3-D printing as a product.

The purpose of this Note is to explore the question of whether 3-D printed objects and their designs are products. Part II of this Note explores the background of 3-D printing. Part III analyzes if a 3-D printed object is an object by delving into what is a product (Section A) and if 3-D printed object are part of the analysis (Section B). Part IV proposes solutions to how 3-D printed objects could be considered products.

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[13] *See id.*
[14] *Liability*, BLACK'S LAW DICTIONARY (10th ed. 2014).
[15] *Product Liability*, BLACK'S LAW DICTIONARY (10th ed. 2014).
[16] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[17] *Id.* cmt. f.
[18] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 1 (AM. LAW. INST. 1998).
[19] David Berke, *Products Liability in the Sharing Economy*, 33 Yale J. on Reg. 603, 610 (2016).

II. BACKGROUND: 3-D PRINTING INDUSTRY

Industrially, 3-D printing has been around since 1981, and was dubbed "Additive Manufacturing."[20] Mostly, it did not disrupt the normal distribution chain on manufacturing, which meant that product liability did not change. If a person was injured based on a design flaw, there was an identifiable tortfeasor and defendant. In essence, the courts could move forward business as usual.

The 3-D revolution has centered around the desktop printer that can be purchased on Amazon for as low as $219.[21] To put things in perspective, a modern gaming system will cost more than a 3-D printer.[22] This means that anyone with a computer and a credit card can become his or her own manufacturer.[23] All he or she needs to do is purchase the 3-D printer and learn how to work the printing software.[24] Now, aided by an Internet connection, people can download thousands of CAD files and start making objects. Users generate most of the objects that can be created.[25] On Thingiverse, an online distributor provided by MakerBot (which is a 3-D printer manufacturer), a user can upload and download as many designs as he or she would like. Thingiverse has a "Verified Prints" program, where the company tests some of the 3-D designs and authenticates their utility.[26] However, most of the designs on the site are not verified, but the company states that "[e]xperimental works-in-progress are a key part of what makes Thingiverse amazing."[27]

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[20] Dana Goldberg, *History of 3D Printing*, REDSHIFT (Sep. 5, 2014), https://redshift.autodesk.com/history-of-3d-printing/.
[21] *Monoprice Select Mini 3D Printer*, AMAZON, https://www.amazon.com/Monoprice-Select-Printer-Heated-Filament/dp/B01FL49VZE/ref=sr_1_3?s=industrial&ie=UTF8&qid=1484155891&sr=1-3&keywords=3d+printer (last visited Feb. 19, 2017).
[22] *Sony PlayStation 4 500GB*, AMAZON, https://www.amazon.com/Sony-PlayStation-4-500GB-Console/dp/B00BGA9WK2/ref=sr_1_4?s=videogames&ie=UTF8&qid=1484156542&sr=1-4&keywords=playstation+4 (last visited Feb. 19, 2017).
[23] Dana Goldberg, *History of 3D Printing*, REDSHIFT (Sep. 5, 2014), https://redshift.autodesk.com/history-of-3d-printing/.
[24] *See* Dana Goldberg, *supra* note 19 *Id.*
[25] *Id.*
[26] *Thingiverse Verified Prints*, MAKERBOT (Oct 16, 2013), https://www.makerbot.com/media-center/2013/10/16/thingiverse-verified-prints.
[27] *Id.*

The 3-D printing industry is growing.[28] In 2016, the projected revenue worldwide was $15.9 billion.[29] In 2017, it is $20.7 billion, and in 2020, $35.4 billion.[30] The uses of 3-D printing are literally growing, too. In China, a construction company is printing two-story homes.[31] In Amsterdam, a bridge builder is printing the first 3-D printed bridge.[32] The trend is that the uses and types of 3-D printing are growing and becoming more complex.

As the growth in 3-D printing continues, the demographic of users will likely grow from interested hobbyists to everyday Americans.[33] Eventually, websites like Thingiverse and independent object designers will become a major part of the new manufacturing distribution chain. Instead of buying a toy from Mattel, a user will be able print his or her toys at home. As an example of scale, Thingiverse has over 700,000 digital files that can be downloaded and printed.[34] As the growth of 3-D printing entails a circumvention of the traditional distribution chain, it is important to properly define the design files and printed objects properly for strict liability purposes.

III. ANALYSIS

A. Product Liability: What is a Product?

In a classic design defect case, *Filler v. Rayex Corp.*, a teenage baseball player was wearing Rayex's baseball sunglasses when he was struck in the face with a fly ball.[35] The glass portion of the product shattered into pieces, splintering into the baseball player's right eye.[36] The court applied the § 402A of R2d (Torts).[37] The court held that "here the thinness of the lenses made

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[28] Alexis Kramer, *3-D Printing Leaps Ahead of Product Liability Law*, BLOOMBERG (Sep. 28, 2016), https://www.bna.com/3d-printing-leaps-n57982077638/.
[29] *Id.*
[30] *Id.*
[31] Clare Scott, *Chinese Construction Company 3D Prints an Entire Two-Story House On-Site in 45 Days*, 3DPRINT.COM (Jun. 16, 2016), https://3dprint.com/138664/huashang-tengda-3d-print-house/
[32] Michael Molitch-Hou, *Construction of World's 1st 3D Printed Bridge Begins in Amsterdam*, 3D PRINTING INDUS. (Oct. 16, 2015), https://3dprintingindustry.com/news/construction-of-worlds-1st-3d-printed-bridge-begins-in-amsterdam-60110/.
[33] Nicole D. Berkowitz, *Strict Liability for Individuals? The Impact of 3-D Printing on Products Liability Law*, 92 Wash. U.L. Rev. 1019, 1027 (2015).
[34] *About*, THINGIVERSE, http://www.thingiverse.com/about/ (last visited Feb. 19, 2017).
[35] Filler v. Rayex Corp., 435 F.2d 336, 338 (7th Cir. 1970).
[36] *Id.*
[37] *Id.*

them unreasonably dangerous to users, so that the doctrine of strict liability is applicable."[38] For strict liability, the overarching rule is that a "seller" is responsible for defective products.[39] While "[p]roducts liability statutes vary by state, but the 'seller' is generally defined as 'any person or entity that is engaged in the business of selling products, whether the sale is for resale, or for use or consumption.' Thus, this definition of 'seller' covers not only retailers, but also manufacturers, wholesalers, distributors, and designers of products."[40] The glasses were marketed as a protective gear for baseball, even though the company knew that it would not protect against this type of force.[41] This is a model example of a "seller" being held liable for a design defect in a product. A "seller" sold a product in a defective condition. In this situation, any "sellers" in the distribution chain could be held strictly liable for the defective product. The remedies available for defective products are thus closely linked to the product's distribution chain.

Defining what is and what is not a "product" can sometimes be difficult. R2d (Torts) defines the liability for "[o]ne who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer. . ." [42] It does not specifically define what a "product" is. In the commentary, it is discussed as:

> It extends to any product sold in the condition, or substantially the same condition, in which it is expected to reach the ultimate user or consumer. Thus the rule stated applies to an automobile, a tire, an airplane, a grinding wheel, a water heater, a gas stove, a power tool, a riveting machine, a chair, and an insecticide. It applies also to products which, if they are defective, may be expected to and do cause only "physical harm" in the form of damage to the user's land or chattels, as in the case of animal food or a herbicide.[43]

Most likely, because R2d (Torts) was written back in 1965, the products described in the comment are all tangible.

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[38] *Id.*
[39] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[40] Nicole D. Berkowitz, *Strict Liability for Individuals? The Impact of 3-D Printing on Products Liability Law*, 92 Wash. U.L. Rev. 1019, 1027–28 (2015).
[41] *Filler*, 435 F.2d at 338.
[42] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[43] RESTATEMENT (SECOND) OF TORTS § 402A cmt. d (AM. LAW. INST. 1965).

R3d (Torts) defines "product" as:

> A product is tangible personal property distributed commercially for use or consumption. Other items, such as real property and electricity, are products when the context of their distribution and use is sufficiently analogous to the distribution and use of tangible personal property that it is appropriate to apply the rules stated in this Restatement.[44]

In both Restatements, products are typically tangible, and bought or sold. Like in *Filler v. Rayex Corp.,* the sunglasses were tangible and commercially bought and sold.[45] Under these definitions, the commonality is that a manufacturer makes an item and then sells it. Therefore, a primary characteristic of a product is that it is part of a distribution chain. Since most manufacturers do not directly sell to their consumers, it is important for potential plaintiffs to identify each link in the distribution chain, because each link may be strictly liable. Under R2d (Torts), this means that every link in the distribution chain that

> is engaged in the business of selling products for use or consumption [may be liable under strict products liability]. It therefore applies to any manufacturer of such a product, to any wholesale or retail dealer or distributor, and to the operator of a restaurant. It is not necessary that the seller be engaged solely in the business of selling such products.[46]

For a strict liability case, it is then important to identify the entire distribution chain to find potential defendants that may be liable for a product's defect as each producer along the chain may be liable. For example, the manufacturing of a tire is very complex from sourcing rubber, the design, the mold, and finally quality control.[47] Before it reaches the consumer, it has gone through a formal prototyping and testing process. It has also been shipped to a distributor, then taken to a store, and sold commercially. Typically, this formal manufacturing and distribution chain defines which products may be held to strict liability. The tire manufacturer, distributor, and store may be held strictly liable for a

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[44] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 19(a) (AM. LAW. INST. 1998).
[45] Filler v. Rayex Corp., 435 F.2d 336, 338 (7th Cir. 1970).
[46] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[47] *How is a Tire Made?*, MICHELIN, http://www.michelinman.com/US/en/help/how-is-a-tire-made.html (last visited Feb. 19, 2017).

tire's defects. Whereas, an occasional seller would not be held to the same standard.[48] The neighbor who sells his or her car to another neighbor would not be held liable in the distribution chain.[49]

These descriptions of a product do not easily translate into the new digital economy. A design file that can be downloaded at any time from GitHub's servers is not the same type of product as an airplane or a gas stove. True, the 3-D printer and the filament are both products under the definitions, but the question of whether the raw design file is a product is more complicated. It could be argued that there was a formal process to make the file,[50] and that it went through a distribution process. Unlike a tire, it is not definite that a design file is a product. If it is not a product, then it could be argued by a defendant that the object made from the file is also not a product, even if the plaintiff paid to download the file.

Digital files on their own are not tangible, but when the data is transferred to a 3-D printer, they are made tangible. There is more leeway in R3d (Torts) for design files to be considered products. The purpose of a design file for 3-D printing is to be "consumable." It is meant to be downloaded and then printed. Further, like electricity which is a necessary component of another product (e.g. a blender), a design file is an essential part of the 3-D printed object. Also, a design file is distributed in a way that can be analogized to traditional distribution. A consumer can walk into a Target and purchase an item that Target distributes. A consumer can also log onto Thingiverse and download a file that Thingiverse distributes. For this argument, 3rd party platforms that transmit digital design files will therefore be treated as "online distributors" because, like a store, they act as the gateway between the designer and consumer.

B. 3-D Printed Objects as Products

As an overview, there is a distinct line between the objects printed at home and those that you can buy online. First, it is important to look at what objects would currently be classified as products under the Restatements, because it will help lay the groundwork for homebased 3-D printed objects being included as products. On Shapeways, another online distributor that sells designs and objects, a customer can purchase a pre-printed item from

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[48] RESTATEMENT (SECOND) OF TORTS § 402A cmt. f (AM. LAW. INST. 1965).
[49] *Id.*
[50] *What is the Engineering Design Process?* VEX ROBOTICS, http://curriculum.vexrobotics.com/curriculum/intro-to-engineering/what-is-the-engineering-design-process (last visited Feb. 19, 2017).

Shapeways.[51] For example, a customer can buy a 3-D printed miniature catapult and have it shipped to them.[52] Unlike Thingiverse, the transaction of collecting money, printing an object, and then sending it to the consumer makes Shapeways a producer of goods. In court, Shapeways may argue that they are just a service provider and that their products do not come under the Restatements' definition of product. But this argument will not likely prevail because they are ultimately sending consumers a finished object. Overall, there is a much clearer path that the printed catapult is a product.

The printer and the printing material are also both products. A consumer can purchase a desktop 3-D printer from a manufacturer, like MakerBot.[53] On April 4th, 2016, MakerBot sold their 100,000th 3-D printer.[54] Traditional strict liability laws would give consumers a remedy for possible design flaws. Many different manufacturers, including MakerBot, sell the filament material.[55] If there were manufacturing or design defects in the filament, a consumer would also be protected by traditional strict liability laws. If the printer and filament are operating correctly, then the final litigation area to explore would be the design of the object, i.e. the design file.

For a digital file to be considered a "product," it may depend on if the court views the design as a highly technical tool, like an Aeronautical chart, or as a how-to guide, like a cookbook. In *Saloomey v. Jeppesen & Co.*, the Second Circuit held that maps could be considered products, and thus the company could be held liable for the wrongful deaths of those in a plane crash.[56] The court reasoned:

> The charts, as produced by Jeppesen and supplied to Wahlund by Braniff, reached Wahlund without any individual tailoring or substantial change in contents—they were simply mass-produced. The comments to § 402A, *supra,* envision strict

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[51] *About* Us, SHAPEWAYS, http://www.shapeways.com/about?li=footer (last visited Feb. 19, 2017).
[52] Stefano Alberti, *Catapult, the ultimate weapon,* SHAPEWAYS, http://www.shapeways.com/product/CZAYASA2K/catapult-the-ultimate-weapon-watch-the-video?optionId=42612343&li=marketplace (last visited Feb. 19, 2017).
[53] *About MakerBot*, MAKERBOT, https://www.makerbot.com/about-us/ (last visited Feb. 19, 2017).
[54] *MakerBot Reaches Milestone: 100,000 3D Printers Sold Worldwide*, MAKERBOT (Apr. 4, 2016), https://www.makerbot.com/media-center/2016/04/04/makerbot-reaches-milestone-100000-3d-printers-sold-worldwide.
[55] *Makerbot Filament*, MAKERBOT, https://www.makerbot.com/filament/ (last visited Feb. 20, 2017).
[56] Saloomey v. Jeppesen & Co., 707 F.2d 671, 671 (2d Cir. 1983).

> liability against sellers of such items in these circumstances. By publishing and selling the charts, Jeppesen undertook a special responsibility, as seller, to insure that consumers will not be injured by the use of the charts; Jeppesen is entitled—and encouraged—to treat the burden of accidental injury as a cost of production to be covered by liability insurance.[57]

For a how-to guide or a cookbook, courts have stated that the book itself is a product, but the ideas contained inside the book are intellectual property and not a product. Referencing *Jeppesen*, in *Winter v. G.P. Putnam's Sons*, the Ninth Circuit distinguished between how-to guides and an aeronautical chart:

> Aeronautical charts are highly technical tools. They are graphic depictions of technical, mechanical data. The best analogy to an aeronautical chart is a compass. Both may be used to guide an individual who is engaged in an activity requiring certain knowledge of natural features. Computer software that fails to yield the result for which it was designed may be another. In contrast, *The Encyclopedia of Mushrooms* is like a book on how to *use* a compass or an aeronautical chart. The chart itself is like a physical "product" while the "How to Use" book is pure thought and expression.[58]

In the case, mushroom enthusiasts were injured by ingesting poisonous mushrooms.[59] The book in question identified the mushrooms as safe.[60] The court sided with the book publisher because the book itself, the paper and binding, was the product.[61] The ideas were intellectual property and not a product.[62]

A design file could be argued to be a step-by-step guide like a cookbook. It would then be considered intellectual property and not a product, and thus the end result object is also not a product. There is some merit to this argument. A design file, or "computer program," or a cookbook can be

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[57] *Id.* at 676–77.
[58] Winter v. G.P. Putnam's Sons, 938 F.2d 1033, 1036 (9th Cir. 1991).
[59] *Id.* at 1034.
[60] *Id.*
[61] *Id.* at 1036.
[62] *Id.*

copyrighted.[63] Courts have held that a computer program is a "work of authorship" and the silicon chip is the "tangible medium of expression."[64] The copyright statute even defines a computer program, which is a design file, as "a set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result."[65] It could then be argued that the design is the intellectual property, like the cookbook, and that any object 3-D printed is just like a user following a recipe. If the recipe comes out bad, it is not the fault of the intellectual property.

In reality, however, the design file is not a step-by-step guide for the user to follow. Rather, it is an instruction manual to tell the printer what to print. The design's purpose is to transmit specific data to a printer, and then for the printer to create using that data. It is more analogous to a design for physical construction of the cookbook and how it should be bound. Overall, the consumer is absent from the design and printing process. In contrast, in a cookbook, the consumer is present for all of the steps.

There are several court cases that have designated software as a product. In the footnote of *Hou-Tex, Inc. v. Landmark Graphics*, the Court of Appeals of Texas (14th District) stated "[w]e accept that the SeisVision software is a product for purposes of this appeal because, as shown by the undisputed summary judgment evidence, it is a highly technical tool used to create a graphic representation from technical data."[66] Similarly, 3-D printing design files are highly technical and made specifically to print an object.

Courts have also distinguished between the intellectual property and product of software. In a case where a child harmed another child based on what he saw in a video game, the court held that the intellectual property was not appropriate for strict liability.[67] The court stated, "the line drawn in these cases is whether the properties of the item that the plaintiff claimed to have caused the harm was 'tangible' or 'intangible.'"[68] In the case of a video game, the "tangible" product is the physical game: the plastic cartridge that transmits the data to the gaming device. The "intangible" is the content or storyline of the game, which is not considered a product. For 3-D printing, the design starts as intangible data and then moves into the tangible world. This is why a 3-D printing design file is distinguishable from the content found in a video game.

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[63] Williams Elecs., Inc. v. Artic Int'l, Inc., 685 F.2d 870, 875 (3d Cir. 1982).
[64] Tandy Corp. v. Pers. Micro Computers, Inc., 524 F. Supp. 171, 173 (N.D. Cal. 1981).
[65] 17 U.S.C. § 101 (2010).
[66] Hou-Tex, Inc. v. Landmark Graphics, 26 S.W.3d 103, 107 (Tex. App. 2000).
[67] Wilson v. Midway Games, Inc., 198 F. Supp. 2d 167, 173 (D. Conn. 2002).
[68] *Id.*

One other hurdle that potential plaintiffs will need to cross is that most of the design files offered now are free of charge. The cost of a product may matter because R2d (Torts) focuses on one who "sells" a product, which implies that there has been some transaction.[69] Indeed, R3d (Torts) defines free items as "giveaways" specifically for promotional purposes.[70] Under R3d (Torts), a plaintiff receiving a free item would not have a claim against the final distributor of the free product, for example, a store giving away a free sample would not be liable for the sample.[71] Instead, a plaintiff would have a claim against the other "commercial sellers who sold the product in a defective condition."[72] Under this definition, it would bar a plaintiff against recovery from an online distributor like Thingiverse, while still allowing for a potential recovery from the individual designer. Thingiverse offers the design files as free downloads. Consumers can "tip" a designer, but ultimately, the design files are available for free.[73] For a plaintiff, this is important because most individual designers will be judgment proof because they are either occasional sellers or do not have the money to pay for potential injuries. For Thingiverse and other websites, they are in a better position to insure against this kind of liability.

Some courts have held that strict liability can attach to free-of-charge products. In *Perfection Paint & Color Co. v. Konduris*, an employee was killed when lacquer reducer caught fire.[74] The defendant argued that the remover was given to the store free-of-charge and thus was exempt from the imposition of strict liability.[75] The Appellate Court of Indiana (Division No. 2) held that free-of-charge items could still be considered products for strict liability.[76] The court reasoned:

> The Restatement does not attempt to define those commercial transactions which may or may not constitute a 'sale' for purposes of imposing strict liability. Rather, the Restatement Comments (see 2 Restatement of Torts, 2d, s 402A at 348-358) refer in context to 'a special rule applicable to sellers of products' and emphasize that the rule of strict liability 'extends to any product sold in the condition, or substantially the same condition, in which it is expected to reach the ultimate

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[69] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[70] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 20 cmt. b (AM. LAW. INST. 1998).
[71] *Id.*
[72] *Id.*
[73] *User-to-User Payment Terms*, THINGIVERSE , http://www.thingiverse.com/legal/user-payments (last visited Feb. 19, 2017).
[74] Perfection Paint & Color Co. v. Konduris, 147 Ind. App. 106, 112–13 (1970).
[75] *Id.*
[76] *Id.*

> consumer'. The instification [sic] for the rule of 'strict liability' rests upon the premise 'that the seller, by marketing his product for use and consumption, has undertaken and assumed a special responsibility toward any member of the consuming public who may be injured by it; that the public has the right to and does expect, in the case of products which it needs and for which it is forced to rely upon the seller, that reputable sellers will stand behind their goods; that public policy demands that the burden of accidental injuries caused by products intended for consumption be placed upon those who market them . . . .[77]

For 3-D printing, the designer is "marketing" his or her design by making it available on an online distributor, and in turn, the distributor is marketing its services to consumers across the Internet. The designer and distributor intend for the design to be consumed. It could be argued that, although the download is free, that does not mean that the designer or distributor should be exempt from strict liability.

For online distributors, most of the terms of service treat the digital file as "content."[78] For example, Thingiverse has over 701,000 digital files that can be downloaded and printed.[79] In Thingiverse's terms of service, it describes this content as such:

> 3.1 User Content. You retain all your intellectual property rights in your User Content. "User Content" means any and all information and content that a User submits to, or uses with, the Sites or Services (e.g., content in the User's profile or postings). You are solely responsible for your User Content. *You assume all risks associated with use of your User Content*, including any reliance on its accuracy, completeness, or usefulness by others, or any disclosure of your User Content that makes you or any third party personally identifiable…[80]

The terms of service for people downloading software on Thingiverse is as follows:

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[77] Perfection Paint & Color Co. v. Konduris, 147 Ind. App. 106, 112–13, 258 N.E.2d 681, 685 (1970).
[78] *Makerbot Terms of Use*, THINGIVERSE (Apr. 28, 2016), https://www.thingiverse.com/legal/terms
[79] *About,* THINGIVERSE, http://www.thingiverse.com/about/ (last visited Feb. 191, 2017).
[80] THINGIVERSE, *supra* note 71 (emphasis added).

> 6.2 Other Users. Each User is solely responsible for any and all of its User Content. Because we do not control User Content, you acknowledge and agree that we are not responsible for any User Content and we make no guarantees regarding the accuracy, currency, suitability, or quality of any User Content, and *we assume no responsibility for any User Content*. Your interactions and transactions with other Users are solely between you and such User. You agree that the Company will not be responsible for any loss or damage incurred as the result of any such interactions...[81]

Thingiverse is mimicking other websites' terms of service to provide a legal barrier between claims against the site and its users. It is trying to be another digital platform for users to share content, like Instagram or SnapChat. Unlike those platforms, users of Thingiverse will be able to download the User Content and make tangible objects, like the YouTube Reviewer's plastic gun.[82] On Instagram, the user experiences the content visually, which is considered "media speech" and "[f]rom a products liability perspective, this facet of the software is untouchable."[83] Based on the nature of the user content, Thingiverse becomes an online distributor and should be limited in their ability to contract around liability.

Design files for 3-D printing should be considered a product. Items, including electricity, when taken into the context of their use are also considered products.[84] Here, the goal of the design file is to be used to create a physical object. The context of the data is to create something tangible. The designer's intentions are for users to create tangible objects. It would only be logical for the designer to take responsibility for the design file and the 3-D printed object.

IV. PROPOSAL

If a 3-D printed gun is not a "product" for strict products liability purposes, when it explodes in a user's hand, then the user could be financially responsible for his or her own injuries. For popular designs, serious design flaws could result in thousands of people being maimed without a path for legal recourse. If the 3-D printed object is a "product," injured plaintiffs will have

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[81] *Id.* (emphasis added).
[82] YouTube Reviewer, *supra* note 1.
[83] *See* David Berke, *supra* note 19 at 616.
[84] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 19 (AM. LAW. INST. 1998).

strict liability open as a bright line remedy for their damages. There would be an easy and legally cognizable path for injured plaintiffs to be made whole.

This Note's first recommendation is to amend R3d (Torts) or introduce a new Restatement to better address the digital world as a whole. The American Law Institute (ALI) is drafting new revisions to R2d (Torts) for International Personal Torts,[85] and Economic Loss.[86] R3d (Torts) was published in 1998;[87] thus, when the Restatements were written, there were no consumer 3-D printers.[88] Instead, all of the 3-D printers were exclusively used commercially, and 3-D prints went through the same process as many manufactured goods.[89] Most likely, the drafters would not have predicted that someone sitting in a garage could download the designs to a gun and have it printed in a few hours. R2d (Torts), which is still used by many courts, was written in 1965.[90] This has forced the courts to determine, alone, if software is or is not a product for products liability cases.

In R2d (Torts), the drafters commented that strict liability extends to "any product sold in the condition, or substantially the same condition, in which it is expected to reach the ultimate user or consumer."[91] On its face, this would not include objects that are printed at home. The design file and 3-D printed object would be viewed as separate parts of the transaction. The downloaded file would be in the same condition as it is expected to reach the user, and it could be argued that the transaction between seller and user is over. The "consumption" would be the act of printing and not the final outcome. In R3d (Torts), the definition of the product stretches to "[ot]her items, such as … electricity . . . [and] are products when the context of their distribution and use is sufficiently analogous to the distribution and use of tangible personal property."[92] However, R3d (Torts) does not build on this definition to include software or intangible forms of communication done on a computer.[93] The

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[85] *Torts: Intentional Torts to Persons*, AM. LAW INST., https://www.ali.org/projects/show/torts-intentional-torts-persons/ (last visited Feb. 19, 2017).
[86] *Torts: Liability for Economic Harm*, AM. LAW INST., https://www.ali.org/projects/show/torts-liability-economic-harm-3rd/ (last visited Feb. 19, 2017).
[87] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 19 (AM. LAW. INST. 1998).
[88] *A Brief Historical View of Additive Manufacturing*, ACADEMY OF AEROSPACE QUALITY, http://aaq.auburn.edu/node/1353 (last visited Feb. 19, 2017).
[89] *Id.*
[90] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).
[91] *Id.*
[92] RESTATEMENT (THIRD) OF TORTS: PROD. LIAB. § 19 (AM. LAW. INST. 1998).
[93] *Id.*

Restatements are not binding law; however, they are highly persuasive and are written by the ALI. The ALI's mission is "to promote the clarification and simplification of the law and its better adaptation to social needs, [and] to secure the better administration of justice. . . ."[94] The ALI woefully did not predict the ability of thousands of people to buy a defective design with a few clicks on a website. To stay true to its mission, the ALI should update the Restatements to reflect digital design files.

In the Restatements, there needs to be a modernizing shift to cover digital torts. Currently, the document has the classic distribution chain covered, but it needs to expand to include digital and personal creations to keep up with the expansion in new technology. The benefit of a new section in the Restatement is that the drafters can contemplate and fully discuss how the digital world impacts strict liability. If other characteristics stay the same, including the caveat for occasional sellers, then the occasional designer will be protected from a strict liability case if the jurisdiction follows the Restatement.

The negatives of waiting on the ALI are that a new draft will take years to publish.[95] A change might also force online distributors to add adequate warnings and more explicit terms of service. Eventually, if the change was made, there would be a challenge to the platforms on their liability. This might force the platforms to carry adequate insurance to cover their liability. If the goal of tort litigation is to make the injured party whole, the positives outweigh the negatives. Without a change to the Restatements, injured parties' complaints will have more difficulty convincing courts that digital files are products within the meaning of state products liability laws.

The second solution is to persuade the courts to interpret "electricity" in R3d (Torts) as "software." The positive to this approach is that it can happen almost immediately. A plaintiff could argue that the software, like electricity, is transferred from a creator to a consumer as a product. The negative to this approach is that each jurisdiction is an island, and if there is no guiding light by the ALI's Restatement, then outcomes across jurisdictions will be less uniform and therefore less predictable for businesses and consumers.

This solution needs to be implemented before 3-D printing becomes as common as an inkjet printer. As more Americans become makers, the long-term consequences will be harder to litigate in court. There would be no specific guidance from the Restatements, and the courts could begin to declare that a 3-D printed object is not a product under strict liability. The decisions

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[94] *Creation*, AM. LAW INST., https://www.ali.org/about-ali/creation/ (last visited Feb. 19, 2017).

[95] *See Current Projects*, AM. LAW INST., https://www.ali.org/projects/ (last visited Feb. 19, 2017).

will then bind the court in the future, when 3-D printing is commonplace. Eventually, there will be a designer who sells a toy design specifically to one user on Thingiverse. Then that maker will become a part-time manufacturer, printing toy-after-toy. The maker then will sell the toys over Etsy, an online marketplace for individuals and manufacturers to sell unique goods, profiting off the wares.[96] There will be no testing, prototyping, or oversight. Then that toy will eventually hurt some child. Courts will then have to wrestle with who is liable out of the four possible defendants: designer, maker, Thingiverse, and Etsy. We need solutions before millions of individuals become part-time manufacturers.

V. CONCLUSION

Currently, 3-D printed objects in the home would most likely not be considered products. A product goes through a distribution chain before it reaches a consumer under the current strict liability rules.[97] Courts will likely view a homebased 3-D printed as not a product. They would view the same object as a product if it was printed by Shapeways and then shipped to the consumer. For the consumer, both objects are the same, but the courts would view them as different. 3-D printed objects circumvent the traditional products distribution chain and strict liability imposed on that chain. Unless there is nothing wrong with the printer or the printing material, injured parties may not have a claim for relief. Therefore, there needs to be a change in how strict liability law views products: the Restatements should be expanded to include digital products. In that way, the court system can properly respond to an evolving, or disappearing, distribution chain.

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[96] *About Etsy*, ETSY, https://www.etsy.com/about/ (last visited Feb. 19, 2017).
[97] RESTATEMENT (SECOND) OF TORTS § 402A (AM. LAW. INST. 1965).

ILLINOIS BUSINESS LAW JOURNAL

QUITTING QUILL: STATE LAWS CHALLENGE QUILL'S PHYSICAL PRESENCE STANDARD FOR OUT-OF-STATE TAX COLLECTION

❖ ARTICLE ❖

*Timothy Yuhasz**

Abstract

Over the last fifty years, one of the bedrock principles of state and local tax jurisprudence has been the physical presence standard. The rise of E-commerce and a shifting economy, however, have for years called into question its validity. States, too, have taken notice, and new state laws are being crafted that either bypass this requirement or challenge it head-on. It may not be long before the physical presence standard becomes a thing of the past.

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I. INTRODUCTION

Twenty-five years ago this May, the United States Supreme Court decided what has come to be one of the most controversial cases in state and local tax history: *Quill*.[1] The physical presence standard that was affirmed in *Quill*–which requires out-of-state vendors have a physical presence within a state before sales tax collection obligations can be imposed–was criticized as "obsolete" at the time.[2] Yet, this many years later, the physical presence standard is still on the books. Recently, however, states have begun enacting use tax reporting and collection statutes that seek to expand taxing authority beyond their boundaries – in complete dereliction of *Quill*.[3] These laws are setting up a showdown in the nation's highest court: one that could dramatically alter states' abilities to require out-of-state vendors to collect their taxes.

II. STATES' ATTEMPTS TO AVOID QUILL'S REQUIREMENTS

A. Evading Quill -- Colorado's Use Tax Reporting Requirements

Colorado is the first state to claim victory against *Quill*. In 2010, Colorado codified a use tax reporting requirement that forces out-of-state vendors who lack physical presence with the state–and thus, do not collect taxes on their sales into the state–to report residents' use tax obligations to the Colorado Department of Revenue.[4] The law was challenged in *Direct Marketing Association v. Brohl*,[5] but in December 2016, the Supreme Court denied cert. in the case.[6] The Supreme Court's decision, or lack thereof, essentially blessed Colorado's reporting obligation, which has allowed other states to enact similar laws. And, interestingly, Judge Gorsuch's concurring opinion in *Brohl* provides insight into the future of state sales and use tax laws as President Trump's nominee to fill Justice Scalia's vacancy on the bench.[7]

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[1] Quill Corp. v. N. Dakota, 504 U.S. 298 (1992).
[2] *Id.* at 301.
[3] COLO. REV. STAT. § 39-21-112.3.5 (2016); H.B. 3057, 100th Gen. Assemb. (Ill. 2017); 32 VT. STAT. ANN tit. 32, § 9712 (2016).
[4] COLO. REV. STAT. § 39-21-112.3.5 (2016).
[5] 814 F.3d 1129 (10th Cir.), *cert. denied*, 137 S. Ct. 591 (2016), *and cert. denied*, 137 S. Ct. 593 (2016).
[6] 137 S.Ct. 591 (2016).
[7] Amy Howe, *Trump Nominates Gorsuch to Fill Scalia Vacancy*, SCOTUSBLOG (Jan. 31, 2017, 9:51 PM), http://www.scotusblog.com/2017/01/trump-nominates-gorsuch-fill-scalia-vacancy/.

1. *Circumventing Quill -- Colorado's Law*

Colorado's use tax reporting law evaded *Quill* by forcing out-of-state vendors to disclose certain information to Colorado consumers and the Colorado Department of Revenue, rather than having the out-of-state vendor directly collect the sales taxes that consumers owed to the state.[8] The law has two primary themes: notice to purchasers and notice to the State – along with three primary requirements.

First, under the statute and regulations, every out-of-state vendor who does not collect Colorado sales tax, and who makes more than $100,000 worth of sales into the State, must send an individual transaction notice to Colorado purchasers notifying them that use tax is due on each purchase.[9] Second, an end of year notice of total purchases made must be sent to each Colorado purchaser whose purchases were greater than $500.[10] And, finally, each vendor must file an end of year statement for each purchaser with the Colorado Department of Revenue.[11] Failure to comply with the various notice and filing requirements could lead to a substantial financial penalty.[12] Thus, vendors are left with either being forced to collect the Colorado use tax, which would shield them from the notice requirements, or comply with the notice and reporting requirements – to avoid serious penalties.

2. *The Supreme Court's Blessing -- Direct Marketing Association v. Brohl*

On December 12, 2016, the United States Supreme Court constitutionally blessed Colorado's reporting statute when it denied certiorari in *Direct Marketing Association v. Brohl.*[13] This denial allowed the Tenth Circuit's prior decision in *Brohl*, which found in favor of the State, to stand.[14]

Brohl was the most prominent challenge to Colorado's law, and Direct Marketing Association ("DMA") used *Quill*'s physical presence standard to

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[8] COLO. REV. STAT. § 39-21-112.3.5 (2016).
[9] COLO. REV. STAT. § 39-21-112.3.5 (c)(I) (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[10] COLO. REV. STAT. § 39-21-112.3.5 (d)(I)(A) (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[11] COLO. REV. STAT. § 39-21-112.3.5 (2016); COLO. CODE REGS. § 201-1:39-21-112.3.5 (2016).
[12] COLO. REV. STAT. § 39-21-112.3.5 (c)(II), (d)(III)(A)–(B) (2016).
[13] 814 F.3d 1129 (10th Cir.), *cert. denied,* 137 S. Ct. 591 (2016), *and cert. denied,* 137 S. Ct. 593 (2016).
[14] *Id.* at 1131.

challenge its constitutionality.[15] DMA's argument was straightforward. Put simply, DMA's contention in *Brohl* was that *Quill*'s physical presence standard limited Colorado's ability to require out-of-state vendors to report tax obligations to Colorado consumers and the state, and, thus, requiring out-of-state vendors to make the disclosures or reports under the law unconstitutionally burdened interstate commerce.[16] However, the court saw a fatal flaw in DMA's argument. Bolstered by a previous intermediate decision by the Supreme Court in this case (the case had previously been appealed on a separate issue), the Tenth Circuit limited *Quill*'s holding to "tax collection," not tax reporting.[17] The court latched onto this idea, planted in its mind by the Supreme Court,[18] that *Quill* was not binding where the state wasn't seeking to collect tax, but rather where it sought compliance with notice and disclosure requirements.[19] Put simply, *Quill*'s strict physical presence standard did not apply in this case because it wasn't asking vendors to act as tax collectors. Because the court made this distinction, it easily found that Colorado's law did not discriminate against or unduly burden interstate commerce – upholding Colorado's reporting law as constitutional.[20]

3. Judge Gorsuch's Premonition – Other States Adopt Colorado's Approach

Buried in the Tenth Circuit's decision, in Judge Gorsuch's concurring opinion, lies an important presentment:

> [I]f my colleagues and I are correct that states may impose notice and reporting burdens on mail order and internet retailers comparable to the sales and use tax collection obligations they impose on brick-and-mortar firms, many (all?) states can be expected to follow Colorado's lead and enact statutes like the one now before us.[21]

If the court's decision withstands future scrutiny (which it somewhat already has), nearly every other state could take Colorado's approach, which would essentially erode *Quill*'s requirements. And, Judge Gorsuch was correct. Other

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[15] *Id.* at 1129.
[16] *Id.* at 1132.
[17] *Id.* at 1139.
[18] Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1131 (2015).
[19] *Direct Mktg. Ass'n*, 814 F.3d at 1147.
[20] *Id.*
[21] *Id.* at 1151 (Gorsuch, J., concurring).

states have begun adopting Colorado's approach, largely mirroring the exact language and requirements of Colorado's law.[22] The most recent state to do so being Illinois.[23]

B. Attacking Quill – States Direct Assault on the Physical Presence Standard

At least two states, Alabama[24] and South Dakota,[25] have launched direct challenges to *Quill*. Both states take direct aim at *Quill*'s physical presence standard by requiring "out-of-state sellers" who "lack physical presence" to collect state sales tax.[26] The only true limitations on the states authority are sales caps. In South Dakota, an out-of-state seller must make more than $100,000 worth of sales into the state before being obligated to collect tax.[27] In Alabama, the requirement is set at $250,000.[28] Unsurprisingly, both states' actions are being challenged by major online retailers, Wayfair and Newegg.[29] It seems likely that one of these cases could make its way to the Supreme Court, given Justice Kennedy's direct call for a case to challenge *Quill* and the constitutional issues involved.[30]

III. THE PATH FORWARD – PREPARING FOR A POST-QUILL TAX WORLD

It is not yet certain that *Quill* will disappear when challenged next. Looking at the DMA decision tells us one thing: states may require that out-of-state vendors make certain disclosures or reports within the state. But it doesn't tell us much more. The court, and especially Judge Gorsuch, were hesitant to get rid of *Quill* just yet. Gorsuch reminded everyone that the court should be hesitant to skirt prior court precedent.[31] He emphasized that *Quill* was valid where a state sought to require those who lack physical presence with a state to collect those states' taxes. But, he emphasized that *Quill* need not be

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[22] *See* H.B. 3057, 100th Gen. Assemb. (Ill. 2017); La. Stat. Ann. § 47:306.5 (2016); OKLA. STAT. ANN. tit. 68, § 1406.1 (2016); 32 VT. STAT. ANN tit. 32, § 9712 (2016).
[23] H.B. 3057, 100th Gen. Assemb. (Ill. 2017).
[24] ALA. ADMIN. CODE r. 810-6-2-.90.03 (2016).
[25] S.D. CODIFIED LAWS § 10-64-2 (2016).
[26] ALA. ADMIN. CODE r. 810-6-2-.90.03 (1) (2016); S.D. CODIFIED LAWS § 10-64-2 (2016).
[27] S.D. CODIFIED LAWS § 10-64-2 (1) (2016).
[28] ALA. ADMIN. CODE r. 810-6-2-.90.03 (1)(a) (2016).
[29] South Dakota v. Wayfair, No. 3:16-CV-03019 (D.S.D., removed May 25, 2016); Newegg, Inc. v. Dep't of Revenue, No. S. 16-613 (Ala. Tax Trib., filed June 8, 2016).
[30] Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1134–35 (2015).
[31] Direct Mktg. Ass'n v. Brohl, 814 F.3d 1129, 1148–49 (10th Cir.), *cert. denied*, 137 S. Ct. 591 (2016), *and cert. denied*, 137 S. Ct. 593 (2016) (Gorsuch, J., concurring).

extended to "comparable tax and regulatory obligations."[32] Given this reasoning, and Gorsuch's likely ascent to the nation's highest court,[33] it seems safe to say that Colorado's reporting obligation is here to stay.

Thus, Colorado has provided an approach that should withstand constitutional challenge. Given the key distinction the court drew between tax collection and tax reporting, it appears a line has been drawn as to what states may require of out-of-state vendors. They may be required to disclose or report certain information to in-state purchasers or the state itself. As soon as a state asks an out-of-state vendor, who lacks physical presence with the state, to collect tax, however, the constitutional line has been crossed. *Quill* is still good law on that point.

On the other hand, the outcome of a direct challenge to *Quill*, through Alabama's or South Dakota's laws, is much more difficult to predict. Justice Kennedy seems ready to throw *Quill* to the wayside. Calling for "[t]he legal system [to] find an appropriate case for this Court to reexamine *Quill* . . . " while emphasizing the dramatic shifts in technology and business that have now caused *Quill* to become defunct.[34] Yet, Judge Gorsuch's devotion to prior precedent could give the Court pause to overturn *Quill*.[35] Judge Gorsuch seems much more likely to side with Justice Thomas, and the late Justice Scalia, who adhered to *stare decisis* when deciding *Quill* in the first place.[36] Which could ultimately leave the decision to overturn *Quill* with Congress rather than the Judiciary.[37]

Even so, businesses must be ready for a shift away from *Quill*. At the very least, the Colorado reporting and disclosure requirements seem here to stay, and will expand into other states. Some businesses will be forced to make the reporting and notice disclosures in any state that chooses to adopt Colorado's approach – as long as their sales exceed the state thresholds, typically $100,000. Therefore, it would be wise for retailers, specifically those who lack physical presence with a state, to begin carefully analyzing where their purchases are heading and exactly how many sales they are making into each respective state.

What's less clear is whether *Quill* will be completely overturned. And, thus, whether vendor's can ultimately be required to collect state taxes, regardless of physical presence. The Tenth Circuit seemed hesitant to distinguish-away

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[32] *Id.* at 1149 (Gorsuch, J., concurring).
[33] Julie Hirschfeld Davis & Mark Landler, *Trump Nominates Neil Gorsuch to the Supreme Court*, N.Y. TIMES (Jan. 31, 2017), https://www.nytimes.com/2017/01/31/us/politics/supreme-court-nominee-trump.html.
[34] *Direct Mktg. Ass'n*, 135 S. Ct. at 1135.
[35] *Direct Mktg. Ass'n*, 814 F.3d at 1149.
[36] Quill Corp. v. N. Dakota, 504 U.S. 298, 320 (1992).
[37] *Quill Corp.*, 504 U.S. at 320; *Direct Mktg. Ass'n*, 814 F.3d at 1149.

Quill just yet, but that doesn't mean the Supreme Court wouldn't overturn the physical presence standard if, say, South Dakota's law made its way to the High Court. Nonetheless, states will be able to expand their taxing authority, whether it be through reporting or disclosure requirements – meaning added expenses for business.

IV. CONCLUSION

As states get more creative expanding their tax base, businesses now, more than ever, must be prepared to comply with state's various use tax reporting, and even collection, requirements. If *Quill*'s physical presence standard is abandoned, out-of-state businesses of all sizes may be required to collect taxes from every state they do business in – even if they make only a handful of sales into a state. Even if it survives, reporting requirements are on the rise, and if businesses fail to make the required disclosures and reports they could face serious financial penalties.

Quill's death knell has been sounding for years -- the expansion of E-commerce only hastening the tones.[38] New state reporting and collection laws should give the Supreme Court the opportunity to hammer the final nail into *Quill*'s coffin, finally laying its physical presence standard to rest. However, there is still the possibility that the Court pulls back and allows *Quill* to live on for years to come. The next few terms of the Supreme Court will largely decide the future of remote sales and use tax requirements.

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[38] U.S. Department of Commerce, *Quarterly Retail E-Commerce Sales 4th Quarter 2016*, (Feb. 17, 2017, 10:00 AM), http://www2.census.gov/retail/releases/historical/ecomm/16q4.pdf.

ILLINOIS BUSINESS LAW JOURNAL

WHEN TO DISCLOSE DATA BREACHES UNDER FEDERAL SECURITIES LAWS

❖ ARTICLE ❖

*Steven P. Wittenberg**

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I. INTRODUCTION

Hacking and cybercrime are on the rise.[1] From 2013 to 2015, twenty major data breaches were reported at Fortune 100 companies.[2] Publicly traded

[1] *The Rise of the Hacker*, ECONOMIST (Nov. 7, 2015), http://www.economist.com/news/business/21677638-rise-hacker.
[2] *How to Disclose a Cybersecurity Event: Recent Fortune 100 Experience*, DEBEVOISE & PLIMPTON (Sept. 12, 2016),

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companies who have securities disclosure obligations should be aware of their duties under the federal securities laws when it comes to data breaches and hacks.[3]

In 2011, the SEC Division of Corporation Finance issued guidelines for cyber incidents.[4] The SEC stated, "[A] number of disclosure requirements may impose an obligation on registrants to disclose such [cyber] risks and incidents," although there are no explicit requirements referring to data breaches.

While major data breaches may be material to reasonable investors of public companies, there is no duty to promptly disclose the occurrence of cyber incidents unless there have been selective disclosures, previous misstatements or circumstances making the omission of the hack misleading.[5] The federal securities laws also impose periodic disclosure duties on public companies.

II. MATERIALITY: A COMMON THRESHOLD

Often, the duty to disclose cyber incidents hinges on the severity or materiality of the hack (e.g. Regulation FD). A hack is material if there would be a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."[6] Put differently, a hack is material "if there is a substantial likelihood that a reasonable shareholder would consider [the undisclosed data breach] important in deciding how to vote."[7]

Cyber incidents are problematic for public companies because they may be material to investors. The effects of hacking might include reduced cash flow, product recalls, contractual obligations, legal liabilities, impairment of assets such as goodwill and software, and devalued intellectual property. Depending on the severity of the effect, hacks may qualify as "material," fulfilling one of the elements sometimes required for disclosure.

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http://www.debevoise.com/~/media/files/insights/publications/2016/09/20160912_how_to_disclose_a_cybersecurity_event_recent_fortune_100_experience.pdf.

[3] Hacking, data breaches and cyber incidents are used synonymously here. They are incidents that cause personal information to be improperly taken without the individuals' consent.

[4] *CF Disclosure Guidance: Topic No. 2*, S.E.C., https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[5] Insider trading and fraud may also create an obligation to disclose data breaches, but are not discussed here.

[6] Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

[7] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 499 (1976).

III. FORM 8-K: CURRENT REPORTS

Form 8-K requires disclosure upon the occurrence of certain enumerated triggering events. There are no events listed in Form 8-K's mandatory sections that would trigger a report for data breaches except for Section 7 (Regulation FD), which is discussed below. Companies should, however, be mindful that § 409 of the Sarbanes-Oxley Act of 2002 requires that public companies "disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the Commission determines."[8] As data breaches become more prevalent and important to the investing public, the SEC might amend Form 8-K to require real time disclosure of cyber incidents.

IV. FORM 10-K AND FORM 10-Q: PERIODIC REPORTS

A. Business

Item 101 requires a description of "the business done and intended to be done," including the "principal products and services."[9] The SEC interprets this section as requiring disclosure "[i]f one or more cyber incidents materially affect a registrant's products, services, relationships with customers or suppliers, or competitive conditions."[10] The SEC's interpretation is broad, so companies should keep track of the effects of hacks on their business, determine if they are material, and disclose them if they are.

B. Risk Factors

The SEC instructs that risks of hacks should be disclosed if they are "among the most significant factors that make an investment in the company speculative or risky."[11] Companies must consider past incidents, the severity and frequency of those hacks, the probability of hacking and the likely magnitude of those hacks and costs. Risk prevention and the type of industry are countervailing considerations. Companies should find a balance between identifying the specific risks without exposing cybersecurity vulnerabilities and without using overly general "boilerplate" language.

A public company that does not rely on software is a clear example in which hacking is not a risk factor. However, because companies often collect vast

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[8] 15 U.S.C. § 78m(l) (2012).
[9] 17 C.F.R. 229.101 (2016).
[10] S.E.C., *supra* note 3.
[11] *Id.*

databases of sensitive personal information from their vendors and customers, most companies should disclose their company's cyber incident history because it bears on future risks as well as other assessed cyber threats.

C. Legal Proceedings

Companies should describe "any material pending legal proceedings" resulting from data breaches, unless the potential liability is less than or equal to 10% of the company's total assets, including subsidiaries' assets.[12] The SEC provided the example of stolen customer information which results in material litigation.[13] In any legal proceeding description, the company should also present the underlying facts surrounding the hack, but should avoid exposing cyber vulnerabilities.

D. Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

In the MD&A narrative, companies must "[d]escribe any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income" that they "believe[] to be necessary to an understanding of its financial condition, changes in financial condition and results of operation."[14] Additionally, companies must address past incidents or future risks when

> the costs or other consequences associated with [them] represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the registrant's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.[15]

The MD&A easily triggers disclosure because severe hacks adversely impact "financial condition and results of operation" and can be categorized as "infrequent events," "significant economic changes," and "material event[s] [or] trend[s]."

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[12] 17 C.F.R. 229.103 (2016).
[13] S.E.C., *supra* note 3.
[14] 17 C.F.R. 229.303 (2016).
[15] S.E.C., *supra* note 3.

V. REGULATION FD: SELECTIVE DISCLOSURE

Regulation FD requires that whenever a public company discloses material nonpublic information to certain covered parties, including broker-dealers, investment advisors, investment companies or any investor reasonably expected to trade on the information, the company must also disclose to the public.[16] A serious hack would likely fall under a duty to disclose to the public if there was a nonpublic selective disclosure because serious hacks are often material to investors. Thus, companies should refrain from selectively disclosing major hack information to those who would be reasonably expected to trade by implementing no-trade and confidentiality policies.

VI. DUTY TO CORRECT

There is no continuous duty to *update* prior disclosures; however, there is a duty to *correct* prior inaccurate statements.[17] Courts formulate the duty to correct as "when a company makes a *historical statement* that, at the time made, the company believed to be true, but as revealed by *subsequently discovered* information actually was not."[18] For example, if a Form 10-K report falsely and affirmatively stated that there were no data breaches in 2014, the company would be required to correct that statement if it later learns that, in fact, there were data breaches in 2014.

VII. DUTY TO UPDATE

When a public company decides to issue securities, it must update its registration statement with an addendum disclosing material hacks through Item 11 of Form S–3 if they were not already described in Form 10-Q or Form 8-K.[19]

VIII. CONCLUSION

In September 2016, Yahoo announced that a massive hack of over 500 million user accounts occurred in 2014. United States Senator Mark Warner (D-VA) requested that the U.S. Securities and Exchange Commission (SEC) "investigate whether Yahoo, Inc. fulfilled its obligations under federal securities

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[16] 17 C.F.R. 243.100 (2016).
[17] Gallagher v. Abbott Labs., 269 F.3d 806, 811 (2001).
[18] In re Burlington Coat Factory Sec. Lit., 114 F.3d 1410, 1431 (1997).
[19] *See also* 17 C.F.R. 229.512 (2016).

laws to keep the public and investors informed about the nature of a security breach."[20]

The Yahoo breach may become a catalyst to expand the scope of the disclosure requirements for hacks because of the notoriety of the hack.[21] Although the SEC has never initiated a data breach disclosure lawsuit, the Commission has "been looking for the right case to bring forward," according to Jacob Olcott, former Senate Commerce Committee counsel.[22] However, Congressional resolve to intervene appears to be lacking, as evidenced by the fact that the Personal Data Notification and Protection Act of 2015, which would have required disclosure of hacks within 30 days, did not pass.[23] Thus, Yahoo's hack may cause an expansion in the disclosure rules through the SEC's rulemaking authority or through the courts.

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[20] *Sen. Warner Calls on SEC to Investigate Disclosure of Yahoo Breach*, MARK R. WARNER (Sept. 26, 2016), http://www.warner.senate.gov/public/index.cfm/2016/9/sen-warner-calls-on-sec-to-investigate-disclosure-of-yahoo-breach.

[21] *See* Dustin Volz, *Yahoo Hack May Become Test Case for SEC Data Breach Disclosure Rules*, REUTERS: TECH. NEWS (Sept. 30, 2016), http://www.reuters.com/article/us-yahoo-cyber-disclosure-idUSKCN1202MG.

[22] *Id.*

[23] H.R. 1704, 114th Cong. (2015-2016).