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THE AGENCY PROBLEM OF LEHMAN BROTHERS' BOARD OF DIRECTORS

By: Young Ah Kim

Introduction

Lehman Brothers is often cited as an example of corporate governance failure largely due to poor oversight by the board.[1] Richard Fuld, former CEO of Lehman Brothers during its bankruptcy in 2008, still does not agree with this general evaluation. Seven years later in 2015, he gave a speech at a conference in New York.[2] Fuld spoke about Lehman's risk management, as quoted in *The Wall Street Journal*: "Regardless of what you heard about Lehman's risk management, we had 27,000 risk managers because they all had a piece of the firm."[3] The problem, however, remains that Lehman's employees owned a very small portion of the company stock, which did not solve its agency problem. Lehman Brothers had a high-leverage, high-risk-taking business strategy supported by limited equity.[4] For instance, it took its leverage ratio up to 30 times its equity.[5] It also had a culture of aggressive growth strategy, which focused on risky and complex financial products such as subprime, derivatives and commercial real estate markets, and failed to carry out deleveraging strategy in 2007 when the commercial real estate market slowed down.[6]

Why did Lehman's board of directors not effectively oversee Lehman and leave it bankrupt? Their responsibilities are the oversight of and advisory to the company. After Lehman Brothers collapsed, many obervers have pointed out that it should not have taken excessive debts, diversified product portfolio and the board of directors should have monitored its strategy and risk management more carefully.[7] All of the root causes of Lehman's failures can be traced back to the dysfunction of the board of directors and the agency problem.

What is the agency problem of the board of directors?

The agency problem arises in a situation where an agent (i.e. a director of a company) does not act in the best interests of a principal (i.e. a shareholder). When a principal chooses to act through others and its interest depends on others, it is subject to an agency problem. "The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest."[8] The main problem is the asymmetrical information between a principal and an agent. An agent is hired in the first place largely because an agent can carry out the tasks a principal may not be able to perform due to lack of time commitment, skillsets or specific knowledge to run the business. After the agent starts working for the principal, he will likely have a greater level of information for the company, because he is the one who actually performs specific tasks on a regular basis.

The principal, on the other hand, can easily be left in the dark because she is not sure the performance that the agent carries out is exactly what is promised in their contractual relationship.

[T]he agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal. This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent. The greater the complexity of the tasks undertaken by the agent, and the greater the discretion the agent must be given, the larger these "agency costs" are likely to be.[9]

Lehman Brothers' employees' having a very small piece of the company ownership does not guarantee that they will act in the best interest of Lehman and effectively manage its risks. If Lehman were incorporated as a partnership firm such as general partnership or limited partnership where general partners put their own capital on the firm and personally assume personally unlimited liability, those partners would object to such a high risk. In other words, Lehman's taking excessive risks was a classic example of the agency problem because employees and executives acted in their own best interest, which was performance-based compensation. To avoid this problem, the board of directors is formed. However, do directors effectively function as a safeguard for the interests of shareholders? The board itself often creates the agency problem. A large public company such as Lehman has so many shareholders, and the composition of the shareholders constantly changes even by minute on the stock market. It is almost impossible for shareholders to directly run the company. Thus, shareholders hire third parties, directors, to minimize such agency problem between shareholders and employees including executives. Directors' roles are to monitor and incentivize management on behalf of shareholders, their principal, including oversight of the company's external audit (the audit committee), setting of the compensation scheme for executives (the compensation committee), evaluation of the company's governance structure and processes (the governance committee), nomination of new directors (the nominating committee) or making decisions on the distribution of dividends.[10]

Under corporate law, the board of directors has the "ultimate responsibility for managing the business and affairs of a corporation."[11]. In carrying out their responsibilities, directors have a fiduciary duty to act in the interest of the corporation and should exercise the duty of care and duty of loyalty. For instance, under the Delaware General Corporation law, directors may exercise their business judgment in the fulfillment of their obligations to the corporation.[12] Consequently, Delaware's case law imposes fiduciary duties on directors to ensure their duty of loyalty and care toward the company.[13] "[T]he fundamental principle of Delaware law [is] that the business and affairs of a corporation are managed by or under the direction of its board of directors. 8*Del.C.* § 141(a). In exercising these powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders."[14]Black's Law Dictionary defines "fiduciary relationship" as: "A relationship in which one person is under a duty to act for the benefit of another on matters within the scope of the relationship. Fiduciary relationships . . . require an unusually high degree of care."[15] Once elected, directors become fiduciaries with powers to act on behalf of the shareholders and are bound by two important duties: (i) duty of care, "[d]irectors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken,"[16] and (ii) duty of loyalty, "[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest. . . . the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[17]

However, a director may choose his own interests rather than shareholders' in conflicts of interest or if he is not fully engaged in his responsibilities. "A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the stockholders."[18] Directors own interests are more closely aligned with executives than with shareholders because executives protect their jobs. Once hired, a director maintains a closer relationship with executives, who he is supposed to monitor, than with shareholders, who elect him. It is probably because 1) the board of directors meet executives in person on a regular basis, thus developing interpersonal relationships with executives while indirectly communicating with shareholders through the company's employees, executives or indirect communication channels such as investment relations (IR) information and 2) the job security of directors in fact lies in the hands of executives. CEOs often use their own contacts or executive search firms that the company has been using to hire directors and the nominating committee comprising of directors themselves control the hiring and firing process of directors. [19] Thus, the job security of directors is actually determined by executives and directors (agents), not shareholders (principals). The agency problem is subject to arising if directors and executives continue to have authority over controlling directors.

Effective ways to mitigate the agency problem of the board of directors

In fact, several safeguards have been developed to solve the agency problem such as director stock ownership and mandatory appointment of independent directors.

Director Stock Ownership

One of the ways to reduce agency costs is to align an agent's interest with a principal's interest, because the agency problem arises due to divergent interests. For example, requiring directors to own company shares can motivate directors to work for the company's best interest, rather than directors' interest. However, because directors are monitors and advisors, not managers, tying directors' compensation with the company's financial success may compromise their ability to provide effective oversight.[20] For instance, a director may become unwilling to approve risky projects that will negatively affect the company's short-term profits but create long-term value,[21] if he prefers immediate financial gains from the company.

There is mixed evidence on this issue. Some scholar such as Mehran did not find a relationship between director stock ownership and improved company outcomes.[22] However, Cordeiro and other scholars found that there is a positive correlation between equity ownership among directors and future stock price performance.[23] Even if there is a positive correlation, is it sufficient to eliminate the agency problem? Lehman Brothers' 27,000 employees and directors had a small piece of the company, but Lehman collapsed. It is questionable that retaining a very small piece of shares will trump a director's strong interest in job security and the reputational benefits from serving on the board.

Independent Directors

The New York Stock Exchange ("NYSE") requires that listed companies have a majority of independent directors.[24] To be independent, directors should have "no material relationship with the listed company." [25] For example, a director is not considered independent if the director or an immediate family member 1) has been employed as an executive officer at the company within the last three years, 2) "[has] received, during any twelve-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service," 3) has been employed as an internal or external auditor of the company in the last three years, 4) is an executive officer at another company where the listed company's present executives have served on the compensation committee in the last three years, or 5) is an executive officer at a company whose

business with the listed company "exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenue" [26]
Unfortunately, the requirements do not stop directors from acting in their own intersts; they only "reduce" the possibility that a director makes a judgment based on his immediate personal gains such as approving and overly risky project that is directly aligned with another business he has interests in. In fact, many studies fail to find a significant correlation between board independence and improved market returns or long-term performance.[27] The NYSE also acknowledges the risks that directors do not reliably make independent judgment even though they meet the NYSE independence standards.[28]

In Lehman, 8 out of 10 directors met the independence of standards of the NYSE in 2006,[29] but they lacked the financial expertise and failed to reliably monitor Lehman. For example, the finance & risk committee met only two times a year and the compensation committee met more times (eight) than the audit committee (seven).[30] Berlind was a theatrical producer, and Evans was a career officer and rear Admiral in the United States Navy.[31] Retired CEOs' professional experience inclued Sotheby's, Vodaphone Group, IBM, Telemundo Group, which are not financial services areas.[32] Until 2006, Lehman's board included Dina Merrill, an 83-year-old actress.[33] In addition, there were no current CEOs of major public corporations and former CEOs were well into retirement.[34] Did the board properly understand the complexity and severity of financial markets well enough to weather the storms when the financial market slowed down? Could these "independent" directors who did not have most updated financial expertise represent the shareholders' best interests? Did they exercise fully their fiduciary duty that they owe to Lehman and act in good faith in exercising their oversight responsibilities solely in the best interests of Lehman's shareholders?

It is very difficult to raise doubts when a company's financial performance has been very strong, because it is a good way to evaluate executives' capabilities of running the business whose purpose is often to maximize the profits. Fuld was the embodiment of Lehman's huge success. During Fuld's tenure, Lehman's revenues grew 600%, from $2.7 billion in 1994 to $19.2 billion in 2006.[35] A culture was created where employees were afraid to ask questions.[36] Lehman's directors failed to challenge Fuld. "[T]his [risky] strategy was fully endorsed by Lehman's board of directors."[37] In this dynamic, executives such as Fuld become a principal and the board of directors become executives' agents, not shareholders'. This reversed relationship resulted in the agency problem between Lehman's shareholders and directors.

Conclusion

The agency problem cannot be eliminated as long as there is an agent who is not the 100 percent true owner of the company. Regulators have been recognizing this problem and trying to safeguard listed companies by requiring them to comply with numerous regulations designed to promote the independence of the board of directors. However, such compliance with regulations is not sufficient to ensure that directors would act in the best interests of the company and its shareholders. Companies need to develop more effective ways to minimize agency costs and maximize the shareholders' benefits, rather than relying on compliance with federal regulations. It may be too late to fix the problem at Lehman Brothers because, the 158-year-old firm with 25,000 employees, no longer exists, but other companies should consider ways of avoiding an agency problem of their own.[38] In addition, directors should keep in mind that they are bound by the fiduciary duty to ensure that they govern the company in the best interests of the company and its shareholders, not themselves, including the duty of care and the duty of loyalty to the company.

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[12] *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. CIV.A. 5215-VCG, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011)

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[15] *Hawkins v. Voss*, 29 N.E.3d 1233, 1239-40 (Ill. App. Ct. 2015) (citing Black's Law Dictionary 1315 (8th ed. 2004))

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[17] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *decision modified on reargument*, 636 A.2d 956 (Del. 1994)

[18] *Seminaris v. Landa*, 662 A.2d 1350, 1354 (Del. Ch. 1995)

[19] David Larcker & Brian Tayan, *Corporate Covernance Matters,* p.105

[20] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.114, 2011

[21] *Id.*

[22] *Id.*

[23] *Id.*, p.114-15

[24] NYSE Corporate Governance Rules, available at http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F

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[26] *Id.*

[27] David Larcker & Brian Tayan, *Corporate Covernance Matters*, p.144, 2011

[28] *Id*., p.143

[29] Stanford Graduate School of Business, *Lehman Brothers: Peeking under the Board Facade*, Jun 4, 2010

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LIFTING THE INJUNCTIONS: THE END OF "THE TRIAL OF THE CENTURY" IN SOVEREIGN DEBT

By: Luis F. Gomezm Alfaro

Introduction

The newly-elected government of Argentina has offered to pay all the holders of its sovereign debt.[1] This proposal is a striking reversal of Argentina's decade-long position of only making payments to the holders of it restructured debt ("exchanged creditors"), but not to those that had refused to exchange their bonds at a 65% loss ("holdout creditors").[2] If the negotiations are successful, and the injunctions against Argentina are lifted, these developments will bring an end to the so called "trial of the century in sovereign debt restructuring," [3]and cement a remarkable empowerment of holdout creditors in sovereign debt restructuring processes.

Argentina's newly elected President, Mauricio Macri, has vowed to regain access to the sovereign debt markets.[4] Currently a series of judgments and injunctions[5] have rendered Argentina unable to make payments only to the exchanged creditors, and has effectively forced the South American nation to default on its sovereign debt. To illustrate the significance of Judge Thomas P. Griesa's injunctions, and how lifting these equitable remedies will determine the resolution of this sovereign-debt landmark case, this note will: (1) present a short overview of Argentina's sovereign-debt debacle; (2) explain how the failed debt restructuring process lead to the District Court for the Southern District of New York issuing the unprecedented injunctions; and, (3) explain how Argentina's new settlement offers will lead to a permanent lifting of the injunctions and the amicable resolution of the most contested sovereign-debt litigation.

Argentina’s sovereign debt debacle

Argentina’s great depression, from 1998 to 2002 generated the largest sovereign debt default in history.[6] After a surprising economic recovery, Argentina began restructuring a debt worth well over $100 billion.[7] The first restructuring attempt occurred on 2005 and it was followed on 2010 by a reopened restructuring exchange that had an even less attractive offer.[8] At the end of the two restructuring processes, Argentina had successfully exchanged almost 93% of its sovereign debt with the participating creditors securing an average of $.30 for every $1 owed by Argentina.[9]

An otherwise successful debt restructuring process began spiraling out of control with the emergence of a group of recalcitrant creditors refusing to exchange their bonds. These holdout creditors were led by investment funds that had purchased secondary-market Argentine debt with the intention to sue and hold out until they were paid in full.[10] These investors followed a litigation strategy, previously employed against Peru, and sued Argentina in the Southern District of New York.[11]

In making a case for full payment, the holdout creditors first relied on an alternative understanding of the *pari passu* clauses in the bonds,[12] followed by a request of equitable remedies to force Argentina to the negotiating table.[13] On December 07, 2011, Judge Griesa of the Southern District of New York ruled for the holdout creditors finding that Argentina had violated the *pari passu* clause in its bonds by making interest payments to the exchanged creditors without also making payments to the holdout creditors.[14] On February 23, 2012, Judge Giresa not only ordered Argentina to make ratable payments to the holdout creditors but also issued injunctions[15] blocking financial institutions from making payments to the exchanged creditors until the holdout creditors also received payments.[16]

After Argentina pursued several appeals, the Supreme Court of the United States refused to take the case against Judge Griesa's orders to pay the holdout creditors in full when it made any payments to the exchanged creditors.[17] With the Second Circuit Court of Appeals lifting its stay, and the orders and injunctions in full effect, Argentina's refusal to make payments at this stage would again have it defaulting on its debt and completely cut off from the international credit markets.[18]

The injunctions

After the holdout creditors secured partial summary judgments, some tried to enforce their judgments by seizing eligible Argentine property. Through this efforts, creditors attempted to seize: other defaulted bonds; Argentina's central bank funds on deposit at the Federal Reserve Bank of New York and at the Bank for International Settlements; taxes and revenues owed to Argentina; the Argentine President's airplane; and even a military ship docked abroad.[19]Since the holdout creditors couldn't have realistically seized enough eligible assets to satisfy their judgments,[20] the court also granted their requests for specific performance and of equitable remedies against Argentina's continued violation of the *pari passu* clause.[21] These unexpected injunctions[22]mandated that "whenever the Republic paid on the exchange bonds, it needed to make a ratable payment to plaintiffs" (holdout creditors).[23]

The injunctions were supported by the holdout creditor's argument that two Argentine laws left them without an adequate remedy at law, and that the equities and the public interest supported the injunctions due to Argentina's "repeated failures to pay plaintiffs and its unprecedented, systematic scheme to pay other debts without paying plaintiffs".[24] These two Argentine laws were Law 26,017 (known as the Lock Law) and Law 26,547.[25] The "Lock Law" plainly prohibits future settlements to holdout creditors, and Law 26,547 prohibits offering more favorable settlements to the creditors that have sued Argentina.[26] Thus, these laws amounts to a legislatively blockade to compliance with the Court's judgments and the injunctions. Further, the passing of a third Argentine law, the Sovereign Payment Law or Law 26,984, led to the Court holding Argentina in contempt for attempting to evade the injunctions through a complex scheme of transactions within Argentina.[27]

These injunctions were consequential because they had very effective extraterritorial effects on a sovereign debtor. Extraterritorial compliance was assured because the court threatened to also sanction the trustees (like to The Bank of New York Mellon); the exchanged creditor as and their depositaries (like Cede & Co. and The Bank of New York Depositary); financial market utilities (like the Depository Trust Company, Clearstream Banking, and Euroclear); trustees (like the Bank of New York Luxembourg and The Bank of New York Mellon); and, their attorneys and other agents.[28] The order's *in terrorem* effect on third parties was designed to force Argentina back to the negotiations.[29] These injunctions were also *sui generis* because instead of requiring payment to any of the creditors, they left Argentina with the choice of either paying every creditor ratably or defaulting on all of its debt by being unable to make payments directly or through any financial institutions.[30]

Faced with the holdout creditors strategy, and unable to receive the agreed exchange payments, many of Argentina's exchanged creditors became "me too" plaintiffs by also filing motions for partial summary judgments in 2015. These exchanged creditors obtained the same *pari passu* summary judgments as the holdout creditors due to Argentina's course of conduct that has led to not paying any plaintiff.[31] Further, the court also extended "me too" injunctions to the exchanged creditors, citing Argentina's failure to entertain meaningful settlement negotiations and its scheme to make payments only to the exchange bondholders in violation of the court's original injunctions.[32]Argentina's appeal of these last orders is pending before the Second Circuit.[33]

The resolution of the case

Having defaulted on its debt, unable to pay its restructured creditors, mired in litigation, and cutoff form the sovereign debt market, the newly elected Argentine government reopened negotiations through the court-appointed mediator, Special Master Daniel A. Pollack.[34] After his election, President Macri dispatched its newly appointed Secretary of Finance and a delegation of senior government officials to hold talks with the representatives of the holdout creditors leading the case in New York. On January 2016, discussions began under the auspices of the Special Master.[35] One month later, on February, 2016, Argentina had presented a settlement offer which lead Mr. Pollack to declare that the case was "now well on its way to being resolved,"[36] and that "Argentina has continued to reach Agreements in Principle with its Bondholders, large and small."[37]
As a product of the negotiations, Argentina proposed an offer with two settlement categories: the Standard Offer and the *Pari Passu* Offer.[38] The Standard Offer provides for a cash payment equal to the original principal of the bond plus 50% as interest.[39] The *Pari Passu* Offer provides that (1) creditors with injunctions

and judgments are to receive the full amount of that judgment, less a 30% discount, and (2) that creditors with judgments are to receive payment equal to the current accrued value of the claims, less a 30% discount.[40] Importantly, Argentina conditioned the offers to obtaining legislative approval by the Argentine Congress and the vacating of the injunctions by the District Court of the Southern District of New York.[41]

Together with the removal of the holdout creditors' injunctions, Argentina also moved to vacate all the "me-too" injunctions; however, because Argentina still has an on-going appeal (remnant of its previous strategy) the court couldn't vacate the injunctions, and instead gave Argentina an indicative Ruling.[42] In that decision, the court stated that it has the inherent power to vacate the injunctions if the requested modification would not thwart the purpose behind them.[43] Affirming that a total compliance with the injunctions was not an absolute precondition to their modification,[44] and that the court may vacate an injunction even though the purpose of the decree has not been completely realized,[45] the court stated a willingness to lift the injunctions in light of Argentina's good-faith willingness to negotiate with the holdouts.[46]
The court also explained that since the *pari passu* clause never required that injunctions be granted, the injunctions have always been a discretionary remedy and not an entitlement.[47] It further explained that the changed circumstances have now render the injunctions inequitable and indicated, through the indicative ruling, that it would vacate the injunctions upon the occurrence of two conditions precedent: (1) The repeal of all Argentinian legislation hampering a settlement with the holdout creditors, including the Lock Law and the Sovereign Payment Law; and (2) for all creditors in the case to enter into agreements in which they receive full payment in accordance with the specific terms of each such agreement.[48]

Conclusion

In the aftermath of Argentina's new offers, the sovereign debt market was left with the blueprint for how to effectively request and use injunctions to force recalcitrant sovereigns to the negotiating table. The District Court for the Southern District of New York, with its effective use of its equitable remedies, has effectively brought the most-contested sovereign debt case to a resolution by actively rebalancing the bargaining power between the sovereign debtors and its holdout creditors.

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v. Republic of Argentina, Nos. 08-cv-6978(TPG), 09-cv-1707(TPG), 09-cv-1708(TPG), 2012 WL 5895784 (S.D.N.Y. Nov. 21, 2012).

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[12] *See* Order, NML Capital Ltd. v. Republic of Argentina, No. 08-cv- 6978 (S.D.N.Y. Dec. 7, 2011).

[13] *See* Order § 2(a), NML Capital Ltd. v. Republic of Argentina, No. 08-cv-6978 (S.D.N.Y. Feb. 23, 2012).

[14] *Id.*

[15] NML Capital, Ltd. v. Republic of Argentina, Nos. 08-cv-6978(TPG), 09-cv-1707 (TPG), 09-cv-1708 (TPG) (S.D.N.Y. Feb. 23, 2012).

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[23] *Id.*

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[25] *Id.*

[26] NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 250-52 (2d Cir. 2012).

[27] See, Am. & Suppl. Order, NML Capital, Ltd. v. Republic of Argentina, No. 08-cv-6978 (S.D.N.Y. Oct. 3, 2014).

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[33] Notice Civil Appeal, NML Capital, Ltd. v. Republic of Argentina, No. 15-3675 (2d Cir. Nov. 10, 2015).

[34] Indicative Ruling, EM Ltd. v. Argentina, No. 14 Civ. 8303 (TPG) (S.D.N.Y. Feb. 19, 2016) (ECF No. 49) at 15.

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[36] Statement of Daniel A. Pollack, Special Master in Argentina Debt Litigation, dated Feb, 29, 2016.

[37] Statement of Daniel A. Pollack, Special Master in Argentina Debt Litigation, dated Mar. 04, 2016.

[38] Indicative Ruling, EM Ltd. v. Argentina, No. 14 Civ. 8303 (TPG) (S.D.N.Y. Feb. 19, 2016) (ECF No. 49) at 8.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *See*, Fed. R. Civ. P. 62.1

[43] Indicative Ruling, EM Ltd. v. Argentina, No. 14 Civ. 8303 (TPG) (S.D.N.Y. Feb. 19, 2016) (ECF No. 49) at 10. (citing Sierra Club, 732 F.2d at 256 and Chrysler Corp. v. United States, 316 U.S. 556, 562 (1942)).

[44] *Id. at* 11-12 (citing Badgley v. Santacroce, 853 F.2d 50, 54 (2d Cir. 1988)).

[45] *Id. at* (citing United States v. Eastman Kodak Co., 63 F.3d 95, 102 (2d Cir. 1995)).

[46] *Id. at* 13.

[47] *Id. at* 21.

[48] *Id. at* 23.

FOUL OR DIVE? OUTLINING THE UNITED STATES WOMEN'S NATIONAL SOCCER TEAM'S PAY FOR PLAY LAWSUIT

By: Alexander Karl

American women have been constantly fighting to have their voices heard and to achieve equal rights. It took until 1920 for women to receive the right to vote.[1] But it goes beyond voting as they sought to establish representation. For decades, women in the workforce have been underpaid to work in hazardous conditions. Eventually they began to strike, and in 1920, formed the U.S. Department of Labor Women's Bureau aimed at representing the needs of wage-earning women in public policy.[2] Ultimately, laws such as the Equal Pay Act were put into place to "prohibit discrimination on account of sex in the payment of wages by employers engaged in commerce or in the production of goods for commerce."[3] Nearly a century since the formation of the Bureau and decades since the passing of the Equal Pay Act, women are still fighting for fair compensation today.

A 2014 study reported that women were paid 79% as much as men.[4] While this number is staggering, the study did not control for the difference in type of job, level of employment, or hours worked; it simply compared full time employees for each state.[5] However, it is still clear there is a problem and the wage gap must be closed. One field where this gap is often overlooked is women's athletics. Recently, the United States Women's National Soccer Team ("USWNT" or "Women") filed a lawsuit against the U.S. Soccer Federation. The USWNT claim that despite being more successful the Federation pays the U.S. Men's National Team ("USMNT" or "Men") significantly more than it pays the women for the same work.[6] The lawsuit has been gaining steam and has even been endorsed by members of the men's team. Landon Donovan, arguably the best American player of all time, stated via Twitter, "USWNT absolutely deserve to be treated fairly in all ways".[7] Although the women have support from many people, the Federation has strongly disputed these claims. This lawsuit is still relatively young and could potentially jeopardize the USWNT's play in this year's Summer Olympics. This article aims to layout both sides of the lawsuit in an effort to understand the best outcome for both parties.

The USWNT Claims Foul

The USWNT filed their complaint alleging they have not received equal compensation for their play and performance. Analyzing the merit of the claim is difficult because the Men and Women have different pay structures. Despite receiving a $72,000 per year salary, which the Men do not receive, the Women claim the total payment they receive is far less; their claim strictly revolves around the differences in bonus structure.[8] When analyzing the numbers, the Men receive $1,400 more per game and nearly $7,000 more per win.[9] In addition, the bonuses the Women receive for medaling in the World Cup is significantly less.[10] The complaint does not stop there: the Women allege the financial support they receive is much less than the Men, and they have numbers to back them up. In 2015, U.S. Soccer spent $30 million to run the Men's program, compared to $11 million for the Women's. Not only do they receive less funding, but they have been forced to play on artificial turf; a faux pas the Federation would never ask the Men to do because of injury risk.[11] In sum, the Women's complaint states there are "no legitimate, non-discriminatory reasons for this gross disparity of wages, nor can it be explained away by a bona fide seniority, merit or incentive system or any factor other than sex."[12]In anticipation of filing, the Women proposed a new Collective Bargaining Agreement (“CBA”) as they no longer agreed to the payment stipulations in the old CBA.[13] This caused the Federation to sue and, with the CBA up in the air, the Women have significant bargaining power as the Summer Olympics approaches.[14]

The Women’s claims are not unfounded, as they have cited statistical findings in support. Last season, the Women’s team generated nearly $20 million more than the Men’s team.[15] Furthermore, the Federation’s annual projections expect USWNT international games to bring in more revenue than the Men’s team in 2016, and significantly more in 2017.[16] While the Women lay out a detailed case, they face a stringent standard to prove they have been wronged. As highlighted by Michael LeRoy, a University of Illinois professor who teaches collective bargaining and, the market conditions of men’s and women’s sports vastly differ.[17] Furthermore, the Women have the difficult task of proving equality of work within similar market conditions.[18] Although the lawsuit has some teeth to it, the Women still have a ways to go in the battle and the U.S. Soccer Federation is not going to roll over.

The Federation Claims Dive

The Federation adamantly denies any wrongdoing and claim the Women are fairly compensated. Their argument centers around two main themes. First, they claim the Women assented twice to their current pay structure.[19]Second, the Federation claims the Women are paid proportionately to their market share.[20] U.S. Soccer initially argues they cannot be liable for unequal pay because the Women consented to the terms within their previous CBA. The Federation claims the Women wanted a more conservative structure with a set salary, rather than a bonus-ridden agreement like the Men. This argument directly ties to contract law in regards to mutual assent and consideration. The Women were clearly worried about having a set amount of pay, as evidence by their yearly wage of $72,000.[21] However, this does not seem to be enough to get the Federation off the hook. Part of the intended scope of the Equal Pay Act states an employer may not use a CBA to justify unequal pay.[22] This means the Women can file a lawsuit regardless of their agreement to the pay. The second of the Federations defenses carries more weight and the Women will have difficulty proving they were unfairly compensated for their market share. U.S. Soccer claims the Women have brought the lawsuit using skewed data, which only highlights one year of numbers.[23] They further elaborated stating, “If you look at four or eight years cumulatively, the men’s national team revenues are almost twice that of the women’s national team.”[24] However, this may be slightly overstated as within the last four years the Men have generated $60 million in comparison to the Women’s $51 million.[25] Although the numbers are slightly exaggerated, the sentiment still holds as the Men have a drastically larger following. In the last three years the Men had an average home attendance of 29,781, compared to 16,229 for the Women.[26] In addition, television viewership is much higher for the Men. The Federation’s president claims television viewership is not 30 or 50 percent higher, but rather multiple times higher.[27] Even as the Federation denies any wrongdoing, they have been open to working with the Women to address their issues. The Federation takes great pride in the USWNT, recentl winners of the 2015 Women’s World Cup, and the Federation’s President stated he has no doubt a new CBA will be reached by the start of 2017.[28]

The Referee has a Close Call

This lawsuit is still very young, and it is unclear how it will unfold. However, a general sense is that both sides want to handle this sooner rather than later. While the Women have power to potentially boycott this years Summer Olympics, their claim is centered on an extraordinary year of revenue generation. The women played, and won, a World Cup in Canada where many Americans were able to flood the stadiums. In comparison, the men participated in a World Cup in 2014. This, in turn, made 2015 a down year for the USMNT. The Federation's argument also has its weaknesses. Although the Women agreed to their current pay and the Men have a strong control over the market, U.S. Soccer projects the Women to generate more revenue within the coming years. Because of this, the Federation must be eager to cement a deal. Finally, as mentioned above, the Women have the power to boycott the summer games and neither party would benefit from this threat coming to fruition. The U.S. Women's National Team is the most dominant women's soccer team in the world and wants nothing more than to add another trophy to the collection. They are constantly finding themselves with chances to win, as evidenced by finishing second and first in the last two World Cups. The Federation also prides itself in showing off the Women's team as a powerhouse. The Men's success pales in comparison to the Women's, as their best ever World Cup finish was third in 1930. There is clearly some animosity between the two sides. Dowever, with forces pushing from each end to settle, do not expect the Women to stop playing anytime soon.

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[1] *Women in Labor History Timeline*, http://www.afscme.org/for-members/womens-leadership-training/leadership-tools/body/Women_in_Labor_History_Timeline.pdf.

[2] *Id.*

[3] 88 P.L. 38, 77 Stat. 56.

[4] Catherine Hill, *The Simple Truth About the Gender Pay Gap*,http://www.aauw.org/research/the-simple-truth-about-the-gender-pay-gap/.

[5]*Id.*

[6] Lester Munson, *Unwrapping the USWNT's Equal Pay Filing and What it Means*, ESPN (Apr. 6, 2016),http://espn.go.com/espnw/voices/article/15138438/unwrapping-uswnt-equal-pay-lawsuit-means.

[7] *Landon Donovan: USWNT 'Deserve to be Treated Fairly in all Ways'*, Sports Illustrated (Mar. 31, 2016), http://www.si.com/planet-futbol/2016/03/31/uswnt-equal-pay-lawsuit-landon-donovan-comments.

[8] Karen Yourish, *How Much Less Are Female Soccer Players Paid?*, N.Y. Times (Mar. 31, 2016),http://www.nytimes.com/interactive/2016/03/31/sports/soccer/us-women-soccer-wage.html.

[9] *Id.*

[10] *Id.*

[11] Andrew Das, *Top Female Players Accuse U.S. Soccer of Wage Discrimination*, N.Y. Times (Mar. 31, 2016),http://www.nytimes.com/2016/04/01/sports/soccer/uswnt-us-women-carli-lloyd-alex-morgan-hope-solo-complain.html?_r=1.

[12] Emmett Knowlton, *Hope Solo and 4 Other Soccer Stars File Lawsuit Claiming 'Gross Disparity' of Wages for Female Players*, Business Insider, (Mar. 21, 2016), http://www.businessinsider.com/uswnt-files-wage-discrimination-complaint-against-us-soccer-federation-2016-3.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] Barry Petchesky, *USWNT Stars File Federal Discrimination Complaint Against U.S. Soccer, Seek Equal Pay*, Deadspin (Mar. 31, 2016),http://screamer.deadspin.com/uswnt-stars-file-federal-discrimination-complaint-again-1768183923.

[17] Das, *supra* note 12.

[18] *Id.*

[19] *Id.*

[20] Donovan, *supra* note 7.

[21] Knowlton, *supra* note 13.

[22] Munson, *supra* note 6.

[23] Donovan, *supra* note 7.

[24] *Id.*

[25] Glenn Crooks, *The Numbers Fueling U.S. Women's Soccer Lawsuits are Telling*, CBS (Apr. 4, 2016), http://newyork.cbslocal.com/2016/04/04/us-soccer-uswnt-lawsuit-red-bulls-revolution/.

[26] Donovan, *supra* note 7.

[27] *Id.*

[28] *Id.*

CHIPOTLE AND THE NEED FOR HR OVERSIGHT IN SETTLEMENT AVOIDANCE STRATEGIES

By: Matthew Lowe

Introduction

When litigation looms for large corporations, settlement becomes a key part of the strategy discussion. In order to avoid the costliness associated with, and reputational damage from, lengthy trials, it is not unexpected for a company to dip into its litigation budget and pay a premium to avoid the hassle. Some companies, however, adopt the opposite strategy: settlement avoidance. If a company is to adopt such a strategy, it will also need to adopt proper defensive measures, such as the implementation of adequate Human Resources ("HR") oversight, in order to effectively ride out the storm of the trial.

Background

Following Chipotle Mexican Grill, Inc. ("Chipotle") going public in January of 2006, it came to be known as an "industry darling".[1] Recognized for its transparency and its commitment to utilizing farm-fresh, high-quality ingredients, Chipotle was a trendsetter and leader in the fast-casual movement in dining.[2] In 2009, the restaurant was even featured in a subplot of the popular animated television series, *South Park*.[3] However, proving that what goes up must come down, the restaurant's success has come to a screeching halt – in fact, it is currently on the decline. As of January 2016, Chipotle's sales have sunk 36%, following a previous drop of 14.6% for the October-to-December quarter of 2015, which marked the first quarterly decline since Chipotle's IPO in 2006.[4] Further, its stock has fallen 31% over this same period.[5]

One likely culprit for this downward spiral is the reputational damage Chipotle has incurred following the myriad lawsuits filed against it over the years. In the past five years alone, Chipotle has had to manage 115 federal employee lawsuits.[6] While dealing with many lawsuits – often many at once – is commonplace for large companies, this number far exceeds what would typically be expected in this industry for a company of similar size. The 115 federal suits represent approximately "4.85 legal actions per 100 stores, more than three times the rate of two of its peers, Panera Bread and Starbucks".[7]Justin Swartz, a lawyer at Outten & Golden, has described the number of suits as "striking".[8] Mr. Swartz and his firm are currently representing over 500 former Chipotle employees.[9] Indeed, while the types of lawsuits filed against Chipotle in the past half-decade have varied, the vast majority has been employment-related, with former employees citing, *inter alia*: underpayment, termination without just cause, and discrimination.[10] Even the recent outbreak of *E. coli* found in Chipotle foods has been speculatively attributed to high levels of labor law violations by industry experts. These violations have led to working conditions conducive to the spreading of illness.[11]

In March of 2013, three former employees of Chipotle filed a lawsuit on account of alleged gender discrimination. Stephanie L. Ochoa, Tina M. Reynolds, and Elizabeth A. Rogers, all general managers in the Greater Cincinnati locations, claim that they were fired from their positions unfairly. Ochoa, who was commended for her helping to improve her location by "100%" by supervisors and who had previously been earning bonuses every six months, was fired in March of 2012 and replaced by a male employee.[12] Reynolds had been promoted numerous times, receiving a bonus, an "above expectations" in two categories of her employee evaluation, and an increase in pay in 2011. Later that same year, she was terminated and replaced by a male employee.[13]Finally, Rogers, following a series of allegedly hostile encounters with an area manager, Herman Mobbs, was fired in November of 2011; the facts surrounding the termination alluded to the termination allowing for the hiring and retention of male employees.[14] What's more is that all of these women were terminated when similarly situated males with worse evaluation scores were not.[15]

Analysis

Studies show that settling cases is often the best choice. This is reflected by the fact that the vast majority of cases do settle 80%-92% of the time.[16] In a study published in the *Journal of Empirical Legal Studies,* it was found that in only 15% of cases that went to trial were both sides right to have done so.[17][18] Thus, there is a statistical misalignment in the thought process between the decision to go to trial and the outcomes of trials. Jeffrey J. Rachlinksi, a law professor at Cornell, has concluded that "most of the time, one of the parties has made some kind of miscalculation or mistake."[19] Despite this empirical reality, Chipotle seems to adopt a strategy, or, at the very least, a tendency to attempt to avoid settlements, according to Katherine Neff, an attorney at Freking Myers & Reul LLC, who worked on the aforementioned gender discrimination suit against Chipotle.[20]

On February 8, 2016, an Ohio federal jury ordered Chipotle to pay approximately $607,000 to the three plaintiffs. Jurors awarded the women between $111,000 and $123,000 in back pay, along with $85,000 each in punitive damages.[21] For those seeking to mount effective defensive strategies and to learn from past mistakes, the question is: where did Chipotle go wrong? Embracing an aversion to settlement options necessarily requires tight oversight measures and, especially with regard to labor and employment disputes, an effective human resources department to monitor that oversight.

The importance of an HR department cannot be overstated. Katherine Neff explained:

Chipotle eliminated its "on the ground" HR folks a few years before our Plaintiffs were terminated. As such, there was no HR oversight for the termination decisions. Chipotle also eliminated the use of progressive discipline, so Plaintiffs had not received warnings prior to their terminations. Therefore, Chipotle neither had a "paper trail" nor a "neutral" review by HR to support the manager-bad actor's decision. According to the jury, this was a fatal flaw for them. Most large companies have both HR review and some form of progressive discipline that they follow before terminating an employee. It simply makes business sense to have this in place. That way if an employee disputes the termination decision, the company has something to point to in support of the termination decision. While progressive discipline and HR oversight is not always full proof, it makes it harder for employees to demonstrate discrimination if there is a paper trail and HR involvement. Also, in this case, several of the plaintiffs received positive performance reviews shortly before their terminations. One received a raise and a bonus in her final paycheck. Receiving good reviews, raises and/or bonuses does not support the employer's claim that these folks were poor performers. These are things that perhaps a skilled HR person would catch prior to authorizing a termination decision. I would guess that any HR person that has undergone training on EEO laws would question the mixed signals being sent to the employee that received a good review/raise, and/or bonus at the same time the manager is recommending termination.[22]

In this case, Chipotle essentially had to justify its termination of women who had evidence to show that their performance exceeded expectations and received high praise from superiors. To do that without an established HR team and without a paper trail to at least counter the one that the plaintiffs had accrued made the steep hill ultimately insurmountable. The organizational procedures put in place by Chipotle's management are questionable because those measures, absent HR oversight, also contributed to their loss at trial. In other words: one wonders why they would use the evaluative means discussed when doing so would amount to an easy and unfavorable comparative metric. At the end of the day, it was proven difficult for defense counsel to talk its way out of the fact that the women terminated excelled and the males retained or hired after-the-fact did not. But the devastating illustration made possible by these evaluative tools were not the silver bullet; they were one of quite a few factors that went into a decision for the plaintiffs. As Neff notes, "I'm not sure whether we would have defeated summary judgment if all that we had were the audit scores of other male comparators who were not terminated. With this particular judge, that may not have been enough, but with others it may have been."[23]

In order to ensure short-term success in defeating Chipotle's motion for summary judgment and long term success in the trial, Neff had to delve into two crucial factors: 1) the comparator evidence, which was the evidence that showed that other individuals outside of the protected class engaged in similar conduct but were not terminated;[24] and 2) changing reasons, which exist "when different witnesses provide varying testimony about the reasons for the termination, but also changing justifications offered by management for the terminations."[25] In addition to these factors, Chipotle made the case even easier for the plaintiffs through an overall lack of a paper trail and a lack of notification.[26] With regards to notification, “one of the plaintiffs received a warning prior to her termination. In the warning she was told her manager would follow up with her in 2 weeks, but he ended up deciding to terminate her just a couple of days later.”[27] The role of HR is to address all of the issues that culminated in bringing Chipotle to its knees. Since Chipotle did not have an “on the ground” HR staff to ensure compliance with labor laws, follow-through of the organization’s procedures, and proper execution of hiring-and-firing techniques, the outcome of this lawsuit should not have come to a surprise for the severely exposed restaurant.

If one were to imagine how things would have played out for Chipotle had they not eliminated its HR forces, the evaluations would likely have been put to better use such as the use for which they were intended: to ensure that good employees like plaintiffs were retained and employees with actually poor scores would be terminated. If plaintiffs had to be terminated, they would have received proper notice. Further, the uniformity of such procedures would have been offered to justify the terminations. In other words, because HR plays such a crucial role in termination decisions, they could have been called upon to testify and provide uniform justifications for those decisions. While HR oversight may not have guaranteed summary judgment, its presence would have made it significantly harder for the plaintiffs to win at trial.

Conclusion

Chipotle has found its way into a crisis and with all of the decisions it could pursue in an attempt to crawl out of its hole, it seems to be making the wrong ones. While it still has a chance to turn things around, lesson here is for other companies that should more successful in avoiding the circumstances plaguing Chipotle. While there have been myriad exposure points outlined, the key takeaway is to rely more on the establishment and role of HR. Companies should defer less to regional decision-makers when it comes to labor and employment matters and more so to those who specialize in the area, in order to ensure that they are not making drastic missteps. Something as seemingly simple as hiring and firing can get very complicated and corporations need to appreciate that and allocate resources accordingly. At a time when its sales have been declining for two fiscal quarters in a row, its stock value has fallen, and these issues are being attributed at least in part to reputational and financial cost of employment-related litigation, reducing HR's local capacity has proven to be a very bad decision. Chipotle should amend that decision and other companies should try to avoid the same mistake.

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[1] Brad Tuttle, *How Chipotle Went From Industry Darling to Restaurant to Avoid*, Time (Dec. 8, 2015)

[2] Id.

[3] South Park: Dead Celebrities (Oct. 7, 2009)

[4] Eric Schwartzberg, Chipotle Lawsuit Alleges Gender Discrimination, Dayton Daily News (Feb. 3, 2016)

[5] Id.

[6] Lisa Fickenscher, *Employees Can't Stop Suing Chipotle*, New York Post (Mar. 23, 2016)

[7] Id.

[8] Id.

[9] Id.

[10] Id.

[11] Id.

[12] Schwartzberg, supra note 4

[13] Id.

[14] Id.

[15] Id.

[16] Jonathan D. Glater, *Study Finds Settling Is Better Than Going to Trial*, New York Times (Aug. 7, 2008)

[17] Id.

[18] “Right to have done so” is assessed based on measuring the outcomes; in these cases, the defendant paid less than the plaintiff had wanted but the plaintiff got more than the defendant had offered during settlement negotiation

[19] Glater, supra note 14

[20] Katherine D. Neff, classroom lecture at the University of Illinois on Feb. 11, 2016

[21] Id.

[22] E-mail from Katherine D. Neff, Attorney, Freking Myers & Reul LLC (Feb. 18, 2016, 14:43 CST) (on file with author)

[23] Id.

[24] Id.

[25] Id.

[26] Id.

[27] Id.

IT'S A BIRD . . . IT'S A PLANE . . . IT'S A DRONE! STATE AND LOCAL DRONE APPLICATIONS IN LAW ENFORCEMENT

By: Steven Wittenberg

Introduction

Drone technology is here to stay. They are the Obama administration's instrument of choice for high-level officials to execute "lawful . . . lethal operations in a foreign country" aimed at enemy combatants (who can be U.S. citizens) who happen to be an "operational leader."[1][2] To qualify, there must be an "imminent threat," capture must not practical, and the slaying must be consistent with the laws of war. "Imminent" is a self-defense term, which demands that the official must "know, in a detailed manner, who poses such a threat, in what circumstances, and how and when such persons can be targeted."[3] At the intersection of intelligence gathering and the decision to strike are the so-called "kill lists,"[4] which are maintained to ensure the targets satisfy all the conditions of a *lawful* targeted killing.

As a vestige of President Obama's grand strategy to forge a "leaner" military to sustain prolonged military engagements in 2012,[5] the Pentagon planned a "sharp increase" in drone flights in August 2015.[6] Drones are both harshly criticized and reluctantly praised as the centerpiece weapon against enemy combatants. [7] The question is whether this new technology can be harnessed (or abused) within the fifty states and how.

Today, the proliferation of drones in civilian society is palpable. One need not look further than the website myfirstdrone.com, which is a one-stop shop for all things drone. Moreover, the headline, “Man Detained Outside White House for Trying to Fly Drone” sums up the current drone climate.[8] The Consumer Technology Association estimated 400,000 drones were sold over the past holiday season.[9] Legislatures have not been inactive. In Illinois, drones may not be used to frustrate another person’s hunt: either “wildlife or aquatic life.”[10] Indeed, Illinois formed a drone task force because “[i]t is clear that increased drone use creates emerging conflicts and challenges to providing guidance into the safe operation of drones, while not infringing upon the constitutional rights of others.”[11]

The typical drone is an “unmanned aircraft” as a part of an “unmanned aircraft system.” The system contains the required “support equipment, control station, data links, telemetry, communications and navigation equipment necessary to operate the unmanned aircraft.” In December 2015, the Federal Aviation Administration (FAA) released a “Fact Sheet” advising state and local authorities on drone regulation.[12] According to the Illinois Freedom from Drone Surveillance Act, a “drone” is “any aerial vehicle that does not carry a human operator.”[13]

There are two ways for people to receive federal authorization to use drones for non-governmental use. You can get a Section 333 Exemption for “commercial operations in low-risk, controlled environments.”[14] Alternatively, you might try getting a Special Airworthiness Certificate (SAC), which requires you to describe the drone, its intended use and its quality assurance procedures.[15] Currently, “carrying persons or property for compensation or hire is prohibited.”[16] Lastly, if you can get federal authorization, you must also comply with state law.
The FAA fact sheet advises cooperation with federal authorities on areas of regulation regarding “navigable airspace” and mandatory training. It also noted

the capacities where state governments would have exclusive control under their police power not delegated to Congress secured by the 10th Amendment to the U.S. Constitution.[17] The areas traditionally under state police power include land use controls, zoning policy, privacy, trespass, and law enforcement operations.[18]

Law Enforcement Drone Application

U.S. states possess the inherent power as once-sovereigns to implement a law enforcement drone program under their police power. Drones may work *in concert* with the state's local law enforcement officers. In fact, today, drones are used for surveillance and have reportedly added great value in search-and-rescue operations.[19] They improve "situational awareness" through their cameras and sensors for border control situations.[20] In addition to working in concert with law enforcement, drones might also be used to work*independently* through a leading role. Independent drones would be a *primary*agent of the state;[21] however, they would still require an unmanned aircraft system to support their operations, but their objectives could be *crime prevention*.
Crime prevention would be premised on a similar self-defense justification the Obama administration marshals for its targeted killing program. Under Article 51 of the United Nations Charter, the U.S. holds a self-defense privilege to use lethal force against individuals planning attacks within and without warzones.[22] For individuals, "self-defense is a primary law of nature."[23] Just as a police officer may use necessary and reasonable force prevent harm to himself or others when he reasonable believes the response was required to avert the harm,[24] so too could a drone defend others (technology permitting).

State law enforcement application of drones could include patrolling neighborhoods with high crime rates. In practice, drones could surveil their vicinity with their sensors and detect firearm discharges and cross-locate origin points, expediting police response times. However, this model is merely responsive and not preventive. As the technology develops, there may be a way for special types of drones, as primary actors of the state, to incapacitate would-be violent criminals by disabling the actor under the self-defense and defense of others justifications. But this application of drones sounds of science fiction and invasion of privacy. Therefore, incapacitation by drone may be applied, if applied at all, only in limited situations.

The real benefit of drones as a policing agent, consequently, would be in their deterrent effect against criminal behavior as mentioned above. A study in 2005 found a fifteen percent reduction in crime when extra officers were on duty during “high terror alert days.”[25] University of Chicago Professor of Economics Steven Levitt estimates that with every ten percent increase in the amount of police, violent crime is reduced by four percent and property crime is reduced by five percent.[26]

The average annual salary of a police officer is $52,810.[27] The average police drone would cost between $20,000 to $30,000.[28] If police drones can quickly summon their human counterparts and apprehend criminals, then crime could feasibly go down with greater economic efficiency than putting more cops on the street. Indeed, the greatest criminal deterrent is certainty about being caught.[29] If criminals acquire the knowledge they will likely be caught through the presence of drones, then crime should go down.

Police State Considerations

The greatest concern about employing drones under the auspices of a state's police power is the fear of an authoritarian police state. There may be worries about the potential invasion of privacy of which drones are capable.[30] It is quite plausible for state and local governments to use drones to invade privacy with the backdrop of the National Security Agency's ever-monitoring presence.[31]
It also might be tempting with the advent of drones to use the technology to*assassinate* criminal ringleaders and dangerous felons within the United States, especially those who are wanted dead or alive, similar to federal government's use of drones abroad. Critics would rally behind the potential violation of the target's right to a trial by jury under the 6th Amendment of the U.S. Constitution and the 14th Amendment's guarantee to not be "deprived of life, liberty or property, without due process of law" by a state.[32] However, at the same time, it could be argued the slaying was necessary for the defense of others if the target was deemed an "imminent" threat, which would echo the Obama administration's authorization to kill U.S. citizen Anward al-Awlaki.[33]

The Current Drone Landscape

The Illinois state legislature has regulated drone use in law enforcement to assuage privacy concerns. The Act provides:

(a) Except as provided in Section 15, a *law enforcement agency may not acquire information from or direct the acquisition of information through the use of a drone owned by a private third party*. In the event that law enforcement acquires information from or directs the acquisition of information through the

use of a privately owned drone under Section 15 of this Act, any information so acquired is subject to Sections 20 and 25 of this Act.
(b) *Nothing in this Act prohibits private third parties from voluntarily submitting information acquired by a privately owned drone to law enforcement*. In the event that law enforcement acquires information from the voluntary submission of that information, whether under a request or on a private drone owner's initiative, the information is subject to Sections 20 and 25 of this Act.[34]
Part (b) may indicate that neighborhood watch groups may help police with their own drones with surveillance footage. However, the above act has plenty of exceptions for extreme circumstances. For example, law enforcement agencies may use drones to counter high-risk terrorist threats, or where "a law enforcement agency possesses reasonable suspicion that, under particular circumstances, swift action is needed to prevent imminent harm . . . ."[35]

The use of drones are undeniably valid exercises of state police power within the law enforcement sphere. There are valid fears of constant overhead surveillance, but there certainly is a potential to use drones for criminal deterrence in high crime areas. Moreover, drone manufacturers can partner with state governments to experiment with the immeasurable applications of drone technology in local law enforcement.

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[1] David Rohde, *The Obama Doctrine*, Foreign Policy (Feb. 27, 2012), http://foreignpolicy.com/2012/02/27/the-obama-doctrine/.
[2] NBC News, *Department of Justice White Paper* (Feb. 4, 2013), http://msnbcmedia.msn.com/i/msnbc/sections/news/020413_DOJ_White_Paper.pdf.

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[8] Kristen Holmes, *Man Detained Outside White House For Trying To Fly Drone*, CNN (May 15, 2015), http://www.cnn.com/2015/05/14/politics/white-house-drone-arrest/.

[9] Ronald J. Hedges & Julie Lewis, *Drones, the Public, and You*, Bloomberg BNA (Feb. 15, 2016), https://www.bloomberglaw.com/document/XE9BIFIO000000.

[10] 720 Ill. Comp. Stat. Ann. 5/48-3(b)(10) (West 2013).

[11] 20 Ill. Comp. Stat. Ann. 5065/5 (West 2015).

[12] Federal Aviation Administration Office of the Chief Counsel, *State and Local Regulation of Unmanned Aircraft Systems (UAS) Fact sheet*, (Dec. 17, 2015) [hereinafter FAA, *Regulation of UAS*], https://www.faa.gov/uas/regulations_policies/media/UAS_Fact_Sheet_Final.pdf.

[13] 725 Ill. Comp. Stat. Ann. 167/5 (West 2014).

[14] Federal Aviation Administration, *Civil Operations (Non-Governmental)* (last visited Apr. 9, 2016), https://www.faa.gov/uas/civil_operations/.

[15] *Id.*

[16] *Id.*

[17] *See generally Mayor of New York v. Miln*, 36 U.S. 102, 103 (1837) ("All those powers which relate to merely municipal legislation, or which may more properly be called internal police, are not surrendered or restrained; and consequently, in relation to these the authority of a state is complete, unqualified and exclusive.").

[18] *See* FAA, *Regulation of UAS, supra* note 10.

[19] American Civil Liberties Union, *Domestic Drones*, https://www.aclu.org/issues/privacy-technology/surveillance-technologies/domestic-drones (last visited Feb. 13, 2016).

[20] PoliceOne.com, *5 UAV Technologies For Police*, (Apr. 10, 2014), https://www.policeone.com/police-products/investigation/video-surveillance/articles/7067279-5-UAV-technologies-for-police/.

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[22] Jonathan Masters, *Targeted Killings*, Council on Foreign Relations (May 23, 2013), http://www.cfr.org/counterterrorism/targeted-killings/p9627.

[23] 33 Am. Jur. Proof of Facts 2d 211 (Originally published in 1983).

[24] Michigan Non-Standard Jury Instr. Criminal § 13:10.

[25] Jill Elish, *More Cops On Beat Reduce Crime On Street, FSU Study Shows*, Florida State University News, https://www.fsu.edu/news/2005/06/24/more.cops/ (last accessed Feb. 13, 2016).

[26] Jens Ludwig, *More COPS*, Brookings Institution (Mar. 2007), http://www.brookings.edu/research/papers/2007/03/crime-ludwig.

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[28] Orange County Register, *Police Drones Could Be Coming To A Sky Near You*, Creators.com, http://www.creators.com/opinion/daily-editorials/police-drones-could-be-coming-to-a-sky-near-you.html (last accessed Feb. 13, 2016).

[29] Office of Justice Programs, *Five Things about Deterrence*, National Institute of Justice (Sept. 12, 2014), http://nij.gov/five-things/pages/deterrence.aspx.

[30] *See* Laura Sydell, *Now You Can Sign Up To Keep Drones Away From Your Property*, NPR (Feb. 24, 2015), http://www.npr.org/sections/alltechconsidered/2015/02/23/388503640/now-you-can-sign-up-to-keep-drones-away-from-your-property.

[31] *See* Krishnadev Calamur, *5 Things To Know About The NSA's Surveillance Activities*, NPR (Oct. 23, 2013), http://www.npr.org/sections/parallels/2013/10/23/240239062/five-things-to-know-about-the-nsas-surveillance-activities.

[32] U.S. Const. amend. VI; U.S. Const. amend. XIV.

[33] Charlie Savage, *Court Releases Large Parts of Memo Approving Killing of American in Yemen*, New York Times (Jun. 23, 2014), http://www.nytimes.com/2014/06/24/us/justice-department-found-it-lawful-to-target-anwar-al-awlaki.html.

[34] 725 Ill. Comp. Stat. Ann. 167/40 (West 2015) (emphasis added).

[35] 725 Ill. Comp. Stat. Ann. 167/15(1), (3) (West 2015).

A FIDUCIARY DUTY REQUIREMENT FOR FINANCIAL PROFESSIONALS IS GREAT, IN THEORY

By: Joe Zender

On April 6, the Department of Labor released a new regulation pertaining to the duties owed by financial advisors to their clients.[1] The new regulation, which is scheduled to go into effect on January 1, 2018, transforms fundamental aspects of the financial services industry.[2] The new rule, called a fiduciary duty rule, requires financial professionals to act in the best interest of their clients.[3] While a savvy investor or an ethical advisor may have already required this as part of their relationships, many retail investors do not know the ramifications of such a duty. The new rule forces this type of duty. Opponents of the rule argue that the new regulation will increase costs across the financial services industry, which could force small budget investors out of the advising market, during a time when they could use it. At the same time, those who can still afford the advice should receive better tailored and more transparent advice from their financial professionals. On the other hand, the new regulation adds one more hurdle for an industry that can ill afford one at this time, when robo-advising is becoming more prevalent.

Financial advisors meet with their clients to discuss the clients' goals, objectives, and long term plans.[4] They explain the types of financial services available to the client and offer advice on the course the client should take.[5]Registered investment advisors have already been held to the fiduciary standard.[6] However, the new Department of Labor regulation would clarify who the duty would cover, because financial advisors use a wide array of titles, from wealth managers to financial planners.[7]

Prior to the Department of Labor's new regulatory changes, financial professionals, other than registered investment advisors, were only required to use a "suitability standard", which required them to sell suitable products for the needs of their clients.[8] Often times an advisor suggests investment options like stocks or mutual funds, and places trades for the client in conjunction with advice and guidance.[9] Financial brokers on the other hand can only sell stocks and financial instruments.[10] These two financial professionals also differ on how they charge for their services. Brokers make their money on commissions per trade, while financial advisors typically charge a percentage of total assets on an annual basis, typically ranging from 1% to 2%.[11]

While a savvy investor would make sure that their financial professional held a fiduciary duty towards them, many investors do not. Under the suitability rule, a broker could legally steer clients towards investments that paid out larger commissions or were even products managed by their own company.[12] The new rule allows those that can afford a financial professional to receive more transparency, particularly, that their broker is not selling them products which enrich the broker at their expense.[13] Not all finance companies are opposed to the new regulation. Merrill Lynch said that they, "support a consistent, higher standard for all professionals who advise the American people on their investments."[14] The higher standard appears to be a good change for retail investors, however, as with all governmental regulations, there will be unintended consequences. In addition, if investors were more intelligent on who they selected to be their financial advisor, this regulation would be entirely unnecessary. Opponents of the higher duty rule argue that their new duties will prevent them from helping more people with their retirement planning.[15] The Securities Industry and Financial Markets Association, an industry trade group, one of the largest opponents of the new higher standard, said it remains "concerned that the DOL's rule could force significant changes to current relationships, which may leave clients without the help they need to prepare for retirement, at a time when we all agree that more can and should be done."[16] The new rule could be costly to firms, adjusting the entire way they do business, which could force budget investors out of the advising marketplace because it just is not profitable for advisers to take them as clients.[17] The people that most need help with retirement advice, the poor and downtrodden, could have less access to that advice because of the new regulation. Just because financial professionals will be required to act in the best interest of their clients, does not mean they need to take on clients if they do not want to.

In addition, as the new rule burdens financial companies more, they may have to increase their fees in order to cover the additional costs.[18] In 2012, federal regulation compliance encompassed $2 trillion in costs in the United States.[19]To argue that more regulations and costs are needed, is counter to economic thought, which would say increased costs lead to more market concentration as companies attempt to spread out the fixed costs of complying with the regulations.[20] Furthermore, economics would say that more market concentration can lead to even higher prices.[21] While the intentions of the regulation might be pure, the consequences of it could be to prevent the poorer segments of the population from getting important financial advice and could also raise the costs to other clients of advising services.

The opponents of the new fiduciary rule are also poised to challenge the regulation in court under the Administrative Procedure Act.[22] The opponents would likely argue that the new regulation is arbitrary and capricious, and the courts need not defer to it.[23] They are unlikely to succeed however, because of the difficulty proving the arbitrary and capricious nature of the regulation.[24]Additionally the opponents cannot rely on Congress overturning the regulation because too many Democrats would not want to counter a regulation promulgated and supported by President Obama.[25] While legally, it appears the regulation will survive, it does not mean the costs associated with it should be allowed to enter the market.

The financial advising industry is bombarded on a number of fronts. While some projections say that the industry may add as many as 74,000 jobs over the next ten years, the future looks bleak.[26] The advent of the so called robo-advisor has caused significant strain in the financial services industry. A robo-advisor is a wealth management service that provides automated, algorithm-based portfolio advice without the use of a financial advisor.[27] While there are countless services, robo-advisors are becoming increasingly sophisticated.[28]Like other industries that have been replaced by automation, financial advisors are progressively needing to provide value to their clients that computer cannot.[29] New regulations like those posed by the Department of Labor, only make it more difficult for human advisors to compete with robo-advisors. While many advisors charge 1 to 2% in annual fees, robo-advisor firms can afford to charge a lot less for the same service, sometimes as low as .25%.[30] The costs associated with possessing a fiduciary duty will only make normal advising less viable.

Robo-advising might seem like a great idea, as it could offer those pushed out of traditional advising because of the costs, an avenue to receive advice about their investments. However, some of the robo-advising firms do not offer well-tailored enough advice to help plan for retirement and some investors like the ‘human touch’.[31] Whereas robo-advisors are great at directing investments, analyzing betas, or finding values in the stock market, they are ill-equipped in understanding the goals and objectives of an individual person.[32] Planning an estate, for the purchase of a house, or in analyzing the risk tolerance of an investor is something an experienced advisor can do much better than a computer. Only one third of the American population would be comfortable using a totally automatized advising service.[33] While robo-advisors still are not fully capable of displacing traditional advisors, they are eating into a market segment that may not be able to withstand more compliance and regulatory costs.

The Department of Labor's new regulation, requiring a fiduciary relationship between financial professionals and their clients is a great idea in theory. It allows those who can afford it a guarantee that their financial professional is doing what is in their best interest. However, a savvy investor would have already been in a fiduciary relationship with their advisor, and that savvy investor is now going to be punished for others' ignorance with higher costs. Additionally, the added cost of compliance may force those who most need the investment and financial advice out of the market. Lastly, the added costs to the financial advising industry, is not what it needs during the ascension of robo-advisors, who are a cheaper alternative, even though less people feel comfortable with them at this time. While the new Department of Labor's regulation will be heralded as a success for the common man, as a destruction of 'greed', it may end up having the exact opposite effect as it was intended to have, less access and worse financial advising available for everyone.

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[3] *Id.*

[4] *What Personal Financial Advisors Do*, Bureau of Labor Statistics (Dec. 17, 2015), http://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm#tab-2.

[5] *Id.*

[6] Elizabeth O'Brien, *Obama administration targets financial advisers better at enriching themselves than clients*, Market Watch (April 6, 2016), http://www.marketwatch.com/story/new-fiduciary-rules-set-to-protect-retirement-savers-2016-04-06.

[7] *Id.*

[8] *Id.*

[9] *What Personal Financial Advisors Do*, Bureau of Labor Statistics (Dec. 17, 2015), http://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm#tab-2.

[10] Eve Kaplan, *The Difference Between A Stockbroker, Financial Advisor And Planner Explained*, Forbes (Mar. 15, 2012), http://www.forbes.com/sites/feeonlyplanner/2012/03/15/the-difference-between-a-stockbroker-financial-advisor-and-planner-explained/#7b93c32a9fc7.

[11] *Id.*

[12] Elizabeth O'Brien, *Obama administration targets financial advisers better at enriching themselves than clients*, Market Watch (April 6, 2016),

http://www.marketwatch.com/story/new-fiduciary-rules-set-to-protect-retirement-savers-2016-04-06.

[13] *Id.*

[14] *Reactions to the Labor Department's Fiduciary Rule*, Wall Street Journal (April 6, 2016), http://www.wsj.com/articles/reactions-to-the-labor-departments-fiduciary-rule-1459954904.

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[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business*, National Association of Manufacturers (2014), http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Executive-Summary.pdf.

[20] William F. Shughart II, Industrial Concentration, The Concise Encyclopedia of Economics, http://www.econlib.org/library/Enc/IndustrialConcentration.html.

[21] *Id.*

[22] *Reactions to the Labor Department's Fiduciary Rule*, Wall Street Journal (April 6, 2016), http://www.wsj.com/articles/reactions-to-the-labor-departments-fiduciary-rule-1459954904.

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *What Personal Financial Advisors Do*, Bureau of Labor Statistics (Dec. 17, 2015), http://www.bls.gov/ooh/business-and-financial/personal-financial-advisors.htm#tab-2.

[27] *Robo-Advisor*, Investopedia (2016), http://www.investopedia.com/terms/r/roboadvisor-roboadviser.asp.

[28] *Can Robo Advisers Replace Human Financial Advisers?,* Wall Street Journal (Feb. 28, 2016), http://www.wsj.com/articles/can-robo-advisers-replace-human-financial-advisers-1456715553.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

THIRD-PARTY LITIGATION FINANCE: LEVELING THE PLAYING FIELD OR OVERSTEPPING ETHICAL BOUNDARIES?

By: Alexander Karl

A teacher of mine once described capitalism as taking piles of money and making them grow. While this is a somewhat elementary definition, the idea is on the right track. The American economy proudly boasts of its capitalist background. We paint a picture (though some say it's wrongly painted) in which an immigrant with no money to his name can strike it rich with a little sweat and elbow grease. Capitalism and its general principles resonate with many Americans to this day as they are finding new unique ways to watch their piles of money grow. As many Americans have figured out, there is no better way to grow your money than investments. When pondering the investments prevalent within today's society a few come to mind such as stocks, bonds, real estate, and gold. However, capitalists are always on the cutting edge of new investment trends and few are larger than Third-Party Litigation Finance (TPLF). The purpose of this article is to give an overview of TPLF and discuss the impact it will have on the judicial system.

What is TPLF?

TPLF is an opportunity to fund other people's lawsuits in a hope of retaining a portion of the potential winnings.[i] The earnings potential of this investment is very large. Initially focusing personal injury claims, investors looked to tap into the $140 billion insurance companies paid out in 2014.[ii] But as more people catch onto this new trend, it is expanding into other fields such as divorce claims and class-action lawsuits against large corporations.[iii] The business model for the investment is simple. Investment firms will give thousands, or even millions, of dollars on speculation there will be damages paid to the plaintiff.[iv] Then the investment firm recoups a portion of the winnings with interest usually around 25-30%.[v] This opportunity allows investors to further diversify, and earn interest on an asset with no other correlation to previous investments.[vi] The investment money is then given to the plaintiff's counsel who delegates it as needed. While the funds can be used within the lawyer's discretion, often times it is to pay for expensive expert testimony and to keep cases moving forward.[vii] Upon initial discovery of this new investment trend, I lauded at how the capitalists had done it again. But the more I began to think about it, ethical considerations crept into the back of my mind. This is what makes TPLF so enthralling: the investment realm of capitalism versus the ethical and prevailing justice of the American Judicial system.

TPLF is a Key to the Courtroom

The main benefit of allowing TPLF is it generates opportunities for citizens to bring cases which would otherwise go unheard.[viii] It is no secret that litigation is expensive. In 2009, the average civil litigation case in federal court cost roughly $15,000.[ix] This cost could go up drastically if expert testimony is involved. For example, medical malpractice claims often have numerous experts, and cases can quickly climb over $100,000.[x] For the average American who is unsure of the strength of their claim, or simply lacks funding, TPLF can be an enticing option. Not only does funding help get the ball rolling on cases, but it also keeps them going. Individuals in malpractice, or personal injury claims are often pitted against large corporations. These corporations have pockets which are bottomless pits compared to the average plaintiff. It's a true David versus Goliath showdown, and one in which corporations attempt to drag on for as long as possible. Corporations drive up the cost of litigation through delay tactics and appeals in an attempt to force the plaintiff into a financial corner and cause them to settle for less.[xi] Often times, knowing the plaintiff has funding will lead to quicker settlements because instead of being armed with a slingshot, David now has a handgun. While TPLF may initially sound like a great idea to level the judicial playing field, there are still ethical considerations and the potential for greedy attorneys and investors to unduly capitalize from client's dire situations.

Is TPLF the Next Capitalist Monster?

Some have deemed TPLF to go against judicial principles. Lisa Rickard, from the Institute for Legal Reform, describes this new investment as "the biggest single threat to the integrity of our justice system."[xii] Her worries have justification for various reasons. First and foremost, what was once meant to be a system of promoting justice could turn into an avenue for third-party investment growth.[xiii] The notion justice may ride on how much investment backing a party has may be unsettling. Cases have already arisen which were manufactured in order to make money. One such case involves a Nevada company which conducted free home inspections and had homeowners unknowingly sign a waiver allowing the company to seek suits on their behalf.[xiv] This led to hundreds of lawsuits which saw the inspectors act as an investor by providing their reports to a law firm.[xv] Their suits eventually got shut down and a court ruled no more suits of its nature could be filed.[xvi] While this is the main concern with TPLF, it is not the only one. The confidentiality of clients can be jeopardized. Funding a lawsuit is like any other investment venture where investors want to gather background information about cases and plaintiffs.[xvii] This puts law firms in the precarious situation of attempting to maintain their client's confidentiality while maximizing their chances for success. Finally, often times firms do not properly communicate to clients they are borrowing funding for their cases, and this can significantly cut into the clients payout.[xviii] One example of this is a plaintiff who only took home $800,000 from a $25 million settlement after fees reduced his stake to roughly 3%.[xix] It's clear these worries have hit legislative ears because some states, such as Nevada and Minnesota, have specifically stated investing in lawsuits is illegal.[xx] Yet, this relatively new form of investment has left officials not knowing how to react. While TPLF has its upsides and downsides, the issue must be looked into more and regulation must be increased.

What Should Be Done

TPLF has the potential to revolutionize the judicial system. No longer must an individual with low income fail to have their claim heard. Nonetheless, there needs to be a set standard for acceptable funding practices, and I believe this begins with controlling the portion of profits investors can retain. This would sway the investing feel towards the promotion of justice. Investors can now charge around 30% interest and, as mentioned above, this can dramatically impact the plaintiff's stake. Regulating a lower interest rate would allow investors a large return on a potentially risky investment while better serving the injured party. Furthermore, increased regulation would create competition amongst investors to offer lower interest rates. This would in turn benefit the plaintiff by allowing them to maximize the amount of damages they retain. Not only must there be rules regulating the investors interest rates, but there must also be strict punishments for manufactured lawsuits. Companies, such as the inspection company in Nevada, who are found to have thrust parties into unwanted litigation should be forced to pay for all litigation fees. This puts the burden on investors and law firms to make sure the claims they are bringing are legitimate and not wasting the courts valuable time. Finally, law firms must be more upfront to clients about investments and divulge who is investing in the lawsuit before litigation. Not only will this keep clients more informed about their own case, but it will also prevent any potential market manipulation from investors.

TPLF points to the very fundamentals of capitalism and has the power to either grow or destroy the American judicial system. As more cases begin to have outside investors, the regulations suggested above would be a good start to harnessing its potential to promote justice. It could lead to the inclusion of every citizen to a system in which high litigation costs may have once precluded them from. While the wary may see another opportunity for the rich to abuse their power at the expense of injured parties, this funding can be revolutionary if it is controlled with the larger picture in mind.

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[iii] Appelbaum, *supra*.

[iv] Sasha Nichols, *Access to Cash, Access to Court: Unlocking the Courtroom Doors with Third-Party Litigation Finance*, 5 U.C. Irvine L. Rev. 197, 198 (2015).

[v] Fisher, *supra*.

[vi] *Id.*

[vii] Appelbaum, *supra*.

[viii] *Id*.

[ix] *Id*.

[x] *Id*.

[xi] *Id*.

[xii] Matthias Schwartz, *Should You Be Allowed To Invest In a Lawsuit?*, N.Y. Times (Oct. 22, 2015), http://www.nytimes.com/2015/10/25/magazine/should-you-be-allowed-to-invest-in-a-lawsuit.html.

[xiii] Nichols, *supra*.

[xiv] Appelbaum, *supra*.

[xv] *Id*.

[xvi] Del Webb Communities, Inc. v. Partington, No. 2:08-cv-00571-RCJ-GWF, 2009 U.S. Dist. LEXIS 85616, at *59 (D. Nev. Sep. 17, 2009).

[xvii] Applebaum, *supra*.

[xviii] Schwartz, *supra*.

[xix] *Id.*

[xx] Nichols, *supra*.

NEW LEGAL PROBLEMS CREATED BY WEARABLE DEVICES

By: Young Ah Kim

I. Introduction

Wearable devices have been drawing serious attention in the media as the next big thing since Google glass, a wearable device with an optical head-mounted display, was launched in 2013.[1] Fitbit, the maker of fitness-tracking wristbands, went public in 2015 after its sales rose 174% to $745 million in 2014.[2] Since GoPro's initial public offering in 2014, the maker of the action camera has climbed over 100% from its top-of-the-range IPO price-per-share.[3] Apple unveiled the Apple watch that can monitor heart rate and activity and create a one-stop shop for health information of consumers.[4] Apple CEO Tim Cook called the Apple Watch "the most personal device we've ever created."[5]According to Statista, an Internet-based statistics provider, "the global wearable device market is expected to grow from $5 billion in 2014 to $12.6 billion by 2018."[6] In a 2014 PwC survey, fifty-six percent of the respondents believed that wearable health devices could extend their life expectancy by 10 years.[7]Similarly, forty-six percent thought that wearable technology will decrease obesity by helping consumers to monitor nutrition and exercise, and forty two percent expected that the devices would improve athletic ability over time.[8]

Wearable devices are defined as electronic technologies that are "incorporated into items of clothing and accessories which can comfortably be worn on the body."[9] "Wearable computers may be worn under, over, or in clothing, or may also be themselves clothes." The difference between mobile phones and these wearable devices is that wearable devices have much greater performance and are more sophisticated in providing sensory and scanning features such as tracking of physiological function than hand-held devices.[11] Wearable technology has far reaching impacts in the fields of health and fitness education, finance, aging, disabilities, gaming and entertainment.[12] For instance, a "Smart Shirt" can monitor vital signs and send that biofeedback information to a hub center in real time.[13] With the increasing popularity of wearable devices, consumers are willing to provide their sensitive information in exchange for the benefits of "self-profiling" and thorough analysis of their health.[14]

These characteristics of wearable devices are likely to create new legal problems regarding privacy and product liability. These legal issues are not novel per se, but the ability of wearable technology to capture real-time information and images in a user's and someone else's life creates many new legal questions.

II. Privacy

Since wearable technologies gather and process considerable amounts of sensitive personal data, they raise a broad range of privacy issues such as identity theft, stalking or discrimination.[15] The International Privacy Conference of 2014 stated in a declaration that big data, a term that describes the large volume of data[16], derived from technologies such as wearable technology should be treated as personal data.[17] Personal information is generally defined as "information relating to an individual that can be used to identify, locate or contact that individual, alone or when combined with other personal or identifying information."[18] Examples of personal information include a person's name, home address, email address, social security number, photographic image, audio and video recordings, or fingerprints.[19]

The precise definition of personal information varies depending on the specific jurisdiction.[20] In Illinois, for instance, under the Personal Information Protection Act, personal information is limited to “an individual’s first name or first initial and last name in combination with any one or more of the following data elements, when either the name or the data elements are not encrypted or redacted: (1) Social Security number; (2) Driver’s license number or State identification card number; (3) Account number or credit or debit card number, or an account number or credit card number in combination with any required security code, access code, or password that would permit access to an individual’s financial account.”[21]

As long as the user of the device consents to such data collection explicitly or implicitly, data collected and processed through wearable devices may be justified in most jurisdictions. Illinois courts have recognized consent as a defense to a publication of private facts claim.[22] In Illinois, “the right of privacy is not absolute but is subject to limitations where there is express or implied consent and legitimate interests.”[23] A more serious problem is someone else’s privacy, because they would not even be aware that their personal information is collected and processed without their express or implied consent. Since wearable devices collect information about the environment in which the wearer is present, the devices can be used to invade someone’s privacy. Since such devices are attached to the body of a person or her clothing and are therefore constantly in motion, the device will generate new data wherever the wearer goes. For instance, Google Glass is able to record real-time facial images of someone walking down the street and search and post data on that person on the spot.[24] Thus, the scope of data collected and processed by such devices should be taken into serious consideration to protect third parties’ sensitive and personal data.

III. Product Liability

In March 2014, the U.S. Consumer Product Safety Commission (CPSC) ordered a recall of the Fitbit Force, one of the most popular wireless activity-tracking wristbands, due to the risk of skin irritation.[25] Fitbit sold more than one million Fitbit Forces in the U.S.[26] According to the official CPSC recall notice, "[u]sers can develop allergic reactions to the stainless steel casing, materials used in the strap, or adhesives used to assemble the product, resulting in redness, rashes or blistering where the skin has been in contact with the tracker."[27]

The increasing use of wearable devices raises various issues regarding potential product liability for manufacturers because they may malfunction and/or protected data may be lost. Since wearable devices are always turned on as long as the user wears it, the risk of product liability also increases. If a healthcare monitoring device that measures heart rate or glucose level for diabetes fails to correctly identify the symptoms of a patient, or if such device has inherent defects, dangerous medical situations may happen. Then, should the manufacturer be liable for the risk of bodily injury?

If wearable devices were designed so defectively that a reasonable patient could still suffer injuries although he used them as instructed, she may be able to recover damages. She may be able to obtain punitive damages as well if she can prove that the device maker knew or should have known about the defects during the manufacturing process. However, if injuries are caused because the device automatically makes an incorrect critical decision, such as incorrect frequency or amount of an insulin injection, the question of the manufacturer's liability becomes even more complicated.

IV. Conclusion

Wearable devices provide comfort and safety by letting users easily locate information, gauge their body conditions such as pulse, heart rhythm or skin temperature and by giving them personalized recommendations based on the analysis of human outputs. At the same time, however, wearable devices may invade someone's privacy or cause serious injuries if they are not properly operated or manufactured. These concerns will increase as wearable devices become more popular. Manufacturers of wearable devices should take into consideration a series of new legal problems, not just current federal and state regulations. Wearable devices producers should follow the proper security procedures when developing their products and services.

[1] Jillian D'Onfro, *An insider's look at the tumultuous launch of Google Glass*, Business Insider (Feb. 28, 2015) http://www.businessinsider.com/google-glass-launch-2015-2

[2] Stephen Gandel, *Fitbit's IPO scores one of the biggest opening pops of the year*, Fortune (June 17, 2015) http://fortune.com/2015/06/17/fitbits-ipo-prices/

[3] Brian Solomon, *GoPro Can't Be Stopped: Stock Up Over 100% From IPO*, Forbes (July 1, 2014) http://www.forbes.com/sites/briansolomon/2014/07/01/gopro-cant-be-stopped-stock-up-over-100-from-ipo/#2f429d069dc9

[4] http://www.apple.com/live/2014-sept-event/

[5] *Id.*

[6] Tom Starner, *Risks of Wearables*, Risk & Insurance (October 15, 2014) http://www.riskandinsurance.com/risks-wearables/

[7] PwC Health Research Institute, Health wearables:Early days, 2014 Summer https://www.pwc.com/us/en/health-industries/top-health-industry-issues/assets/pwc-hri-wearable-devices.pdf

[8] *Id.*

[9] Wearable Devices, *Wearable Technology and Wearable Devices Everything You Need to Know* (March 26, 2014) http://www.wearabledevices.com/what-is-a-wearable-device/

[10] Steve Mann, Wearable Computing, in: Mads Soegaard / Rikke Friis Dam (eds.), The Encyclopedia of Human-Computer Interaction, 2nd ed., 2012 (available at https://www.interaction-design.org/literature/book/the-encyclopedia-of-human-computer-interaction-2nd-ed/wearable-computing)

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] Ben Rossi, *Wearable technology: will legal issues spoil the party?*, Information Age (July 29, 2015)

[15] *Id.*

[16] http://www.sas.com/en_us/insights/big-data/what-is-big-data.html

[17] *Id.*

[18] Personal Information, Practical Law Glossary Item 1-501-8805

[19] *Id.*

[20] *Id.*

[21] 815 Ill. Comp. Stat. Ann. 530/5

[22] Brents v. Morgan, 221 Ky. 765, 299 S.W. 967, 55 A.L.R. 964 (1927); Green v. Alaska Nat. Ins. Co., 759 So. 2d 165, 2000 A.M.C. 1369, 1999-2844 (La. Ct. App. 4th Cir. 2000), writ denied, 763 So. 2d 606 (La. 2000).

[23] *Bloomfield v. Retail Credit Co.*, 14 Ill. App. 3d 158, 173 (1973)

[24] Tom Starner, *Risks of Wearables*, Risk & Insurance (October 15, 2014) http://www.riskandinsurance.com/risks-wearables/

[25] the U.S. Consumer Product Safety Commission, Fitbit Recalls Force Activity-Tracking Wristband Due to Risk of Skin Irritation http://www.cpsc.gov/en/Recalls/2014/Fitbit-Recalls-Force-Activity-Tracking-Wristband/

[26] Mark Rogowsky, Fitbit Force Recall Is Bad News For The Company And Wearable Tech, But Is It Necessary?, Forbes (March 13, 2014) http://www.forbes.com/sites/markrogowsky/2014/03/13/fitbit-force-recall-is-bad-for-the-company-and-wearable-tech-but-is-it-necessary/#61a9f2887e8a

[27] *Id.*

NEW YORK'S LEGALLY DUBIOUS AND HARMFUL SODIUM LABELING SCHEME

By: Joseph Zender

In September, New York City's Board of Health ("Board") passed an ordinance that requires restaurants to post warnings on items on their menus that are have high sodium content.[1] The National Restaurant Association is challenging the new law in state court on the grounds that it is overly burdensome and that it circumvents the legislative process.[2] The new law would require restaurants with more than 15 locations nationwide to place a black triangle next to any item on their menu that contains more than 2,300 milligrams (0.08 ounces) of sodium.[3] Not only is the New York City Board of Health's move legally dubious by circumventing the legislative process and overly burdening the restaurants, it will also have unintended consequences that will affect the community at large in adverse ways.

The sodium posting requirement is reminiscent of another action by the Board back in 2012, when they attempted the so-called 'Soda Ban'.[4] The Soda Ban restricted restaurants and convenience stores from selling soft drinks greater than 16 ounces, in the name of obesity prevention.[5] In the instant case, just like the Soda Ban case, the Board has worked without any legislative guidance and sidestepped the city council to pass a first in the nation type rule.[6] The sodium plan is enacted to prevent cardiovascular disease much like the Soda Ban was enacted to prevent obesity.[7] And while less cardiovascular disease is a scourge, it is not likely that the Board can legally regulate it by enacting such a law.

The Soda Ban was struck down by the New York Court of Appeals in 2014 for three reasons.[8] Firstly, the city Board of Health did not have inherent legislative powers separate and apart from the City Council to enact the law.[9]Secondly, the Board, when promulgating the rule, chose between public policy ends, thereby engaging in law-making beyond its regulatory authority.[10] And lastly, the board did not supplement existing legislation when promulgating the Soda Ban.[11] Because the Board is appointed by the Mayor, they are not a designated legislative body in New York and thus do not have the power to legislate.[12] In addition, only regulations are within the purview of the Board because the New York Court of Appeals held that policy making, which is the process of solving difficult social problems, is reserved to the legislature.[13] It likely will not be difficult for the National Restaurant Association to show that the board is participating in policy making by attempting to legislate on this difficult social issue. By doing so, the board is exceeding its powers as a mere regulatory agency and the sodium labeling scheme will likely be struck down.

Beyond the legality, which will likely be in favor of the National Restaurant Association, the institution of a sodium labeling program will have many unintended consequences. For example, a new study of the comprehensive literature surrounding the health consequences of sodium intake reduction at a community level is inconclusive.[14] Startlingly, the study was completed by a former member of the Board and states that there is a true polarization of the literature, between those who posit no health changes across the population when sodium intake is decreased and those who think there is.[15] So while the consequences of sodium consumption are in doubt, the Board desires to pass a law warning of its consumption. Thus, burdening the restaurants in New York City with this addition law is potentially unnecessary.

In addition to the dubious legality and rationale surrounding the passage of the Board's new ordinance, there are far ranging economic ramifications. The first and most obvious of which is adding an addition cost to restaurants in New York City. Proponents of the new law may say that the requirement of adding black triangles to a menu is not particularly expensive and only targets restaurant 'chains' with more than 15 locations nationwide.[16] However, if individual franchise owners are forced to comply without the help of the corporate entities, it may do more to burden individuals than the corporate 'chains'. This is just one more cost placed on business owners who are tasked with creating jobs and products for consumers. It is difficult to consider how burdensome additional regulations are without considering how expansive regulation already is in the United States. Just on the federal level, the total costs of business regulation was over 2 trillion dollars in 2012.[17] Forcing restaurants to research and analyze each product in order to determine if menu items exceeds the 2,300 milligram threshold just burdens restaurant businesses even further. Moreover, for every new product these businesses want to develop, they'll have to do the same analysis for fear of accidently violating the regulation. This type of increased regulation in business only creates higher costs, which in turn effects the services businesses can provide and the prices of those services.

These higher costs are not all going to be paid by the corporate entities or persons who own restaurants in New York City, a portion of them will be passed off to the consumer. The restaurant industry in New York City would be considered in monopolistic competition. Monopolistic competition is a form of imperfect competition where sellers sell products that are differentiated and thus not perfect substitutes.[18] Which means restaurants have some price setting power and can profit in the short run by setting their marginal revenue of producing another good at the marginal cost of producing another good.[19] This allows some of the costs to be passed onto the consumer through higher prices.[20] The consequences of this is that some consumers will be pushed out of the market. The greatest burden may be felt by those that can least afford it. By increasing the costs and thus the prices, the Board is making it more difficult for those in poverty to find a cost effective meal. All governmental regulations pick winners and losers, in this case, the losers are both the restaurants and the consumers.

Furthermore, the higher costs associated with the regulation may prevent some companies from expanding into the New York City market. As the barriers to entry increase, the amount of competition will decrease overtime as firms exit the market due to higher costs more quickly than firms enter it.[21] With less competition, prices will rise further.[22] This would create even worse outcomes for the consumers. Not only would existing firms increase prices in the short run due to the market structure, but the lack of new competition due to the higher costs of moving into the market may lead to even higher prices.[23]Which would disadvantage consumers even further. As Christin Fernandez, the spokesperson for the National Restaurant Association, said in a statement to announce their suit, “While the Board of Health thinks they are targeting corporate ‘chains’, in reality they are dealing yet another blow to many of New York’s small businesses that have been working and continue to work hard to provide nutritional access to their customers.”[24]

Lastly, the Board is using a paternalist rationale to pass a regulation, when consumers are better placed to know their own preferences. Each individual has preferences that through rationality allow them to choose what they want to spend their money on and thus the restaurants they want to go to in order to maximize their utility. If consumers prefer to not eat sodium, determined through their own rational decision making, they can choose not to eat salty foods. It is much simpler, and conforms much more closely with notions of liberty than allowing a quasi-governmental board of health to make decisions for others by marking foods with an ominous black symbol.

New York City's Board of Health attempted to pass a restrictive law in September for which is had no legal authority. And beyond the move's legal dubiousness, it will increase costs for businesses and prices for consumers. If the Board truly was concerned about the wellbeing of the residents of New York, they would make nutritional access and competition more accessible not less. The sodium regulation should easily be struck down by the New York Court of Appeals, but hopefully this 'first of its kind' regulation does not start a trend across the nation.

[1] *National Restaurant Association Sues New York City Over Sodium Warnings on Menus*, Entrepreneur (Dec. 4, 2015), http://www.entrepreneur.com/article/253591.
[2] Id.
[3] Dan Goldberg, *Restaurant group to sue NYC over sodium rule*, Politico (Nov. 30, 2015), http://www.capitalnewyork.com/article/city-hall/2015/11/8584218/restaurant-group-sue-nyc-over-sodium-rule.
[4] Declaratory Judgment Petition, Nat'l Rest. Ass'n v. The New York City Dep't of Health & Mental Hygiene, (Dec. 3, 2015).
[5] Id.
[6] Id.
[7] *Notice of Public Hearing and Opportunity to Comment on Proposed Amendment to Article 81 of the New York City Health Code*, Department of Health and Mental Hygiene – Board of Health (July 29, 2015), https://www1.nyc.gov/html/doh/downloads/pdf/notice/2015/noi-repeal-article81.pdf.

[8] New York Statewide Coal. of Hispanic Chambers of Commerce v. New York City Dep't of Health & Mental Hygiene, 23 N.Y.3d 681, 16 N.E.3d 538 (2014)

[9] Id.

[10] Id.

[11] Id.

[12] Id.

[13] Id.

[14] Ludovic Trinquart et al., *Why do we think we know what we know? A metaknowledge analysis of the salt controversy*, International Journal of Epidemiology (Feb. 17, 2016), https://ije.oxfordjournals.org/content/early/2016/02/17/ije.dyv184.abstract.

[15] Id.

[16] Dan Goldberg, *Restaurant group to sue NYC over sodium rule*, Politico (Nov. 30, 2015), http://www.capitalnewyork.com/article/city-hall/2015/11/8584218/restaurant-group-sue-nyc-over-sodium-rule.

[17] *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business*, National Association of Manufacturers (2014), http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Executive-Summary.pdf.

[18] Libby Rittenberg et al., Monop*olistic Competition: Competition Among Many*, Microeconomic Principles (2012).

[19] Id.

[20] Id.

[21] William F. Shughart II, *Industrial Concentration*, The Concise Encyclopedia of Economics, http://www.econlib.org/library/Enc/IndustrialConcentration.html.

[22] Id.

[23] Id.

[24] Dan Goldberg, *Restaurant group to sue NYC over sodium rule*, Politico (Nov. 30, 2015), http://www.capitalnewyork.com/article/city-hall/2015/11/8584218/restaurant-group-sue-nyc-over-sodium-rule.

The Alienability of Digital Distribution Licenses

By: Steven Wittenberg

We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.[1]

Evidently, digital distribution licenses should have also been listed with the other "unalienable Rights…"

Digital distribution describes the system in which non-tangible digital content – such as movies, music, books and video games – is delivered to consumers. To analogize, think of the internet as the river of commerce and the online delivery medium (e.g. a Kindle or a PlayStation 4) as the port where goods are unloaded; the articles of online electronic commerce include digital products (e.g. a novel or standalone video game) and their sub-products including downloadable content and other add-ons.

Depending on the demands of the consumer, the product might be streamed or downloaded. To illustrate, it might be more convenient for someone to purchase a subscription[2] to "HBO NOW" and stream all HBO shows online for $14.99 per month, while another consumer might only desire one episode of *The Wire*, an HBO show, and would be willing to purchase a special license to just watch that episode.[3] Another consumer, however, might prefer to *own* the product as if it were tangible, thereby securing her right to transfer the product at a later time. "Transfer" (a/k/a alienation) describes the giving of ownership in property to another individual. Transfer can be accomplished in several ways: through a gift, sale, will, trust, etcetera. Property is, therefore, deemed freely alienable or freely transferrable when the owner's interest can be given to others without restraint. Under the doctrine of first-sale, purchasers of copyrighted products may resell, rent, lend or destroy the *physical* copies of the good.[4] Rather than conveying title (i.e. legal ownership) for digital products to enhance alienability, companies ought to permit consumers to gain *freely alienable licenses* to (1) gain a competitive advantage and (2) improve sales. This article explores the limited property rights provided for in contemporary digital distribution licenses and offers a compromise between full-blown digital personal property and modern limited licenses, viz., transferrable licenses.

I. Personal Property vs. Limited Licenses

Personal property ownership confers many benefits often unavailable with digital licenses. In the context of digital products, the right to *include* (i.e. to share) friends and family may be the most important because it enhances the enjoyment of the product through community participation. The free alienability of property rights is also significant to ownership. For example, buying a DVD copy of *Star Wars: Episode I – The Phantom Menace* conveys the right to*transfer* (per the aforementioned doctrine of first-sale), in addition to the rights to include and exclude. It is worth noting that the right to *exclude* (i.e. to deny use to others) is a fundamental requirement of true ownership.[5]

For digital distribution products, personal property ownership, of course, would not be unlimited. It would still be subject to the copyright restrictions that the holder of the intellectual property enjoys. Owners would be able to freely transfer their interest in the digital product by any conveyance. Today, however, freely transferrable *ownership* of copies of digital products is almost unheard of for fear of copyright infringement. Moreover, another hurdle lies with the intermediary instrument that conveys the intellectual property (e.g. a video game) to the digital distributor. Under the principle of *nemo dat quod non habet*("no one gives what he does not have"), this intermediary licensing instrument would need to be enlarged to account for the additional rights being conveyed to the end consumer (e.g. the video gamer). Thus, to avoid unduly excessive costs, the most reasonable compromise between the competing interests of the consumer and the producer is a marketplace of freely alienable licenses.

Indeed, some consumers may want more than a mere license to use the product.[6] Licenses restrain the alienability of property by preventing the licensee from transferring her interest to another who would value the digital product more. A fundamental goal of contract law and economics is to allocate resources from a low value user to a higher value user, thereby achieving a more efficient allocation of resources.[7] In an ideal system, as suggested through a system of transferrable licenses, people would enjoy the convenience of digital distribution and gain the benefits of personal property ownership.[8] Nonetheless, digital distribution licenses (DDLs) are still justifiable because they fill a niche in the market in which some consumers are willing to buy fewer rights (i.e. the right to use (subject to ever more restrictions), but not transfer) in exchange for the *convenience* of digital access. Furthermore, the limited nature of end user digital distribution licenses may even be necessary for the continued vitality of its constituent industries. Intellectual property, by its nature, is un-excludable (i.e. the inability to prevent others from using it freely, hamstringing profitability) and tends to be under-produced because its creators must overcome threshold risks and costs. In addition to their convenience and protective mechanisms, digital distribution platforms promote smaller game companies (a/k/a indie) and stimulate sales through discount seasons,[9]which are routine and offer hefty price cuts.[10] For example, Steam, a digital distribution platform that sells downloadable DDLs for computer games, uses discount sales for indie game companies to invite more consumer participation.[11] On the discount extravaganza, a Steam Community post discussed the discount sales, noting:

Both [Autumn and Winter] sales can have great discounts. The Christmas Sale is just a much grander event. It's longer, usually has some kind of "Mini Event" that has giveaways attached to it . . . . Although, honestly, if you can get any of the above listed [games] for 66-75+% off during this sale then I'd go for it. You're unlikely to see a deeper discount.[12]

Note that the Steam subscription license is non-exclusive and emphasizes, "The Content and Services are licensed, *not sold*. Your license confers *no title or ownership* in the Content and Services."[13]

II. Alienable Licenses

Although its license subscriptions do not convey title to its digital products, Steam does something quite unique: it permits the alienation of licenses for add-ons to games.[14] The so-called Steam Community Market allows subscribers to buy and sell digital add-ons at market rates.[15] While Steam's license transfer market does not allow users to exchange actual video games, it has at least experimented with the concept of alienable digital products. Another permutation of consumer-friendly licenses includes PlayStation 4. A user can log-in with her PlayStation Network account on a friend's PS4 and permit *inclusion* of the non-licensee to use the game.

Digital distribution platforms should offer consumers digital products that can be freely alienated through mechanisms like Steam's Community Market. As it is consumer-friendly, it would likely incentivize more purchases because a transferrable license has great value. For example, people can hedge their bets with a freely alienable license that they can always sell later if they no longer want it. Moreover, selling transferrable licenses may also add a competitive advantage for one digital distribution platform. To demonstrate, if PlayStation offered a transferrable license on their video games, they would likely gain more market share from its competitors.[16]

A possible rebuttal to a freely alienable license regime for digital distributor products would be a robust second-hand market where "new" products are no longer purchased, thereby leading to fewer video games being produced, especially for indie game developers. However, it is unlikely the benefits of a transferrable license regime to the public and businesses would be outweighed by any potential decline in primary sales resulting from a secondary market. In the 1990s, for example, people were able to sell their video games and VHS cassettes on the second-hand market without debilitating developers of new media and intellectual property.

The video game industry grew at a rate of 10 percent each year from 2009 to 2012 while the rest of the U.S. economy only grew at a rate of 2.4 percent annually.[17][18] It seems unlikely the creation of transferable licensee rights would slow the growth of the industry, especially if it arose internally from digital distributor platforms as a means to gain a competitive advantage. Moreover, secondary markets for used digital products will increase affordability and accessibility.[19] Further, the addition of freely alienable licensee rights will uphold the digital distributor platform industry's reputation as an innovative and consumer-friendly marketplace.[20] In sum, a system with freely alienable licenses for digital distributor products is better for consumers and businesses than the restrained system of digital licenses that exists today.

[1] The Declaration of Independence para. 2 (U.S. 1776).

[2] The preface to the terms to use HBO NOW is reproduced below:

The Service provides subscribers with access to HBO's award-winning original programming, exclusive Hollywood hit movies and so much more, streamed over the Internet to your device. Access to and use of the Service, including its features, content, software, functionality, and access to and use of the user interface and the website(s) associated with the Service (such as hbonow.com) (collectively, the "Site"), is provided by HBO subject to the following Terms. HBO Terms and Conditions, https://www.hbonow.com/terms (last visited Feb., 7, 2016).

[3] Note that HBO does not allow consumers to purchase single episodes online like its competitor Amazon, which allows individuals to rent or buy single products.

[4] R. Anthony Reese, The First Sale Doctrine in the Era of Digital Networks, 44 B.C. L. Rev. 577, 577 (2003).

[5] Jesse Dukeminier et al., Property 104 (Vicki Been et al. eds., 8th ed. 2014).

[6] HBO's license provides:

HBO grants you a *limited*, non-exclusive, *non-transferable* license to access . . . . HBO may control the *maximum number of simultaneous streams* per account . . . . Once you have created a Registered Account, subject to availability, you may be given the option to add authorized users tied to your Registered Account . . . . *You may not copy, reproduce, distribute, transfer, sell,license*, publish, enter into a database, display, perform publicly, modify, create derivative works, upload, edit, post, link to, frame, *transmit, rent, lease, lend or sublicense* or in any way exploit any part of the Service and/or the Site . . . you may access and display material and all other Content displayed on the Service for non-commercial, personal, entertainment use for a *limited time only*as strictly authorized herein.

HBO, *supra* note 2 (emphasis added).

[7] Contract Law and Economics 32 (Gerrit De Geest eds., 2nd ed., 2011).

[8] See Joshua J. Dubbelde, *A Potentially Fatal Cure: Does Digital Rights Management Ensure Balanced Protection of Property Rights?*, U. Ill. J.L. Tech. & Pol'y, Fall 2010, at 409, 416 ("[Digital personal property (DPP)] attempts to prevent the unauthorized dissemination of electronically stored works by analogizing the user's property rights in the media to those inherent in physical property.").

[9] *See generally* Jamie Madigan, *The Psychology Behind Steam's Summer Sale*, The Psychology of Video Games (July 15, 2013), http://www.psychologyofgames.com/2013/07/the-psychology-behind-steams-summer-sale/.

[10] *See* Wesley Yin-Poole, *For this developer, Steam sales "screw your fans"*, Eurogamer.net (Jan. 16, 2014), http://www.eurogamer.net/articles/2014-01-16-for-this-developer-steam-sales-screw-your-fans (discussing the negative events of seasonal discount sales for digital distributors).

[11] Charlie Hall, *Steam data shows just how much money was made during the Summer Sale*, Polygon (Jun. 25, 2015), http://www.polygon.com/2015/6/25/8847597/steam-summer-sale-data-steamspy-2015.

[12] Citrine, *Steam season sales (Autumn vs Christmas) [HELP] :)*, Steam Community (Nov. 21, 2012, 6:30 PM), http://steamcommunity.com/discussions/forum/0/882966056668138055/.

[13] Steam Subscriber Agreement, http://store.steampowered.com/subscriber_agreement/ (last visited Feb. 7, 2016) (emphasis added).

[14] *Id.* ("Steam may include one or more features or sites that allow Subscribers to trade, sell or purchase certain types of Subscriptions (for example, license rights to virtual items) with, to or from other Subscribers ("Subscription Marketplaces"). An example of a Subscription Marketplace is the Steam Community Market.").
[15] *See* Steam Community Market, https://steamcommunity.com/market/ (last visited Feb. 7, 2016).
[16] *See* Sebastian Lindig, *Market Share for PC Digital Distribution Platforms 2011*, Gamasutra (Jun. 6, 2011), http://www.gamasutra.com/blogs/SebastianLindig/20110606/89588/Market_Share_for_P C_Digital_Distribution_Platforms_2011_based_on_unique_users.php.
[17] Entertainment Software Association, *Games: Improving the Economy*, (Nov. 4, 2014), http://www.theesa.com/wp-content/uploads/2014/11/Games_Economy-11-4-14.pdf.
[18] *See also* International Federation of the Phonographic Industry, http://www.ifpi.org/facts-and-stats.php (last visited Feb. 7, 2016) (subscription services in music grew 39% in 2014).
[19] *Id.* at 587.
[20] *See generally* Daniel Starkey, *Trends of this Generation: Digital distribution*, Destructoid (Feb. 20, 2013), http://www.destructoid.com/trends-of-this-generation-digital-distribution-244003.phtml.

THE BEST OFFENSE IS A GOOD DEFENSE: THE STRATEGIC VALUE OF BUILDING A STRONG CORPORATE CULTURE

By: Matthew Lowe

I. Introduction

In 2014, a University of Virginia Law Professor, Brandon L. Garrett, wrote a book entitled: *Too Big to Jail: How Prosecutors Compromise with Corporations*. In his book, Garrett inadvertently outlined a strategy for companies to follow, which would allow them to increase morale and productivity while also putting measures in place to avoid damaging litigation. Relying on the development and successful implementation of a healthy, viable corporate culture, the benefits of this strategy should serve as the catalyst for wide scale adoption.

II. Background

In the 1930s, a Republican attorney by the name of Conrad Printzlien left his position in the district attorney's office in the Eastern District of New York to work as a probation officer.[1] While this voluntary career shift meant a 50% salary reduction, Printzlien accepted the position partially due to the urging of the court, but also because he was concerned over the plight of offenders.[2]Specifically, he recognized issues faced by young offenders who had a tendency to be socially stigmatized by prosecution and conviction.[3] Thus, in 1936, he proposed an idea to the district attorney to divert situational juvenile offenders from the criminal justice system before arraignment.[4] On April 26, 1937, the first referral of an arrested offender to the probation department was made.[5] It was at this point that this style of deferred prosecution, known as the

"Brooklyn Plan", truly became an optional feature of criminal litigation. The initial design of the Brooklyn Plan relied on the potential for rehabilitation for juvenile offenders and was conditional on the juvenile's adherence to the following:

(a) to refrain from the violation of any state and federal penal laws; (b) to live a clean, honest, and temperate life; (c) to keep good company and good hours; (d) to keep away from all undesirable places; (e) to work regularly and, when out of work, to notify the probation supervisor at once; (f) to leave or stay away from the city or town where the juvenile resides only with permission of the probation supervisor and to notify the probation supervisor at once of any intended change of address; (g) to contribute regularly to the support of those for whom the juvenile is legally responsible; (h) to follow the probation supervisor's instruction and advice; and (i) to report promptly on the date set forth in the probation supervisor's instructions.[6]

Over six decades following the proposal of the Brooklyn Plan, another Republican would repurpose the Brooklyn Plan for matters pertaining to corporate oversight. In 2002, President George W. Bush created the Corporate Fraud Task Force[7], which would later become the Financial Fraud Enforcement Task Force[8] ("Task Force"). The Task Force is comprised of prosecutors who work with various U.S. Attorney's offices around the country, regulators (e.g., Securities and Exchange Commission ("SEC") and the Internal Revenue Service ("IRS")), and some state prosecutors to coordinate investigation and prosecution of companies. Under this Task Force, a new strategy began to emerge that relied on the application of the basic tenets of the Brooklyn Plan to major corporations.[9] Following this strategy, the Task Force treats offending corporations like juveniles would be treated under the Brooklyn Plan, seen as "not entirely innocent, but mainly in need of guidance, rehabilitation, and supervision."[10] As Garrett notes, the modern corporate culture revolution dates back to 1991 following the implementation of the U.S. Sentencing Guidelines, which emphasize rewarding a company for efforts to "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."[11]

In his book, Garrett notes that by 2003, "the overriding goal" of corporate prosecutions has been to "rehabilitate a firm's culture, not to punish."[12] This notably ambitious approach includes efforts to put systems in place to detect and prevent crime among a company's employees and to foster a true culture of ethics inside of the economy.[13] Thus, it is imperative for large corporations to use this knowledge to their benefit and to construct prevention strategies around it in order to minimize exposure to costly litigation risks. "Costly" in this context does not equate solely to budgetary woes. "Costly" here takes into account all of the hits a company can take during the litigation process. For example, one of the biggest corporate downfalls in recent decades was that of one of the former "Big 5" accounting firms, Arthur Andersen.

On June 15, 2002, the lower courts found Andersen guilty of obstructing justice relating to the downfall of Enron.[14] As Garrett notes in his coverage of the Andersen catastrophe, before the unfavorable decision was handed down, Andersen was already smoldering in the flames of the ancillary impacts of litigation. Indeed, by the time the verdict to convict was handed down, Andersen had lost a quarter of its clients, laid off 7,000 of its employees, and had been forced to sell off many of its US practices.[15] This is not to suggest that the verdict's ultimate effect was minimal. In fact, the verdict provided the kill shot. In illustrating the weapons the government has at its disposal, the verdict meant that, under SEC rules, Andersen had to stop doing accounting work for public companies — a demographic vital to the operations of the company.[16]Eventually, Andersen fell and became a cautionary tale.

III. Analysis

Corporate culture can be understood as the shared assumptions, values, and beliefs that guide the actions of a company's members. The strategic benefits of building a strong corporate culture are myriad. On a fundamental performance level, culture can account for 20-30% of the differential in corporate performance when compared with 'culturally unremarkable' competitors.[17] But perhaps more importantly, a strong culture can be the difference between life and death for a company that finds itself under the prosecutorial gun for any number of reasons. However, a corporate culture is not born overnight: there are no quick and easy techniques for building a new organizational culture.[18] Thus, if it is to be incorporated into a business strategy and be maximally effective, companies should start developing their cultures long before fraud charges fall into their laps. While building a corporate culture from the ground up could be an overwhelming and time-consuming endeavor, from a legal perspective, a good defense can be simpler to construct. Prosecutors are concerned primarily with compliance with laws, so this aspect of corporate culture should be a main point of focus.

Some companies may forego an opportunity to build a particularly strong cultural defense, seeing as many large companies budget for anticipated legal costs.[19] This is ill advised. It is likely that a massive accounting firm like Arthur Andersen had such a budget, yet its ability to withstand the monetary costs of litigation were, as described above, not the dagger to its heart. In fact, even winning the type of case Andersen had to defend itself against does not guarantee survival.

In 2005, following the Fifth Circuit's 2004 upholding of the lower court's verdict to convict Andersen, the Supreme Court reversed.[20] However, by then, the damage was done, there was no way that Andersen could recover, and, alas, it never did. As the defense attorneys in this case commented: the win at the Supreme Court level may have been "an incredible triumph for the judicial system in America," but at the end of the day, "the company has been destroyed and the employees are scattered to the winds."[21] This illustrates a crucial lesson: throwing money at fire is simply not the best method of extinguishing it. In this arena, preventative measures are what are needed.

The keyword here is: compliance. Of course virtually every large corporation has compliance measures put in place, but perhaps it is best to reevaluate the efficacy of these measures. As Garrett advises, it is imperative that employees be engaged during training sessions and it would also help if they actually read their corporate ethics handbooks.[22] Tools that companies can and ought to utilize include: testing employees' understanding of the rules, creating anonymous reporting hotlines, and performing random audits.[23] Adopting one or even all of these tools cannot guarantee that fraud claims, for example, will not slip through the cracks. There is no reasonable method of preventing against all exposure. However, the benefits of adopting these tools are not derived solely from direct outcomes. Adoption, instead, is a long-term strategy that has the potential to pay dividends if the SEC winds up knocking at the door. This is because prosecutors are, as the DOJ described, tasked with being "a force for positive change of corporate culture" and with "alter[ing] corporate behavior."[24]

While punishment is a possible outcome when litigation against a company proceeds, it is not the only outcome and it is not the main goal of such proceedings. In fact, the central goal of prosecutors' involvement, harking back to the Brooklyn Plan, is to rehabilitate corporations and make them better and more ethical, which is the foundation of the modern deferred prosecution agreement.[25] That being said, it is crucial to identify which companies are more likely to be offered governmental rehabilitation and which are not. When prosecution is threatened, the preferred route is rehabilitation. This is where strategic defense comes into play. This defense, predicated on a strong organizational culture, does not mean simply espousing slogans like Google's classic: "Don't be evil," which drew attention to its ethical duties, while describing a bare minimum standard of ethics.[26]

At the end of the day, prosecutors and regulators (including the SEC) alike create incentives for self-policing by "giving credit for good compliance."[27]However, prosecutors look at the history of a company up until the moment that it is investigated. This is, again, why putting those aforementioned tools in place is a company's best route to receiving a deferred prosecution agreement. "[I]f an agency thinks a … corporation is being defiant or has violated the rules in an egregious way, it may decide that the case should be criminal."[28]Demonstrating cooperation before an investigation begins is the most effective means of having the government see a company through rehabilitation. The benefits of which include: avoidance of litigation costs (monetary and non-monetary) and avoidance of bad public relations. With regards to the latter, a company will be seen as cooperative and working towards fixing a problem it helped to identify or, in a best-case scenario, a company may never even have to accept responsibility or admit guilt, thus keeping it out of the public eye entirely.[29]

IV. Conclusion

For large corporations, merely having a litigation budget is not a sufficient fail-safe when looking to protect against the severe damage that can be incurred from prosecution. Instead, companies should look to protect themselves by building strong corporate cultures to not only serve as a performance-enhancing perk, but to also establish a powerful defensive measure if the worst case comes to fruition.

[1] Stephen J. Rackmill, *Printzlien's Legacy, the Brooklyn Plan, A.K.A. Deferred Prosecution*, Fed. Probation (1996)

[2] Id.

[3] Id.

[4] Id.

[5] Id.

[6] Id.

[7] Exec. Order No. 13271, 67 FR 46091

[8] Exec. Order No. 13519, 74 FR 60123

[9] Brandon L. Garrett, *Too Big to Jail: How Prosecutors Compromise with Corporations* (1st ed. 2014)

[10] Id.

[11] *U.S. Sentencing Guidelines Manual* (2011), §8B2.1(a)(3)

[12] *Garrett*, supra note 9

[13] Id.

[14] Luisa Beltran, et al., *Andersen Guilty*, CNN (2002)

[15] Id.

[16] Jonathan Weil, et al., *Arthur Andersen Is Convicted On Obstruction-of-Justice Count*, Wall Street Journal (2002)

[17] Deidre H. Campbell, *What Great Companies Know About Culture*, Harvard Business Review (2011)

[18] Barry D. Baysinger, *Organizational Theory and the Criminal Liability of Organizations*, Boston University Law Review (1991)

[19] Rebecca K. Myers, et al., *What Good is a Litigation Budget?*, LexisNexis (2010), available at http://www.lexisnexis.com/legalnewsroom/legal-business/b/finance/archive/2010/02/24/what-good-is-a-litigation-budget.aspx

[20] *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005)

[21] Mary Flood, *Supreme Court Overturns Artur Andersen's Enron Conviction*, Houston Chronicle (2005)

[22] *Garrett*, supra note 9

[23] Id.

[24] Memorandum from Deputy Attorney General Larry D. Thompson, U.S. Department of Justice, to Heads of Department Components and U.S. Attorneys, *Principles of Federal Prosecution of Business Organizations*, January 20, 2003

[25] Garrett, supra note 9

[26] David Mayer, *Why Google Was Smart to Drop Its 'Don't Be Evil' Motto*, Fast Company (2016)

[27] *Garrett*, supra note 9

[28] Id.

[29] Id.