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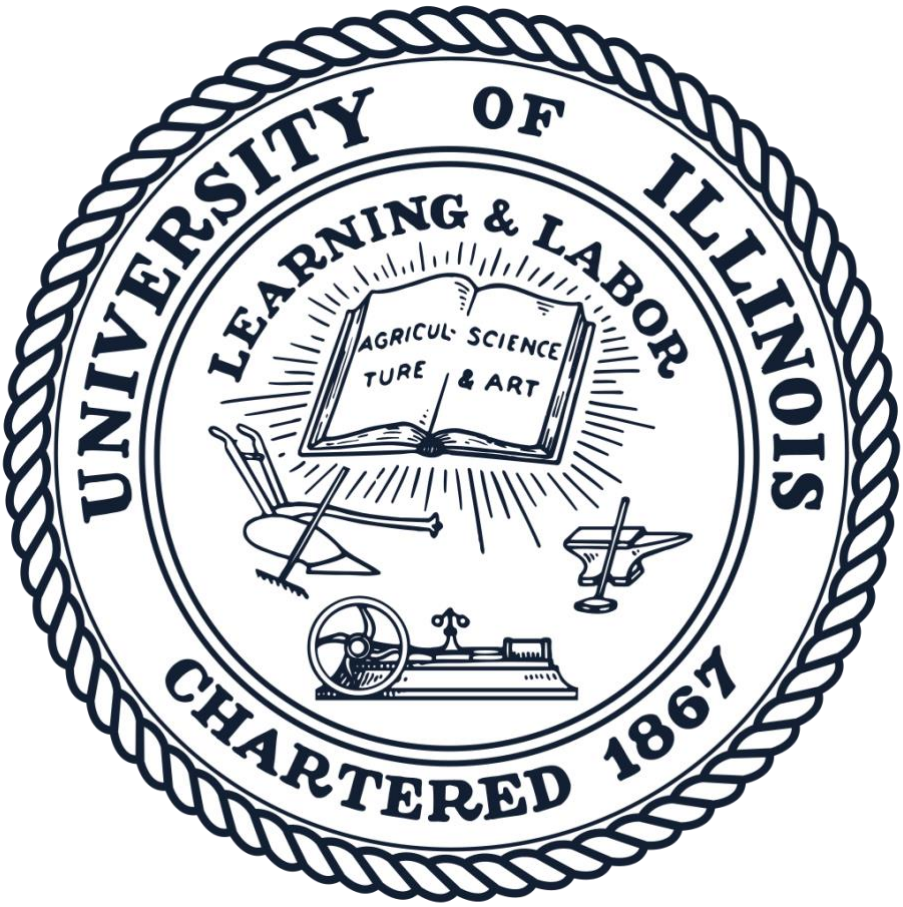

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ROLL FOR DAMAGE: EXPLORING THE STRUGGLE BETWEEN INTELLECTUAL PROPERTY PROTECTIONS AND INNOVATION WITHIN TABLETOP ROLEPLAY GAMES

❖ Note ❖

*Natalie Boyd**

I. INTRODUCTION

In early January 2023, the Dungeons and Dragons publisher, Wizards of the Coast, became the center of widespread controversy, with over 60,000 people signing an open letter condemning their actions after a revised version of their open gaming license ("OGL") was leaked (the "Leak").[1] Dungeons and Dragons, a popular tabletop roleplay game, has used an OGL since 2000 to allow fans and publishers to create works compatible with the original game.[2] This OGL has allowed third party creators to use Dungeons and Dragons rules and systems without any form of royalty fees.[3] Since 2000, third party content created under this OGL has helped build a large network of Dungeons and Dragons gamers who have innovated the game while driving it into mainstream success.[4]

The Leak revealed major potential changes for third party creators including the termination of the original OGL, and a new OGL that imposed restrictions and royalty systems.[5] Third party creators such as Foundry Virtual Tabletop and Sly Flourish signed the open letter condemning the proposed OGL.[6] This open letter

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[1] Benjamin Abbot, *D&D OGL Controversy, Explained – All the Drama Explained and Why You Should Care*, GAMES RADAR (Jan. 30, 2023), https://www.gamesradar.com/dandds-licensing-controversy-explained-heres-why-you-should-care/.

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] *Open Letter*, OPEN DND, (last visited Apr. 25, 2023), https://www.opendnd.games.

expressed concerns that the proposed OGL "chokes the vibrant community that has flourished under the original license."[7] The letter noted how the proposed OGL would affect small time creators as well as larger third party creators.[8] While smaller creators would face restrictions on their work and need to report their revenue, the larger creators would face high royalty fees.[9] The royalties would make it near impossible for these small businesses to afford publishing products.[10] The backlash did not end there as Paizo, a company who relies on the original OGL, announced that they did not believe the original OGL could ever be deauthorized and were "prepared to argue that point in a court of law if need be."[11]

Wizards of the Coast Executive Producer, Kyle Brink, responded to the backlash by asking the Dungeons and Dragons community to give their feedback on the proposed OGL.[12] Brink posted another update, recognizing that 89% of those responding were dissatisfied with the deauthorization of the original OGL.[13] He announced that Wizards of the Coast were backing down from the proposed OGL and allowing third party creators the options to publish materials under the original OGL or a Creative Commons license.[14]

Wizards of the Coast is not the only company releasing OGLs to permit the use of tabletop gaming rules and mechanics.[15] However, Wizards of the Coast's attempt to balance protecting their intellectual property and their customer base's satisfaction illustrates a much bigger issue within the tabletop roleplay game industry.[16] While OGLs promoted innovation, a Creative Commons license is an alternative that is widely recognized and easily understood.[17]

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[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Paizo Announces Systems-Neutral Open RPG License,* (Jan. 12, 2023), https://paizo.com/community/blog/v5748dyo6si7v?Paizo-Announces-SystemNeutral-Open-RPG-License.

[12] Kyle Brink, *A Working Conversation About the Open Game License (OGL)*, D&D BEYOND, (Jan. 18, 2023), https://www.dndbeyond.com/posts/1428-a-working-conversation-about-the-open-game-license.

[13] Kyle Brink, *OGL 1.0a & Creative Commons*, D&D BEYOND, (Jan. 27, 2023), https://www.dndbeyond.com/posts/1439-ogl-1-0a-creative-commons.

[14] Abbot, *supra* note 1.

[15] Paizo Publishing, Green Ronin Publishing, White Wolf Publishing, and Frog God Games have released variations of OGLs. Renata Price, *Dungeons and Dragons Is Jeopardizing Its Greatest Strength: Its Ubiquity*, VICE (Jan. 12, 2023), https://www.vice.com/en/article/3ad9kn/dungeons-and-dragons-is-jeopardizing-its-greatest-strength-its-ubiquity.

[16] *See id.*

[17] Brink, *supra* note 13.

Companies producing tabletop roleplay games who want to promote third party creation should opt for transparency of unprotected game mechanics and release of these mechanics through Creative Commons licenses. Part II provides a necessary background of both Dungeons and Dragons and its licenses. Part III analyzes the slim intellectual property protections covering tabletop roleplay and how gaming licenses such as OGLs and Creative Commons seek to cover that while promoting innovation. Part IV uses the findings from Part III to create a practical solution that balances protecting intellectual property and promoting innovation.

II. BACKGROUND

A. Dungeons and Dragons Overview

Tabletop games have been a staple in homes, with games like Monopoly and Clue being easily recognizable to the vast majority of Americans.[18] While most mainstream tabletop games are confined to a predetermined board, characters, set of moves, and number of players, Dungeons and Dragons offers more freedom and creativity for its players. With the freedom players have in creating their own adventure, games can take an afternoon or a lifetime to complete. As long as players can create their own content, the only limitation they face is their own imagination.

Dungeons and Dragons began in 1974.[19] Gary Gygax and Dave Arneson created the game using a ruleset from a 1971 game, Chainmail.[20] Their new game differed from other wargames by allowing players to create and play their own characters.[21] The ultimate idea behind the game was that players could choose adventures by purchasing scenarios created by publishers.[22] From there, players used publisher materials to create characters who could develop as a direct result of their combat encounters and other events within the game.[23] Since its creation, Wizards of

[18] Alexander Kunst, *Frequency of Buying New Card and Board Games in the U.S. 2018*, STATISTA (Jan. 6, 2020), https://www.statista.com/forecasts/862853/frequency-of-buying-new-card-and-board-games-in-the-us.

[19] Sarah Le-Fevre, *A Brief History of Role Playing Games*, LUDOGOGY (Apr. 14, 2022), https://ludogogy.co.uk/a-brief-history-of-role-playing-games/.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

the Coast acquired Dungeons and Dragons in 1997.[24] Two years later, Hasbro acquired Wizards of the Coast and remains the parent company today.[25]

B. Original Open Gaming Licenses

At the turn of the 21st century, Wizards of the Coast released an Open Gaming License: OGL1.0(a) (the "original OGL").[26] The original OGL allowed third parties to create Dungeons and Dragons compatible games, characters, creatures, and adventures without any special permission or contracts.[27] It also allowed for creators to sell their works without permission from Wizards of the Coast.[28] This document was released with a System Reference Document (SRD) that outlined the specific parts of Dungeons and Dragons intellectual property people could use.[29]

Third party creators who took advantage of the original OGL could use any content contained in the SRD.[30] They could not, however, use anything that fell under the umbrella of product identity.[31] The listed product identity included several elements such as "Dungeons & Dragons, D&D, Player's Handbook, Dungeon Master, Monster Manual, d20 System, Wizards of the Coast, d20 (when used as a trademark)[.]"[32] This would restrict third party creators from even indicating that their content was compatible with anything listed as product identity.[33]

The original OGL ultimately gave third party creators "perpetual, worldwide, royalty-free" usage of the SRD.[34] This allowed for outside designers and publishers to make revenue through creating Dungeons and Dragons compatible products without any royalty fees to Wizards of the Coast.[35] Paizo, for example, created a

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[24] Janelle Brown, *Disaffected Fans Cheer D&D Buyout*, WIRED (Apr. 10, 1997), https://web.archive.org/web/20180623061913/https://www.wired.com/1997/04/disaffected-fans-cheer-dd-buyout/.

[25] Danni Button, *Hasbro Just Tanked One of Its Biggest Revenue Drivers*, STREET (Jan. 14, 2023), https://www.thestreet.com/media/hasbro-just-tanked-one-of-its-biggest-revenue-drivers.

[26] Linda Codega, *Why Are Dungeons & Dragons Fans so Upset?*, GIZMODO (Jan. 27, 2023), https://gizmodo.com/dungeons-and-dragons-ogl-1-1-explained-wizards-of-the-c-1850006448/slides/2.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Open Gaming License v 1.0a*, WIZARDS OF THE COAST, (last visited Apr. 28, 2023), https://media.wizards.com/2016/downloads/SRD-OGL_V1.1.pdf.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] Linda Codega, *Dungeons & Dragons' New License Tightens Its Grip on Competition*, GIZMODO (Jan. 5, 2023), https://gizmodo.com/dnd-wizards-of-the-coast-ogl-1-1-open-gaming-license-1849950634.

tabletop roleplay game, Pathfinder, around the original OGL.[36] Pathfinder later became Dungeons and Dragons' top competition in the tabletop roleplay game market.[37]

C. Proposed Open Gaming License

In January 2023, Gizmodo released an article detailing the leaked draft of a proposed OGL agreement, OGL 1.1.[38] This leaked draft proposed key changes to the original OGL.[39] The proposed OGL required creators to register their content with Wizards of the Coast and report revenue.[40] Based on this information, third party users would be separated into three tiers: initiate, intermediate, and expert.[41] While the first two tiers imposed no royalties, creators generating over $750,000 in sales from OGL content would fall into the expert tier and pay 20% to 25% royalty on revenue in excess of that amount.[42]

Beyond that, the proposed OGL intended to replace the original OGL completely.[43] Part of this replacement would allow Wizards of the Coast to use anything created under the proposed OGL without paying royalties to the third party creator.[44] The language of the proposed OGL specifically stated that, Wizards of the Coast would have a "nonexclusive, perpetual, irrevocable, worldwide, sub-licensable, royalty-free license to use that content for any purpose."[45]

In response, fans and creators alike signed an open letter to Wizards of the Coast voicing their support for the original OGL and condemning the proposed OGL.[46] The open letter claimed that the original OGL has been a pillar of the tabletop gaming industry since its release in 2000 and has done more to foster creativity and innovation within the industry than any other element.[47] It stressed that terminating and replacing the original OGL with the proposed OGL would

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[36] Price, *supra* note 15.

[37] *Id.*

[38] *Id.*

[39] Codega, *supra* note 35.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] Kit Walsh, *Beware the Gifts of Dragons: How D&D's Open Gaming License May Have Become a Trap for Creators*, EFF DEEPLINKS BLOG (Jan. 10, 2023), https://www.eff.org/deeplinks/2023/01/beware-gifts-dragons-how-dds-open-gaming-license-may-have-become-trap-creators.

[44] *Id.*

[45] Codega, *supra* note 35.

[46] *Open DnD, supra* note 6.

[47] *Id.*

effectively dismantle the entire industry through stifling innovation and crushing small businesses with royalties.[48]

Wizards of the Coast recognized this backlash and released a survey asking creators for their opinions on the proposed OGL.[49] The survey showed an overwhelming support for the original OGL.[50] Beyond that, 62% of the community was satisfied with the inclusion of some content in Creative Commons.[51] Those who were dissatisfied asked for an increase in content released in Creative Commons.[52] In response, Wizards of the Coast announced that they would allow creators to choose to publish content under the original OGL or under a Creative Commons license.[53] This Creative Commons license would make content freely available for any use.[54] More importantly, the Creative Commons license would be open and irrevocable.[55]

III. ANALYSIS

The proposed OGL would not promote innovation within the tabletop gaming industry.[56] The original OGL was good for innovation in the industry, however, there are few benefits, and better alternatives have been developed since the OGL's release in 2000.[57] A Creative Commons license is a better alternative because it (1) is widely used across other industries and (2) completes the same goals as the OGL, protecting intellectual property while promoting innovation.[58]

A. Intellectual Property Protections and Tabletop Gaming

Intellectual property protections for tabletop games are complex and, in many cases, minimal. Copyright is extended to works of authorship including: "(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and

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[48] *Id.*

[49] Brink, *supra* note 12.

[50] Brink, *supra* note 13.

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *Open Gaming License 1.1*, WIZARDS OF THE COAST, (last visited Apr. 28, 2023), https://rollforcombat.com/wp-content/uploads/2023/01/Open-Game-License-1-1-Leak.pdf; *Open DnD*, *supra* note 6.

[57] *Open Gaming License v 1.0a*, *supra* note 30; *The Story of Creative Commons*, CREATIVE COMMONS, (last visited Apr. 28, 2023), https://certificates.creativecommons.org/cccertedu/chapter/1-1-the-story-of-creative-commons/.

[58] *The Story of Creative Commons*, *supra* note 57.

choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works."[59]

Games in their entirety, however, are traditionally not protected by copyright law.[60] Tabletop games as a set of rules and systems are typically not available for copyright.[61] While the game may not be entirely protected under copyright law, limited protections are available for some parts of the game.[62] Game designers may copyright pieces of their game that fall within 17 USC § 102(a).[63] These elements can range from labels for the game, the design of game boards, playing cards, and graphic works.[64] Beyond those elements, the wording of the game's instructions may also be protected from literal copying.[65]

The *scenes-a-faire* doctrine limits what aspects of a game may be protected by copyright.[66] Aspects covered by the *scenes-a-faire* doctrine include "incidents, character or settings which are as a practical matter indispensable, or at least standard, in the treatment of a given topic."[67] Aspects that are found to be *scenes-a-faire* only receive protection from virtually identical copying.[68] For example, the 7th Circuit found that the maze, scoring table, and tunnel exits in PAC-MAN were all standard game devices for a maze-chase game and, as such, *scenes-a-faire*.[69] This doctrine could apply to elements that are standard for tabletop roleplay games, such as the components players use to create a character.[70]

While there are some opportunities for tabletop game creators to protect their creations, these can also be limited by fair use.[71] Fair use of copyrighted works

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[59] 17 U.S.C. § 102(a).

[60] 1 Melville B. Nimmer & David Nimmer, *Nimmer on Copyright* § 2A.14[c][1] (Matthew Bender, Rev. Ed.).

[61] *Id.*; 17 U.S.C. § 102(b) ("In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work.").

[62] Nimmer, *supra* note 60.

[63] 17 U.S.C. § 102(a); Nimmer, *supra* note 60.

[64] Nimmer, *supra* note 60; *Tetris Holding, LLC v. Xio Interactive, Inc.*, 863 F.Supp.2d 394, 404 (D.N.J. 2012).

[65] Nimmer, *supra* note 60.

[66] *Atari, Inc. v. N. Am. Philips Consumer Elecs. Corp.*, 672 F.2d 607, 616 (7th Cir. 1982).

[67] *Alexander v. Haley*, 460 F. Supp. 40, 45 (S.D.N.Y. 1978).

[68] *Atari, Inc.*, 672 F.2d at 617.

[69] *Id.*

[70] *See id.*; *Chapter 1: Step-By-Step Characters*, D&D BEYOND, (last visited Apr. 28, 2023), https://www.dndbeyond.com/sources/basic-rules/step-by-step-characters (explaining components for characters, including (1) race (elf, human, etc), (2) class (rouge, bard, etc.), and (3) abilities).

[71] 17 U.S.C. § 107.

is not considered an infringement of the copyright.[72] It includes instances where the copyrighted work is used for, "purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research."[73] Four factors are considered when determining fair use:

> 1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work.[74]

Ultimately, this makes it clear that third parties looking to create and publish content compatible for tabletop roleplay games have two options outside of OGLs. First, for example, in the absence of the original OGL, third party creators could create and publish companion content compatible with the rule system of Dungeons and Dragons without ever infringing on copyright protected content. Second, third party creators could use game mechanics to create their own content and use copyrighted Dungeons and Dragons content, so long as their content fits within the legal bounds of the fair use doctrine.[75]

B. Open Gaming Licenses Stunt Innovation

OGLs can be useful tools to reassure third parties that they can use original source material.[76] In the tabletop gaming industry, however, OGLs can limit the use of noncopyrighted material and make it difficult for small-time hobbyist creators to use.[77]

The primary purpose of an open license is to act as an offer for third parties to use the original material in specific ways.[78] The benefit third parties usually derive is the right to use copyrighted material without having to fit within the fair use exceptions found in 17 USC § 107.[79] However, in the original and proposed OGLs released by Wizards of the Coast, third party creators are limited in what they may

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[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] Walsh, *supra* note 43.

[77] *Id.*

[78] *Id.*

[79] *Id.*; *Open Gaming License 1.1, supra* note 56.

use.[80] The original OGL offered creators access and use of Open Game Content, which they defined as "the game mechanic and includes the methods, procedures, processes and routines to the extent such content does not embody the Product Identity" and listed in the SRD.[81] The list of Product Identity is extensive and prevents creators from even advertising that their content is compatible with 'Dungeons & Dragons' or 'D&D" unless they have an agreement with Wizards of the Coast outside of the OGL.[82]

Comparing the two OGLs, the proposed OGL provides no incentive for third party creators to publish content. It gives creators access to the same content as the original OGL with more strings attached.[83] In comparison to the shorter original OGL, the proposed OGL is more complicated by including distinctions between commercial and non-commercial use, and explicitly clarifying that the proposed OGL would not allow for anything other than roleplay games and supplements in the form of printed media and static electronic files.[84] This would restrict third party creators from using the Open Game Content to create virtual tabletop roleplay games, novels, graphic novels, and many other forms of content.[85]

While it only authorizes creators to use non-protected content (the Open Game Content) that they would have been able to use absent an OGL, the original OGL still incentivizes innovation within the industry.[86] The original OGL's largest incentive for creators is a document detailing what content is considered Open Game Content.[87] It also did not prohibit the creation of non-printed media or static electronic files.[88] In fact, under the original OGL, many virtual tabletop roleplay games have flourished, including Foundry Virtual Tabletop and Roll20.[89]

C. Creative Commons Licenses Promote Innovation

While the original OGL does a superior job at incentivizing creators than its proposed counterpart, there are other licensing options that tabletop roleplay companies can embrace. Wizards of the Coast used one of these alternatives when

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[80] Walsh, *supra* note 43.

[81] *Open Gaming License v 1.0a*, *supra* note 30.

[82] *Id.*

[83] *Open Gaming License 1.1*, *supra* note 56.

[84] *Id.*

[85] *Id.*

[86] *Open Gaming License v 1.0a*, *supra* note 30.

[87] *Id.*

[88] *Id.*

[89] Rami Tabari, *Best Virtual Tabletop Software in 2023: How to Play D&D and More TTRPGs Online*, LAPTOPMAG,(Apr. 4, 2013), https://www.laptopmag.com/best-picks/best-virtual-tabletop-software.

they released the Dungeons and Dragons game mechanics into the Creative Commons following community backlash to the Leak.[90]

Creative Commons is a nonprofit organization that creates licenses to make it easier for companies to allow third parties to use their content.[91] The nonprofit began in 2002 in response to the growth of the internet and the ability to access, share, and collaborate that came with it.[92] They published a set of public licenses allowing original creators to keep their copyrights while simultaneously allowing for sharing and remixing.[93]

Since the founding of this nonprofit, Creative Commons licenses have been developed, updated, and adopted by governments, institutions, and individuals as the "global standard for open copyright licenses."[94] It has become so broadly accepted that today, Creative Commons licenses cover nearly two billion works.[95]

The Creative Commons offers six types of licenses with a range of permissive behavior and adaptations.[96] The Creative Commons license that makes the most sense to use in place of an OGL would be the most permissive license – a CC BY 4.0.[97] Third party creators publishing under the CC BY 4.0 license would be free to share and adapt content released under the license.[98] The only term third parties are required to comply with is attribution: they must give appropriate credit, link the license, and indicate if they made changes.[99] Where the OGLs lacked the ability to cover technological advances such as virtual adaptations of tabletop roleplay games, the CC BY 4.0 addresses media formats and allows for technical modifications.[100]

Beyond this, the CC BY 4.0 also contains a downstream recipients clause.[101] The clause guarantees that every recipient of the material created under the license automatically receives an offer to use the CC BY 4.0 to create their own work based on that material.[102] This clause ensures that licensees may not offer or impose

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[90] Brink, *supra* note 13.

[91] *Systems Reference Document (SDR),* WIZARDS OF THE COAST, (last visited Apr. 28, 2023), https://dnd.wizards.com/resources/systems-reference-document.

[92] *The Story of Creative Commons*, *supra* note 57.

[93] *Id.*

[94] *Id.*

[95] *Id.*

[96] *About CC Licenses*, CREATIVE COMMONS, (last visited Apr. 28, 2023), https://creativecommons.org/about/cclicenses/.

[97] *Attribution 4.0 International (CC BY 4.0*), CREATIVE COMMONS, (last visited Apr. 28, 2023), https://creativecommons.org/licenses/by/4.0/.

[98] *Id.*

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

additional or different terms to the material they publish using the CC BY 4.0.[103] This inability for licensees to impose restrictions would allow for the creative process within the tabletop roleplay game community to continue indefinitely.

As only particular portions of tabletop roleplay games fall into intellectual property protections, the primary purpose of an OGL is to facilitate and encourage innovation.[104] However, based on restrictions within the proposed OGL, it would not promote innovation.[105] The original OGL did promote innovation, however, a Creative Commons license is a better alternative. A Creative Commons license is a better-known alternative that protects intellectual property while promoting innovation.[106] As such, companies publishing tabletop roleplay games should opt for a Creative Commons license instead of OGLs.

IV. RECOMMENDATION

Ultimately, companies in the tabletop roleplay game industry should move away from OGLs. Instead, they should clearly disclose what parts of their game are unprotected mechanics and release those under a well-recognized license such as a Creative Commons license. Historically, OGLs have allowed the tabletop gaming industry to grow and innovate by incentivizing third party creators to create and publish their own content.[107] However, considering the proposed OGL leak, community response to it, and Wizards of the Coast's final decision, it is apparent that the future of gaming licenses within the tabletop community is unsteady. Companies similar to Wizards of the Coast have several options moving forward.

First, companies could choose to do away with gaming licenses all together. To begin, OGLs do not give licensees such as third party creators any access to materials beyond those that the public has access to use. Unless the game mechanics in question under the OGL are protected by copyright or another intellectual property avenue, then it is free for third party use and creation.[108] The main legal benefit an OGL provides is a guideline for what is considered game mechanics versus protected product identity. Meaning it gives third party creators an idea of what the company releasing the OGL would sue over. In turn, the legal benefit reaped by companies is that their intellectual property is clearly distinguished from game mechanics. While there have been non-legal benefits such as community

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[103] *Id.*

[104] 17 U.S.C. § 102(a); 17 U.S.C. § 102(b); *see Atari, Inc. v. N. Am. Philips Consumer Elecs. Corp.*, 672 F.2d 607, 616 (7th Cir. 1982); Nimmer, *supra* note 60; *Open Gaming License v 1.0a*, *supra* note 30.

[105] *Open Gaming License 1.1*, *supra* note 56; *Open DnD*, *supra* note 6.

[106] *The Story of Creative Commons*, *supra* note 57.

[107] Codega, *supra* note 26; Codega, *supra* note 35; Price, *supra* note 15.

[108] 17 U.S.C. § 102(b); 17 U.S.C. § 107; Nimmer *supra* note 60.

building, game innovation, and increased revenue due to widespread knowledge, the lack of legal benefits makes OGLs redundant and confusing.

Additionally, companies could follow Wizards of the Coast's lead by publishing a document outlining what aspects of their game are game mechanics and what constitutes intellectual property. Since game mechanics are traditionally uncopyrightable, third party creators do not need an OGL to publish content as long as they do not include intellectual property.[109] However, it can be confusing for anyone to determine what is and is not protected by a copyright or trademark. By identifying what materials are not subject to copyright protections, companies would be facilitating and incentivizing the same third party content that brought the tabletop roleplay community from niche to mainstream.

Lastly, if companies truly want to facilitate third party involvement and put their gaming community on notice that content is free to use, they should opt for a Creative Commons license. The original OGL was released shortly before the creation of the Creative Commons and release of those licenses.[110] While the original OGL functions similar to Creative Commons licenses, it makes far more sense for companies to switch to the Creative Commons.

The Creative Commons is widely accepted and commonly used across many different industries. Specifically, CC BY 4.0 would be the most comparable to the original OGL.[111] It allows for the licensee to use content in all media and formats and share them with the public by any means or process.[112] Beyond facilitating community involvement, the Creative Commons license would ensure that the company is protected through attribution and indication of changes.[113] Licensees would attribute to companies to ensure they are given proper credit as well as indicate where they made changes to the companies work.

V. CONCLUSION

By phasing out OGLs, releasing document outlining unprotected game mechanics, and releasing those game mechanics through a well-recognized license such as a Creative Commons license, tabletop roleplay game companies can best promote community involvement while protecting their intellectual property. As illustrated with Dungeons and Dragons, OGLs can create chaos and confusion. Due to the complicated relationship between copyright law and games, the line between what is and is not an uncopyrightable game mechanic is difficult for the average

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[109] 17 U.S.C. § 102(b); 17 U.S.C. § 107; Nimmer, *supra* note 60.

[110] Codega, *supra* note 26; *The Story of Creative Commons*, *supra* note 57.

[111] Brink, *supra* note 13; *Open Gaming License v 1.0a*, *supra* note 30; *The Story of Creative Commons*, *supra* note 57.

[112] *About CC Licenses*, *supra* note 96; *Attribution 4.0 International (CC BY 4.0)*, *supra* note 97.

[113] *Attribution 4.0 International (CC BY 4.0)*, *supra* note 97.

gamer to determine. As such, a document clarifying would completely remedy this. Lastly, the creation of Creative Commons offers a recognizable alternative OGLs that fundamentally serves the same purpose while being easier and more accessible for third party creators to understand.

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PARALLEL GOVERNANCE: THE PATH TO UNLOCKING THE POTENTIAL OF ISLAMIC FINANCE IN A CONVENTIONAL FINANCE SYSTEM

❖ Note ❖

*Rema Marie Kodaimati**

I. INTRODUCTION

The global debt levels have reached new records despite the massive technological advances made in recent decades.[1] The current global debt has reached approximately 350% of the global GDP, or the equivalent of $37,500 per person in the world.[2] Although international economists have forecasted that the global economy will continue to grow in 2023, albeit at a decreased rate of 2.7% from the 6% of 2021, their predictions are based upon gross domestic product, ("GDP"),[3] a metric that is often criticized as misrepresenting the true state of economic health or the general well-being of societies.[4] Looking at the debt levels within the United States alone, circumstances do not appear to be any better as federal borrowing has practically reached the nearly $31 trillion national cap, with the Treasury Department using latch ditch accounting maneuvers to postpone a default on the debt, which many view as being inevitable.[5]

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[1] *See* Nicole Goodkind, *The World Has a Major Debt Problem. Is a Reset Coming?*, CNN BUS. (Jan. 17, 2023, 7:37 AM), https://www.cnn.com/2023/01/17/investing/premarket-stocks-trading/index.html.

[2] *See id.*

[3] *See* IMF, *Countering the Cost-of-Living Crisis*, World Economic Outlook (Oct. 2022).

[4] *See, e.g.*, Joseph E. Stiglitz, *GDP Is the Wrong Tool for Measuring What Matters*, SCI. AM. (Aug. 1, 2020), https://www.scientificamerican.com/article/gdp-is-the-wrong-tool-for-measuring-what-matters/.

[5] *See* Drew Desilver, *5 Facts about the U.S. National Debt*, PEW RSCH CTR(Jan. 14, 2023) https://www.pewresearch.org/fact-tank/2023/02/14/facts-about-the-us-national-debt/.

However, as the governments of the world's economic powers rush to stave off a debt crisis that could reach cataclysmic proportions,[6] the global Islamic finance industry has proven itself to be resilient under mounting pressures, like the recent pandemic. Its success has come from its, unique principled approach that complies with the Environmental, Social, and Governance ("ESG") framework,[7] a tool utilized by institutions in assessing the sustainability of an organization.[8] Driven significantly by the high demands of increasing Muslim populations and consumers averse to the heightened risks of conventional financing from increasing interest rates, assets held by Islamic financial institutions ("IFIs") are forecasted to maintain double digit growth rates like the record rate of 17% seen in 2021.[9]

The theory that widespread adoption of Islamic financial practices could provide relief from the mounting debt levels is one of rational basis, but the feasibility of implementing Islamic financial practices on a large scale and stimulating the sustainable growth of these institutions in the American market may be problematic. Despite their demonstrated resilience and high demand amongst consumers, the principles of IFIs, especially the requirement that all transactions be underpinned by a legitimate trade or real asset,[10] are inherently at odds with the conventional financial scheme upon which the American system of regulating was built around,[11] and significant regulatory changes would be necessary if IFIs are to successfully proliferate and provide the economy with the needed relief.

This note will argue that if the current regulatory regime is modified to create a parallel governing structure that accommodates the principles and practices of IFIs, the growth of these institutions and their services could remedy the looming threat of increasing debt and grant the economy a reprieve for recovery. Part II provides a breakdown of the history and fundamentals of Islamic financial practices as well as conventional Western financial practices, how they differ from one another, and describes the current regulatory regime. Part III will analyze the risks associated with Islamic financial practices, the risks of the conventional Western financial practices, and the sustainability of each of the categories in practice. Part IV will argue that a substantive change in the regulatory framework to accommodate IFIs and their growth should be adopted if regulators want to avoid the total economic collapse threatened by the national and global debt crises.

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[6] *See* Goodkind*, supra* note 1.

[7] *See* Shereen Mohamed & Tayyab Ahmed, *Islamic Finance Development Report 2022: Embracing Change*, REFINITIV, https://icd-ps.org/uploads/files/ICD%20Refinitiv%20ifdi-report-20221669878247_1582.pdf.

[8] *See generally What Is Islamic Finance?*, CORPORATE FINANCE INSTITUTE: CAPITAL MARKETS (Mar. 15, 2023), https://corporatefinanceinstitute.com/resources/capital-markets/islamic-finance/.

[9] *See* Mohamed & Ahmed, *supra* note 7.

[10] *See* CORPORATE FINANCE INSTITUTE, *supra* note 8.

[11] *See* Mona E. Dajani, *Islamic Financing and Structures in the USA*, 5 ISLAMIC FIN. AND MKTS L. REV. 133, 134 (2020).

II. BACKGROUND

The twentieth century marked the beginning of a new era in rapid growth of the global economy, driven largely by developments in international monetary systems, a restructuring of the major industries from technological innovations, and an expansion in the role of the public sector into the commercial space.[12] Spurred by decreased administrative controls on international capital mobility and increased free trade, the efforts to address the financial instability that arose following the World Wars, Western financial institutions were able to bypass any remaining controls[13] and penetrate the Islamic world by establishing branches.[14] Although the basic principles guiding trade and business in the Islamic world were established in the seventh century,[15] the end of European colonization, which had destroyed the previous socio-political and economic structures in the Middle East, brought forth a need for new systems as a means of asserting Muslim independence and self-determination.[16]

The presence of Western banks in the Islamic world combined with an absence of viable alternatives to the Western banking model that could meet the demands of a globalized economy was a serious issue that needed resolving if Muslims wanted stabilized communities and participation in global trade.[17] The banking institutions of the West, having been developed and made profitable on the charging of interest, were found incompatible with the religious doctrines of Islam, as it strictly prohibits the use of interest in transactions.[18] In Islamic law, also known as "*Shariah"*, interest is considered usury, or "*riba*" in Arabic, and is strictly prohibited as it is traditionally seen as being a means for devouring the wealth of others and inherently based on a system of the gain of one at the loss of another.[19] Also, the *Shariah* prohibitions on gambling or speculation, known as "*maysir,"* as well as excessive risk and uncertainty in investments, known as "*gharar*," has made dealing

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[12] *See* IMF, *The World Economy in the Twentieth Century: Striking Developments and Policy Lessons*, World Economic Outlook (May 2000).

[13] *See id.*

[14] *See* Nagaoka Shinsuke, *Critical Overview of the History of Islamic Economics: Formation, Transformation, and New Horizons*, Kyoto University Asian and African Area Studies. 114, 115 (2012).

[15] *See generally* ROBERT CROTTY & TERRENCE LOVAT, ISLAM: ITS BEGINNINGS AND HISTORY, ITS THEOLOGY AND ITS IMPORTANCE TODAY, 2 (2016) (providing a historical account on the development of Islamic ideologies and practices).

[16] *See* ACADEMY FOR INTERNATIONAL MODERN STUDIES, *History of Islamic Banking*, https://aims.education/study-online/history-of-islamic-banking/.

[17] *See* Shinsuke, *supra* note 14, at 117-20.

[18] *See id.*

[19] *See* AZZAD ASSET MANAGEMENT, *Understanding Riba in Islamic Finance*, https://azzadasset.com/wp-content/uploads/2018/05/Riba-White-Paper.pdf.

with Western financial institutions while maintaining adherence to Islamic values extremely challenging.[20]

In response to the impracticalities of Western banking in the Islamic world and increasing pressure on the governments of Muslim countries, the 1970s witnessed a push for Islamic financial services[21] which spilled into the United States in the 1980s.[22] Emerging IFIs sought to base their services in three basic principles compliant with the rule of Shariah: equity, risk sharing, and real ownership.[23] Regarded as an alternative to interest-based transactions, the application of the principle of equity and equality of risk sharing is adopted in the transactions and services of IFIs as a measure of ensuring that none of the parties in any given transaction are at a disadvantage to another.[24] Whereas in conventional debt-financing the bulk of the risk is bore by the borrower in a lending transaction in the use of interest rates, Islamic finance views this practice as being unilaterally exploitative of borrowers[25] and returns on capital borrowed are predetermined in the form of a markup fee at the origination of a lending transaction, profit-and-loss sharing partnerships, or deferred payment contracts.[26]

The sharpest contrast between conventional Western and Islamic financial practices is the general underpinning of each of their respective transactions. *Shariah* requires all banking products and finance transactions to be backed by assets which are traded, rented, or invested in on a risk sharing basis.[27] Thus, IFIs are generally known to be asset-based,[28] although some EFIs may also offer equity-based products and services.[29] In contrast, Western financial conventions treat money as a

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[20] *See* CORPORATE FINANCE INSTITUTE, *Islamic Finance: Financing Activities that Must Comply with Sharia (Islamic Law)*, (Mar. 16, 2023), https://corporatefinanceinstitute.com/resources/capital-markets/islamic-finance/; *See also* Hamoudi, *infra* note 34 (arguing that true adherence to the Shariah is impossible under current regulations).

[21] *See* Ali Adnan Ibrahim, *Financial Innovations in the Muslim World: The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and Challenges of International Integration*, 23 AM. U. INT'L. REV. 661 (2008).

[22] *See* Dajani, *supra* note 11.

[23] *See* Mumtaz Hussain, Asghar Shahmoradi, & Rima Turk, IMF, *An Overview of Islamic Finance*, IMF Working Paper, WP/15/120, (Jun. 2015).

[24] *See id.*

[25] *See* Ibrahim, *supra* note 21.

[26] *See* Hussain, Shahmoradi, & Turk, *supra* note 23.

[27] *See* UBL, *Differences Between Conventional and Islamic Bank*, https://www.ubldigital.com/Banking/UBL-Ameen/Knowledge-Center/Differences-between-Conventional-Bank-and-Islamic-Bank.

[28] *See* Hussain, Shahmoradim & Turk, *supra* note 23.

[29] *See generally* Celine Meslier, Tastaftiyan Risfandy, & Amine Tarazi, *Islamic Banks' Equity Financing, Shariah Supervisory Board, and Banking Environments*, 62 PAC. BASIN FIN. J., (Sept. 2020) (inquiring into why IFIs rarely adopt equity-based practices despite their stronger compliance with the Shariah).

commodity in itself and lend and borrow against it, operating on a system of credit with interest being its sole driver of profit.[30] The standard bank essentially acts as a liaison between the depositor and the borrowers the funds are lent to.[31] At any given moment, only a fraction of a customer's funds is readily available as banks rely on the notion that most will not need to access more than that fraction of their funds at any given moment.[32] Therefore, the entire system in practice operates as a debt-based system on credit.

Moreover, all banks in the United States must be licensed by either the Office of the Comptroller of the Currency ("OCC"), if they are national, or a state banking authority and all banks are subject to regulations imposed by the Federal Reserve System ("the Fed") and the Federal Deposit Insurance Corporations ("FDIC").[33] Although none of the laws in the current regulatory scheme of the United States expressly prohibit IFIs, many of the current regulations impose requirements that IFIs cannot comply with because they impose practices that conflict with *Shariah*.[34] This makes their proliferation within the U.S. banking market difficult, if not impossible, on a principled basis.[35]

For example, Islamic mortgage lenders must abide by the *Shariah* capital guarantee requirement that all transactions be underpinned by assets.[36] One way IFIs do so is by engaging in transactions called "*murabaha*."[37] In these transactions, the IFI will purchase real property, a home for example, and simultaneously enter into a lease-to-purchase agreement with a customer for the property from the IFI for the amount paid plus a flat premium markup.[38] In practice, this type of transaction resembles a lease-to-own deal.[39] However, the issue lies in that the National Bank

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[30] *See* UBL, *supra* note 27.

[31] *See* Kyle Peterdy, CORPORATE FINANCE INSTITUTE, *ESG (Environmental, Social, and Governance): A management and Analysis Framework to Understand and Measure How Sustainably an Organization Is Operating*, (Feb. 22, 2023), https://corporatefinanceinstitute.com/resources/wealth-management/banking-fundamentals/.

[32] *See id.*

[33] *See* Dajani*, supra* note 11, at 135.

[34] *See* Haider Ala Hamoudi, Article, *The Impossible, Highly Desired Islamic Bank*, WM. & MARY BUS. L. REV. 105, 121-36 (2014) (discussing how American laws and regulations force violations of Shariah onto Islamic Banks).

[35] *See id.* at 121-24 (arguing that the current US regulations make Shariah compliant banking "absolutely impossible" and that its current permissibility has been conditioned on the maintenance of a fictional representation of its practices).

[36] *See* Dajani*, supra* note 11.

[37] *See* Keith S. Varian and Jennifer M. Rockwell, *Islamic Financing and Foreclosure*, 34 REAL EST. ISSUES 31, 33 (2009).

[38] *See id.*

[39] *See id.*

Act[40] prohibits banks from holding real property with a provision that grants exceptions to four circumstances, none of which this type of transaction would fall under.[41] Although the statute was designed to protect consumers by preventing banks from holding masses of property[42] and by preventing speculation in real estate by banks[43] it was also largely implemented to forcefully reduce the risk banking institutions could take on.[44] The risk it was intended to prohibit, however, was exactly the type of risk created in the profit and loss sharing principles that IFIs base their practices upon.[45] In 1997 an accommodation was made for *murabaha* transactions when the OCC, under pressure from the Bank of Kuwait,[46] issued an interpretive letter reconciling the statutory violations posed by its principle in practice.[47]

Additionally, the Western banking system has long operated on a system of creditworthiness, requiring institutions to partake in the debt-based credit system in order to access the capital that is needed to hedge against liquidity risks and insure themselves.[48] IFIs in the United States are subject to the insurance requirements governing deposits, imposed by the FDIC, if they do not meet the high minimum

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[40] *See* 12 U.S.C. § 38 (codified The National Bank Act).

[41] *See* 12 U.S.C. § 29.

[42] *See* National Bank and Federal Savings Association Premises, 86 Fed. Reg. 7979 (proposed Feb. 3, 2021) (codified in 12 C.F.R. 7).

[43] Colorado Nat'l Bank v. Bedford, 310 U.S. 41, 49 (1940); Exchange Bank of Commerce v. Meadors, 184 P.2d 458, 463 (Okla. 1947).

[44] *See* Office of the Dist. Counsel, Comptroller of the Currency, Interpretive Letter #867, (June 1, 1999) (stating that Murabaha transactions were compliant with the National Bank Act, in part, because they would not expose the IFI to greater risks than it would face in a traditional real estate financing transaction).

[45] *See* Office of the Dist. Counsel, Comptroller of the Currency, Interpretive Letter #806, (Oct. 17, 1997) (arguing that when an agreement transfers all of the benefits and risks incident to the ownership of property to the lessee while the lessor retains title to the property it is not a form of an impermissible risk to banks); *see also* Hamoudi, *supra* note 34, at 115-36 (describing the profit and loss sharing scheme underlying IFIs and analyzing why it runs directly afoul and is the very antithesis of conventional Western banking practices).

[46] *See* Huda Ahmed, Note, *Not Interested in Interest? The Case for Equity-Based Financing in U.S. Banking Law*, OHIO ST. BUS. LAW. J. 479, 481 & n.9 (2007).

[47] *See generally* Office of the Dist. Counsel, Comptroller of the Currency, *supra* note 45; *see also* Office of the Dist. Counsel, Comptroller of the Currency, *supra* note 44; U.S. DEP'T OF TREASURY, *Speech: Regulation of Islamic Financial Services in the United States*, (Mar. 2, 2005) (discussing regulations on Islamic financial services and noting that although federal regulators have provided "little formal guidance with respect to Islamic financial products," the OCC has been able to deem certain products permissible through its interpretive letters).

[48] *See* Dajani, *supra* note 11, at 135-38; *see also* Hamoudi, *supra* note 34, at 130-31 (explaining how FDIC insurance prevents financial collapses caused by bank runs by depositors).

capital requirements[49] to be sufficiently liquid and allow depositors to withdraw funds at any time without notice.[50] The FDIC, established during the catastrophic bank failures of the Great Depression, was intended to promote stability and consumer confidence in the nation's banking systems by guaranteeing that depositors would not lose their funds if a bank failed.[51] However, this standard practice of insuring is not *Shariah* compliant because it creates an imbalance in the apportionment of risk by reimbursing depositors using funds which they have not contributed to regularly.[52] As commentators have argued, by ensuring that bank depositors suffer no losses from risky lending practices, this insurance requirement effectively requires IFIs to violate their *Shariah* compliant profit and loss sharing model.[53] But, if IFIs are to offer relief to the issues caused by overleveraging, regulatory agencies need to make substantive changes to accommodate the alternative approach, rather than use superficial technicalities to reconcile them with the very practices and standards that caused the debt crisis in the first place.

III. ANALYSIS

In the years preceding the Great Recession of 2008, the residential housing market experienced a boom which mortgage lenders were eager to capitalize on.[54] Lenders proceeded to approve as many loans as they could, including to subprime borrowers not typically qualified for conventional loans due to their heightened risk of defaulting, and then, to profit off the low interest rates, bundled the loans together and sold them to secondary market investors.[55] Through the complex process of securitization, Western mortgage lenders were able to secure new

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[49] 12 C.F.R. § 324.1 (establishing minimum capital requirements and overall capital adequacy standards for FDIC-supervised institutions).

[50] 12 U.S.C. § 1841(c)(1)(b) (defining banks under the purview of the Federal Deposit Insurance Act as including those that "accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others"); *see also* Hamoudi, *supra* note 34, at 129-31 (stating that due to the widespread practice of offering FDIC insurance, it would be hard for any banking institution of a significant size to operate without it and noting that there is only one IFI in the United States offering demand deposit services, which has had to become federally insured).

[51] *See generally* Bill Chappell, *The FDIC Was Created Exactly for this Kind of Crisis. Here's the History,* NPR, (Mar. 14, 2023, 8:05 AM), https://www.npr.org/2023/03/13/1163138002/the-fdic-insurance-limit-was-last-raised-in-2008-heres-how-it-works.

[52] *See* Dajani*, supra* note 11, at 136.

[53] *See also* Hamoudi, *supra* note 34, Part II (describing the areas of financial regulation that make Shariah compliant banking based on profit and loss sharing principles illegal).

[54] *See* Anne Field & Jasmine Suarez, *What Caused the Great Recession? Understanding the Key Factors that Led to One of the Worst Economic Downturns in US History*, BUS. INSIDER (Aug. 8, 2022, 2:56 PM), https://www.businessinsider.com/personal-finance/what-caused-the-great-recession.

[55] *See id.*

fundings by selling off their consumer debt holdings to securities investors, effectively transferring the risks to the investors while generating new capital for lending.[56] Then during the recession, Congress authorized the Department of Treasury (the "Treasury") to establish federal programs to stabilize the financial system[57] or, as many viewed them, bail outs for the lending institutions whose risky lending practices caused the recession in the first place.[58] Rather than acknowledging the failure of the conventional financing system and its high-risk propensities, the government swept it under the rug.

As originally intended, the securitization of debt assets allows institutions to reduce their borrowing costs through the transfer of risk and thus lower their minimum capital requirements as enforced by regulators.[59] This practice has historically proven to have a net positive outcome in slow-moving developing economies in need of capital to stimulate their growth.[60] However, as demonstrated, practices like securitization, that leverage and transfer debts, are inherently high risk because their profits and the value of their assets are dependent on interest rates.[61] Once interest rates rose to remedy inflation fears, loans that originated at lower interest rates and were securitized became practically worthless.[62] The overall value of assets held by institutions engaged in this practice dropped and they became faced with a liquidity crisis.[63] As the banks failed, the FDIC stepped in and made sure that no one lost a penny of insured deposits.[64] Ultimately, it was consumers who bore the cost of the risky banking practices through higher interest rates on their debts, foreclosures on their homes, high unemployment rates, and through the government bail outs, using taxpayer dollars, of the very institutions who were at fault in the first place.[65]

Despite the global impact of the crisis, institutions that did not engage in high-risk securitization practices and those who took caution in retaining non-

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[56] *See* IMF, MONETARY AND CAP. MKTS. DEP'T. *Back to Basics: What Is Securitization*, (Sept. 2008) Andrea Jobst (Economist).

[57] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (authorized the Department of Treasury to create the Trouble Assisted Relief Program or "TARP").

[58] *See, e.g.*, Field & Suarez, *supra* note 54.

[59] IMF, *supra* note 56.

[60] *Id.*

[61] Field & Suarez, *supra* note 54.

[62] *Id.*

[63] *Id.*

[64] *See generally* Brit McCandless Farmer, *What the FDIC Does When a Bank Fails*, CBS NEWS, (Mar. 19, 2023), https://www.cbsnews.com/news/what-the-fdic-does-when-a-bank-fails-60-minutes-2023-03-19/ (explaining how the FDIC responds to bank failures and what it does for consumers).

[65] *See generally* John Cassidy, *The Real Costs of the 2008 Financial Crisis*, NEW YORKER, (Sept. 17, 2018), https://www.newyorker.com/magazine/2018/09/17/the-real-cost-of-the-2008-financial-crisis (describing the aftermath of the 2008 crisis and its long-term consequences).

interest rate dependent assets weathered the storm better.[66] Amongst them were IFIs, whose principles prohibited them from engaging in the high-risk interest-rate dependent practices that precipitated the crisis.[67] It is likely that if the institutions at fault adhered to the *Shariah* prohibitions on the use of interest for profit and speculation, the crisis never would have occurred. Hence, IFIs have become attractive for investors with recession concerns and those seeking to mitigate risks through diversification.[68]

Also, the inherent alignment of IFIs with the ESG approach has led some across the world to review it as a being well suited for economic recovery. Due to their macro-level aim of reducing inequity while fostering prosperity through contract moderated risk sharing,[69] IFIs would never engage in the excessively high-risk practices that caused the crisis. Even lenders responsible for the 2008 crisis, like Fannie Mae and Freddie Mac, have purchased *Shariah* compliant Islamic mortgages as hedges against their own subprime lending.[70] However, the profit and loss sharing basis of IFIs has its own risks but, unlike conventional financing, its risks incentivize stronger management and due diligence.[71] Being outcome dependent, IFIs have a greater incentive to exercise caution in their investment practices and thus, theoretically, a higher utility can be achieved using their methods of financing as opposed to debt financing.[72] In contrast, western debt-based financing practices are not only inherently higher risk, but their practice is also enabled by the assurances granted by FDIC regulations and requirements.[73] Although FDIC insurance was intended to maintain stability in the banking industry, it also creates a problem of a "moral hazard," where banks can take excessive risks with deposits knowing that if

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[66] Hussain, Shahmoradim & Turk, *supra* note 23.

[67] *Id.*

[68] SHAYERAH ILIAS, CONG. RSCH. SERV., ISLAMIC FINANCE: OVERVIEW AND POLICY CONCERNS, 7-5700 (2010).

[69] *See* Susannah Hammond, *The ESG potential of Islamic Finance*, THOMSON REUTERS, (Jun. 14, 2022), https://www.thomsonreuters.com/en-us/posts/news-and-media/islamic-finance-esg/.

[70] ILIAS, *supra* note 68.

[71] *See generally* Hamoudi, *supra* note 34 (describing the profit and loss sharing scheme).

[72] *See generally* Abdulali Hadizada and Peter Nippel, Article, *Islamic Profit and Loss Sharing Contracting versus Regular Equity in Entrepreneurial Finance: Risk Sharing and Managerial Incentives*, 24 PEPP. UNIV. J. ENTREPRENEURIAL FIN. 209, 238-39 (2022) (providing a theoretical mathematical analysis of Islamic finance practices).

[73] *See* Sheila Bair, *Bank Bailouts Propped up the Financial System. But We Should Never Repeat Them,* WASH. POST, (May 23, 2019, 9:50 PM), https://www.washingtonpost.com/outlook/bank-bailouts-propped-up-the-financial-system-but-we-should-never-repeat-them (Sheila Bair is the former chair of FDIC and she argues that banks should be allowed to fail as check on risky behavior rather than bailed out).

they fail the government will rescue their depositors rather than hold them accountable.[74]

In recent news, US banking saw the second largest bank failure in history which has caused great alarm in the markets.[75] Silicon Valley Bank ("SVB") experienced a reckoning when its decision to invest 94.4% of its deposits in low interest rate bonds and mortgage securities proved to be fatal once inflation increased and interest rates rose to tame it.[76] Not only was SVB dependent on interest for profit, but it also failed to back its transactions with enough liquid assets while gambling that interest rates would not rise and drop the value of its holdings.[77] Keeping in line with the 2008 failures, the federal government has announced that all depositors will be fully protected,[78] making an exception for funds that surpassed the $250,000 maximum that has been in place since 2008.[79] Given the current debt crisis, this exception complicates the issue because the funds used to repay depositors will need to be borrowed from the Treasury if the Deposit Insurance Fund ("DIF") runs out.[80] Market commentators are concerned that if additional bank failures like SVB continue to occur before Congress can raise the debt ceiling, the risk of default on the national debt will increase.[81]

While recent times have shown that the government will bail out financial institutions when they make a mess, IFIs do not have those same assurances due to the limitations of the Establishment Clause of the Constitution[82] and the markets lack the infrastructure that can assist them in hedging liquidity risks.[83] Even though IFIs are structured around compliance with a particular moral framework, they are also open to consumers seeking their offered services from all backgrounds. However, their religious affiliation subjects any governmental support to judicial

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[74] *See* John Turner, *Why Did Silicon Valley Bank Fail,* ECONOMICS OBSERVATORY, (Mar. 17, 2023), https://www.economicsobservatory.com/why-did-silicon-valley-bank-fail.

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *See* U.S. DEP'T OF TREASURY, FED. RSV., AND FDIC, *Joint Press Release* (Mar. 12, 2023, 6:15 PM).

[79] *See* Chappell, *supra* note 51.

[80] *See* Sonali Basak, *The Big Bailout Bet: Markets are Rattled and Waiting for More Shoes to Drop,* BLOOMBERG, (Mar. 13, 2023, 11:17 AM), https://www.bloomberg.com/news/newsletters/2023-03-13/what-comes-after-svb-signature-bank-collapse-bailout.

[81] *Id.*

[82] U.S. CONST. amend. I ("Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof.").

[83] Dajani*, supra* note 11.

strict scrutiny when challenged[84] against the Establishment Clause.[85] Additionally, since they are privately held, like all financial institutions in the United States, IFIs face another issue in the operational differences across the industry.[86] The religious underpinnings of their principled approaches are varied across the different Islamic schools of thought, with each IFI having its own *Shariah* Board advising it on compliance with respect to the schools of thought adhered to by the Board members,[87] and devising a regulatory framework that can meet all their needs in a uniform manner could be difficult.[88]

IV. RECOMMENDATION

With the looming threat of economic collapse on the horizon, financial regulators should be looking at all potential remedies rather than transferring debts through accounting measures. Granted, individual consumers may be reluctant to allow changes in regulatory regime to accommodate institutions grounded in religiously derived viewpoints, specifically those associated with Islam, because of the negative stigmas associated with the faith practice.[89] However, as researchers for some of the preeminent capital market indexes have said, averting the crisis will require unpopular actions and a great reset of policymaker mindset.[90] While members of Congress are calling for the quick fix of raising the debt cap, it will not provide a long-term solution if financial institutions continue to trade debt as a commodity rather than backing their trades by liquid assets.[91]

For the long-term sustainability and health of global markets and the US economy, it is imperative for financial institutions and governing bodies to transition away from high-risk speculative practices associated with debt-based financing and towards asset-based or equity-based financing. Regulators should hold banks accountable instead of enabling them to invest in interest dependent assets under the

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[84] *See* Agostini v. Felton, 521 U.S. 203, 222-23 (1993) (modified the criterion of the *Lemon* test for excessive entanglement inquiries between government and religion in federal statutes).

[85] *See generally* Hania Masud, Paper, *Takaful: An Innovative Approach to Insurance and Islamic Finance*, 32 UNIV. PA. J. INT'L LAW, 1133-1164 (2011) (examining the viability of the practice of insurance under the principles of Islamic finance in light of potential Establishment and Entanglement Clause issues).

[86] Hussain, Shahmoradim & Turk, *supra* note 23.

[87] *See generally* Shinsuke, *supra* note 14 (describing the various views held by Islamic scholars on finance practices).

[88] *See, e.g.*, Hussain, Shahmoradim & Turk, *supra* note 23.

[89] ILIAS, *supra* note 68 (stating that some U.S. financial institutions express concerns about the possible ties of IFIs to terrorist finance networks but that others assert that the risks of IFIs funding terrorism are not greater or different from conventional financing institutions).

[90] *See e.g.,* Goodkind, *supra* note 1.

[91] *See* Goodkind, *supra* note 1.

FDIC safety net. Allowing the reliability of institutions to dictate customer deposits would be a much more prudent approach. As such, the FDIC insurance requirements should be lifted, providing banks and consumers the option to choose their level of participation.

Additionally, to enhance oversight of IFIs, financial regulators should establish a separate agency with a specialized Shariah Board, well-versed in various schools of thought, that runs parallel to current agency regulators.[92] This agency can enforce consistent requirements across all IFIs, ensuring consistency and uniformity in their financial practices while limiting potential confusion for customers arising from a lack of familiarity with the products and services they offer. Moreover, the creation of a parallel regulatory structure for IFIs will facilitate their development and offer a safety net to IFIs that hedges against the risks of debt-based financing, serving as a remedy to the current debt crisis. By adopting these measures, financial institutions can contribute to the stability and long-term prosperity of both global and US markets.

V. CONCLUSION

When repeatedly faced with economic crises resulting from reckless speculative financial practices, the reasonable conclusion becomes that the practices must cease and be replaced with healthier alternatives. The current debt-based financing practices have proven to be unreasonably reckless, exploitative of consumers, and only beneficial to a minority profiting off them. Consumers entrusting their wealth to financial institutions should have confidence that their funds will not be used in reckless lending schemes. This fundamental fiduciary trust lies at the core of Islamic finance and banking practices. Implementing such principles into the economy, if done properly and embraced, can effectively address issues stemming from overleveraging debts.

[92] *See* U.S. DEP'T OF TREASURY, *Speech: Regulation of Islamic Financial Services in the United States*, (Mar. 2, 2005) (expressing that US regulators understand the importance of IFIs and have a desire to learn about the principles so that they can accommodate them. Also explained the case-by-case approach adopted in issues raised by IFIs in granting them special permissions for the financial products and transactions).

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IS STARBUCKS A BANK? HOW THE BILLIONS CONSUMERS UPLOAD ONTO STARBUCKS CARDS SHOULD BE REGULATED

❖ Note ❖

*Mackenzie Morgan**

I. INTRODUCTION

As technology has continued to advance, so have company reward programs. In 2021, Starbucks customers loaded $11 billion onto mobile Starbucks Cards,[1] accounting for almost half of all Starbucks sales.[2] The amount of money consumers have loaded onto their mobile applications to prepay for their coffee orders has allowed Starbucks to overtake most banks in terms of assets.[3] "85% of US banks have less than $1 billion total in assets, illustrating the major player Starbucks has become in this space."[4] Should the billions of dollars that consumers have uploaded onto Starbucks Cards be regulated by the federal government?

Part II of this Note discusses the history of the Starbucks Reward System and how it is currently regulated. Part II also addresses how different traditional banking categories are regulated. Part III discusses the category into which Starbucks Cards best fit and how this impacts the way they should be regulated. Part IV will provide a recommendation on whether the government should insure Starbucks Cards and will give advice to consumers on the best ways to protect themselves.

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[1] Mary Meisenzahl, *Starbucks Customers Have More Than $1 Billion Sitting on Gift Cards*, BUS. INSIDER, (May 4, 2022, 1:50 PM), https://www.businessinsider.com/starbucks-says-over-1-billion-is-sitting-on-cards-2022-5.

[2] Lisa Moyle, *Starbucks: Banking & Serving Coffee*, FUTURE IDENTITY FIN., (July 19, 2022), https://fttembeddedfinance.com/starbucks-banking-serving-coffee/.

[3] *Id.*

[4] *Id.*

II. BACKGROUND

Starbucks released its first rewards program in 2008 and launched mobile payment in 2011.[5] The Starbucks reward program has continued to grow, and in 2021, more than $11 billion was loaded onto Starbucks Cards.[6] In addition, a large amount of the money deposited onto Starbucks Cards ends up going unused.[7] In 2019, based on historical data, Starbucks calculated that it generated $141 million in revenue from unused deposits.[8]

The structure of the Starbucks rewards program incentivizes consumers to load money onto Starbucks Cards. When a Starbucks rewards member uses another form of payment, such as cash or a credit/debit card, they earn one Star per $1 spent.[9] However, when a Starbucks rewards member uses a Starbucks Card to pay, they earn two Stars per $1 spent.[10] Consumers are so persuaded by this incentive that Starbucks itself sells more gift cards than all other companies combined.[11]

According to the Starbucks Card Terms and Conditions, "the dollar value that consumers load onto their Starbucks Card is a prepayment for the goods and services of participating stores."[12] Money that has been uploaded onto a Starbucks card is nonrefundable and cannot be redeemed for cash.[13] In addition, the "value of the Starbucks Card is not insured by the Federal Deposit Insurance Corporation ("FDIC"), nor does it earn interest."[14]

Starbucks Cards are gift cards. Gift cards are regulated by the Credit Card Accountability Responsibility and Disclosure Act of 2009.[15] The Act requires that gift cards do not expire until at least five years after they have been activated and sets

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[5] Peter Bondarenko & Melissa Petruzzello, *Starbucks*, BRITANNICA, https://www.britannica.com/topic/Starbucks (last updated Mar. 3, 2023).

[6] Meisenzahl, *supra* note 1, at 1.

[7] *Id.*

[8] Neil Patel, *How Starbucks Quietly Benefits From its Most Passionate Customers*, MOTLEY FOOL, (Jun. 18, 2022), https://www.fool.com/investing/2020/06/17/how-starbucks-quietly-benefits-from-its-most-passi.aspx.

[9] *Earning Stars*, STARBUCKS, https://www.starbucks.com/rewards#:~:text=Earning%20Stars&text=Earn%201%20Star%20per%20%241,pay%20directly%20through%20the%20app. (last visited Mar. 17, 2023).

[10] *Id.*

[11] *See* Meisenzahl, *supra* note 1, at 1.

[12] *Starbucks Card Terms & Conditions*, STARBUCKS, https://www.starbucks.com/terms/manage-gift-cards/ (last visited Mar. 17, 2023).

[13] *Id.*

[14] *Id.*

[15] Heather Morton, *Gift Cards and Gift Certificates Statutes and Legislation*, NCSL, https://www.ncsl.org/financial-services/gift-cards-and-gift-certificates-statutes-and-legislation (last updated Apr. 22, 2016).

limits on inactivity fees.[16] In addition to federal legislation, many states have passed statutes regulating gift cards.[17] Ten states require that issuers of gift cards allow purchasers to redeem their gift cards for cash, but generally only if the remaining balance is less than $5.[18]

As the public has started to learn about the amount of money consumers are uploading onto Starbucks Cards, Starbucks has often been compared to a bank.[19] In addition, the money loaded onto Starbucks Cards could be considered an investment or loan.[20] In the United States, banks are regulated by both the federal government and individual states.[21] The government imposes restrictions on how traditional banks can invest customer deposits.[22] Most banks are insured by the Federal Deposit Insurance Corporation ("FDIC"), which is backed by the full faith and credit of the U.S. government.[23] The FDIC does not insure investments,[24] but the Securities Investor Protection Corporation ("SIPC") does.[25] The SIPC does not insure losses incurred as a result of market activity or fraud, but it does cover the losses of investors' accounts incurred by the bankruptcy of their broker or dealer.[26] Loans, on the other hand, are not insured by the government.[27] However, most lenders create their own insurance by securing their loans.[28]

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[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] Jason Kottke, *Starbucks Is a Bank that Sells Coffee*, KOTTKE, (Feb. 3, 2022), https://kottke.org/22/02/starbucks-is-a-bank-that-sells-coffee.

[20] *See* Kevin Mwanza, *Starbucks Customers Have a Balance of $1.4 Billion on the App, Interest-Free Loan*, MOGULDOM NATION, (Jun. 9, 2021), https://moguldom.com/357346/starbucks-customers-have-a-balance-of-1-4-billion-on-the-app-interest-free-loan/.

[21] Adam Barone, *How Banking Works, Types of Banks, and How to Choose the Best Bank for You*, INVESTOPEDIA, https://www.investopedia.com/terms/b/bank.asp (last updated Aug. 19, 2022).

[22] Patel, *supra* note 7, at 2.

[23] *Are My Deposit Accounts Insured by the FDIC?*, FDIC, https://www.fdic.gov/resources/deposit-insurance/financial-products-insured/index.html (last updated Mar. 14, 2023).

[24] Matthew Goldberg, *FDIC Insurance: What it is and How it Works*, BANKRATE, (Mar. 13, 2023), https://www.bankrate.com/banking/fdic-insurance/

[25] Mark P. Cussen, *Who Insures Your Investment in the Stock Market*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/are-my-investments-insured/#:~:text=The%20element%20of%20risk%20is,the%20higher%20the%20potential%20return. (last updated Apr. 9, 2022).

[26] Goldberg, *supra* note 23, at 4; Cussen, *supra* note 24, at 4.

[27] Will Kenton, *Commercial Loan: What it Is, how it Works, Different Types*, INVESTOPEDIA, https://www.investopedia.com/terms/c/commercial-loan.asp (last updated Nov. 24, 2020).

[28] *Id.*

III. ANALYSIS

A. Is Starbucks a Bank?

In 2021, $11 billion was uploaded by consumers onto Starbucks Cards.[29] This figure has led Starbucks to surpass the number of assets held by most banks.[30] In fact, 85% of banks in the United States have less than $1 billion in assets.[31] Starbucks has more assets than the majority of U.S. banks, and therefore, the first category that the company may fit into is a traditional bank.

"A bank is a financial institution that is licensed to accept checking and savings deposits and make loans. Banks also provide related services, such as individual retirement accounts (IRAs), certificates of deposit (CDs), currency exchange, and safe deposit boxes."[32] While Starbucks does take in substantial amounts of money, Starbucks is not licensed to accept deposits or make loans. In addition, Starbucks does not offer any other financial services that banks typically offer. Starbucks does not fit into the traditional definition of a bank.

B. Is Starbucks Receiving an Unregulated Investment?

The money loaded onto Starbucks Cards could be considered an investment in the company. "An investment is an asset or item acquired with the goal of generating income or appreciation."[33] Additionally, "[i]n general, any action that is taken in the hopes of raising future revenue can also be considered an investment."[34] A Starbucks Card is purchased with the goal of earning rewards faster. Technically, this could be considered income, because customers get free rewards, such as cups of coffee, for specific amounts of money they spend on their Starbucks Cards.

Even if the money was considered an investment, it would not be insured by the federal government. Consumers are not putting money onto their Starbucks Cards through a broker or dealer, which is a requirement for an investment to be one that the SIPC will insure.[35] Instead, this is a direct transaction between Starbucks and the consumer.

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[29] Meisenzahl, *supra* note 1, at 1.

[30] *Id.*

[31] *Starbucks, a Bank that Sells Coffee! – The Epitome of Digital Wallets Strategy*, FIE-CONSULT, (Aug. 19, 2022), https://fieconsult.com/starbucks-a-bank-that-sells-coffee-the-epitome-of-digital-wallets-strategy/.

[32] Barone, *supra* note 20, at 4.

[33] Adam Hayes, *Investment Basics Explained with Types to Invest In*, INVESTOPEDIA, https://www.investopedia.com/terms/i/investment.asp (last updated Mar. 16, 2023).

[34] *Id.*

[35] Cussen, *supra* note 24, at 4.

C. Are Consumers Giving Starbucks an Interest-Free Loan?

The money consumers deposit onto Starbucks Cards could be considered a loan to Starbucks. "A loan is when money is given to another party in exchange for repayment of the loan principal amount plus interest."[36] Most loans have interest rates, but they do not necessarily have to.[37] Starbucks customers load money onto their Starbucks Cards as a prepayment for their future coffee orders. When consumers upload money onto their Starbucks Cards, Starbucks is "essentially gaining access to an interest-free line of credit, one that equates to roughly 4% of the company's total liabilities."[38] Starbucks is then able to use this money to enhance their cash flow, decrease their working capital, and make investments into expanding their business.[39] Starbucks repays these customers when they purchase their coffee. A large amount of the money deposited onto Starbucks Cards goes unused.[40] In 2019, based on historical data, Starbucks calculated that it generated $141 million in revenue from unused deposits.[41] Therefore, Starbucks is not actually getting an interest free loan. Instead, the company is borrowing $11 billion a year at an effective rate of negative 10%.[42]

D. Where Does Starbucks Fit Best?

While Starbucks could theoretically fit into either the investment or loan category, the money on Starbucks Cards is best described as a loan to Starbucks. Out of the three categories, loans are the only one not insured by the federal government or the states individually. Instead, the government leaves it to private parties, including banks and other lenders, to protect themselves. While Starbucks is technically getting a $11 billion loan at an effective interest rate of negative 10%, Starbucks Cards are just gift cards. No other company has sold anywhere near the amount of gift cards that Starbucks does each year, but truthfully, any company's gift card sales could be considered a loan. The federal government has been regulating gift cards since 2009, and many states have additional regulations on gift cards. However, neither have shown an interest in insuring gift card purchases.

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[36] Julia Kagan, *What Is a Loan, How Does It Work, Types, and Tips on Getting One*, INVESTOPEDIA, https://www.investopedia.com/terms/l/loan.asp (last updated Apr. 19, 2021).

[37] *See* Lindsay VanSomeren & Jordan Tarver, *Should You Get an Interest-Free Loan?*, FORBES ADVISOR, https://www.forbes.com/advisor/personal-loans/interest-free-loans/#:~:text=Do%20Interest%2Dfree%20Loans%20Exist,as%20electronics%2C%20jewelry%20or%20furniture. (last updated Apr. 16, 2021, 2:25 PM).

[38] Patel, *supra* note 7, at 2.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.*

Banking accounts and investments are very distinguishable from the purchase of gift cards. In October of 1929, the stock market crashed, causing more than 9,000 banks to fail by March 1933.[43] "Congress took action to protect bank depositors by creating the Emergency Banking Act of 1933, which also formed the FDIC."[44] The federal government insures banks with the FDIC to prevent consumers from losing their entire life savings if their bank fails and closes. The SIPC was created under the Securities Investor Protection Act of 1970.[45] The SIPC "oversees liquidation of broker-dealers who go bankrupt, lapse into financial trouble, or if the assets of their customers go missing."[46] The SIPC "is not an agency, nor is it part of the United States government."[47] Instead, "it is an insurance."[48] The federal government created the SIPC because it was worried about people losing their entire college fund or retirement account if their brokerage went bankrupt. In contrast, consumers typically load relatively insignificant amounts onto their gift cards. In fact, Starbucks does not allow an individual to have more than $500 on a Starbucks Card at any time.[49] A loss of $500 is a small amount compared to someone losing their entire life savings, college fund, or retirement account. The amount of money on gift cards is very distinguishable from bank accounts and investments, and therefore, it is unlikely the federal government would have any interest in insuring it.

In addition, the federal government regulating Starbucks Cards is a slippery slope. If the government insures Starbucks Cards, it will be pressured to insure all gift cards. One problem with this is that it would be extremely difficult for the government to keep track of. The federal government would not step in to provide insurance until a business goes bankrupt, and it would be difficult to figure decipher who deserves to be paid back. In addition, it is likely that many people would only be owed extremely tiny amounts. For example, what would the government do about a consumer with sixteen cents left on a gift card they never intended to use? It seems like an extraordinarily complex and tedious task. Furthermore, small businesses are much more likely than large businesses to go bankrupt.[50] Small businesses are often

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[43] Robert Stammers, *The History of the FDIC*, INVESTOPEDIA, https://www.investopedia.com/articles/economics/09/fdic-history.asp#:~:text=The%20Federal%20Deposit%20Insurance%20Corporation,of%20the%20nation's%20financial%20system. (last updated Mar. 15, 2023).

[44] *Id.*

[45] Kenton, *supra* note 26, at 5.

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Starbucks Card Terms & Conditions, supra* note 11, at 3.

[50] *Why are Small Businesses More Likely to File for Bankruptcy?*, REINHERZ L. OFFICES, https://reinherzlaw.com/why-are-small-businesses-more-likely-to-file-for-bankruptcy/ (last visited Mar. 17, 2023).

not as technologically advanced, so insuring their gift cards would be even more difficult.

IV. RECOMMENDATION

Based on the above analysis, the federal government should continue to regulate gift cards to protect consumers. However, the government should not extend that protection to insure Starbucks Cards. First, individual consumers do not put enough money on their Starbucks Cards to require them to be backed by the full faith and credit of the federal government. Bank accounts hold individuals' life savings and investment accounts hold college and retirement funds, which gives the government a large incentive to make sure they are insured. In addition, the government has a strong interest in preventing financial crises. On the other hand, the money loaded onto Starbucks Cards is a small amount of money that an individual consumer has decided to deposit for their future purchases at Starbucks. A consumer can put as little as $5 on a Starbucks Card at any given time, making it likely that consumers are only uploading amounts they can afford to be without.[51]

Second, the federal government insuring Starbucks Cards is a slippery slope. If the government insures Starbucks Cards, it will be pressured to insure all gift cards. In addition, there are other companies, such as PayPal and Venmo, that allow consumers to upload balances and are not insured.[52] PayPal and Venmo actually have a much more compelling need for insurance than Starbucks because they put all of their customers balances together and invest the money into liquid investments.[53] It would be impossible for the federal government to insure every mobile application that consumers have the ability to upload money onto. If the government goes down the path of insuring Starbucks Cards, it will be pressured to regulate all gift cards, as well as other companies, such as PayPal and Venmo, that have an even more compelling need for insurance than Starbucks Cards.

Consumers upload their money onto Starbucks Cards because they are happy with the return of earning rewards, such as free cups of coffee, for half the cost. The government should not interfere with the choices and judgments of individuals on how they wish to spend their money, especially when it equates to such a small amount of money per consumer.

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[51] *Starbucks Card Terms & Conditions, supra* note 11, at 3.

[52] *Program Banks*, PAYPAL, https://www.paypal.com/us/legalhub/program-banks-tnc?locale.x=en_US#:~:text=FDIC%20insurance%20does%20not%20protect,failure%20of%20PayPal%20or%20Venmo (last visited Apr. 14, 2023).

[53] *PayPal Balance Terms and Conditions*, PAYPAL, https://www.paypal.com/us/legalhub/pp-balance-tnc?locale.x=en_US#:~:text=If%20your%20Balance%20Account%20is%20not%20eligible%20for%20FDIC%20pass,with%20state%20money%20transmitter%20laws (last visited Apr. 14, 2023).

The best solution is for consumers to protect themselves by being more informed when uploading money onto Starbucks Cards. One way that consumers can protect themselves is by not uploading too much money onto their Starbucks Cards at once. Consumers should only upload an amount of money that they will realistically spend in one month. In addition, consumers should ensure that they know the terms and conditions prior to uploading money onto their Starbucks Cards, or any other mobile application. For example, if an individual uploaded money onto a Starbucks Card and later needed that money back, they may be disappointed to find out that Starbucks Card cannot be redeemed for cash.

V. CONCLUSION

In conclusion, while it does seem unfair that Starbucks is getting a large loan that they are effectively earning interest on, the government should not step in and insure this money. The amount of money uploaded by each consumer is too little to be comparable to the other areas that the federal government chooses to provide insurance, and therefore, it should not be a concern of the federal government. Instead, consumers should be left to make these value judgments, and should take initiative on protecting themselves.

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CRIMES WITHOUT CONSEQUENCES: EXPLORING THE METAVERSE AS A CRIMINAL FRONTIER

❖ Note ❖

*Doyeon Oh**

I. INTRODUCTION

A conception of digital worlds in the form of virtual and augmented realities has been a science-fiction vision since the 20th century.[1] As of 2023, that vision has become more than just a reality.[2] Established tech giants like Meta and Google are already taking the next step in developing the "metaverse"—a universal platform promising a fully immersive real-life experience within a network of multiple virtual worlds.[3] Theoretically, the metaverse will allow users, or their "avatars," to live, work, and socialize as they would in the real world.[4] Casual users may think of it as a "digital playground;" others may see potential business opportunities.[5] Ideas of its use are limitless and exciting,[6] and the metaverse hype seems more than deserving.

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[1] *See generally* Linda Tucci, *What Is the Metaverse? An Explanation and In-depth Guide*, TECHTARGET (Nov. 18, 2022), https://www.techtarget.com/whatis/feature/The-metaverse-explained-Everything-you-need-to-know.

[2] *See* Hall Koss, *What Is the Metaverse, Really?*, BUILTIN (Oct. 6, 2022), https://builtin.com/media-gaming/what-is-metaverse.

[3] Tucci, *supra* note 1.

[4] *Id.*

[5] *What Is the Metaverse?*, MCKINSEY & CO. (Aug. 17, 2022), https://www.mckinsey.com/featured-insights/mckinsey-explainers/what-is-the-metaverse#/.

[6] *Id.*

However, this exciting prospect brings forth a dangerously overshadowed issue: violent crimes.[7] With the creation of an entirely new world that may inevitably become a part of many people's lives, opportunities to commit violent crimes with ease will undoubtedly arise.[8] The question is whether developers will recognize them as legitimate crimes in the first place, as it is technically the avatars that are being harmed, not the user.[9] If a user's avatar violently assaults another's so as to intentionally cause severe emotional distress, should the crime be treated how it would be if it occurred in the real world?[10] If not, how would such implications affect the development and success of the metaverse?

This note argues that the current legal framework falls short in sufficiently addressing the issues of violent crimes in the metaverse and will further explore the potential repercussions this may have on businesses. Part II provides a background on the progressive development and success of the metaverse and sheds light on past occurrences of violent crimes within existing virtual platforms. Part III analyzes how the current legal framework may regulate these crimes, as well as how such inadequacy may affect the metaverse business. Lastly, Part IV discusses pragmatic solutions that developers can employ to proactively address this issue.

II. BACKGROUND

A. Evolution of the Virtual World

Before the emergence of the metaverse, virtual reality ("VR") technology had already established itself as a prominent form of virtual worlds.[11] Unlike augmented reality, VR creates an interactive, three-dimensional world accessed through goggles and headsets.[12] Depending on the specific platform and its intended purpose, users can move around and engage with the virtual environment as if in the real world.[13] Most VR technologies are popular for their entertainment uses; however, they have increasingly been utilized for other purposes such as education, professional training,

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[7] *See* Pin Lean Lau, *The Metaverse: Three Legal Issues We Need to Address*, CONVERSATION (Feb. 1, 2022, 9:44 AM), https://theconversation.com/the-metaverse-three-legal-issues-we-need-to-address-175891.

[8] *See id.*

[9] *See* Ben C. Cheong, *Avatars in the Metaverse: Potential Legal Issues and Remedies*, 3 INT'L CYBERSECURITY L. REV. 467, 472 (2022).

[10] *See* Lau, *supra* note 7.

[11] *See* Mark A. Lemley & Eugene Volokh, *Law, Virtual Reality, and Augmented Reality*, 166 U. PA. L. REV. 1051, 1054–56 (2018).

[12] *Id.* at 1055.

[13] *Id.*

architecture, and healthcare.[14] One of the key features of VR is the ability to design a computer-generated environment tailored for its intended use.[15] The virtual space is fictional and does not necessarily have to reflect the real world.[16] For instance, VirTra assists law enforcement agencies in training their personnel through simulated scenarios, while other platforms like Glue and Arthur may provide exclusive virtual spaces for users to hold business conferences.[17]

In contrast, the metaverse uses the elements of immersive technologies along with a handful of others to create an advanced virtual simulation that closely resembles the real world.[18] Users are represented by their personal avatars and, in a way, form a new identity through these avatars.[19] They can socially interact with each other, conduct business, engage in recreational activities, and more.[20] Often referred to as the next version of the Internet, the metaverse will operate in real-time in an open virtual environment, with its own unique infrastructure to support it.[21] The critical difference would be its three-dimensional capabilities; otherwise, the metaverse would be no different from the regular Internet.[22] The ideal, envisioned metaverse would be as large and diverse as the real world, and available around the clock.[23] Currently, there is no fully-realized version of the metaverse, but certain sophisticated VR platforms like Horizon Worlds are being labeled as its early-stage form.[24]

B. What Investors See in the Metaverse

In 2022, metaverse businesses had a market size of $93.9 billion that was predicted to grow 40% per year through 2030.[25] Bloomberg analysts forecasted that the entire metaverse market— social media ads, tech services, live entertainment,

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[14] Sophie Thompson, *VR Applications: 23 Industries Using Virtual Reality*, VIRTUALSPEECH (Mar. 1, 2022), https://virtualspeech.com/blog/vr-applications.

[15] *See id.*

[16] Lemley & Volokh, *supra* note 11, at 1064.

[17] Thompson, *supra* note 14.

[18] *See generally* Fabio Moioli, *The Metaverse: Don't Confuse It with Virtual Reality*, FORBES (Aug. 11, 2022, 6:45 AM), https://www.forbes.com/sites/forbestechcouncil/2022/08/11/the-metaverse-dont-confuse-it-with-virtual-reality.

[19] *See* Tucci, *supra* note 1.

[20] *See id.*

[21] *See* Koss, *supra* note 2.

[22] *Id.*

[23] *Id.*

[24] *See* Kashmir Hill, *This Is Life in the Metaverse*, N.Y. TIMES (Oct. 7, 2022), https://www.nytimes.com/2022/10/07/technology/metaverse-facebook-horizon-worlds.html.

[25] Takashi Miura, *Seven Keys to Success in the Metaverse*, EY (Nov. 25, 2022), https://www.ey.com/en_jp/tmt/seven-key-elements-for-companies-to-develop-metaverse-business.

etc.— would reach $800 billion by 2024, and Citigroup analysts expected that it would reach $13 trillion by 2030.[26]

Tech giants and major businesses hope to use the metaverse as a medium to transform the global economy.[27] For instance, the immersive technologies would allow for a revolutionary consumer experience where people can test drive cars before making a purchase, all at the comfort at their homes.[28] Nvidia claimed that the metaverse would "create economies of scale that had the potential to dwarf the current economy itself."[29] Although the metaverse's development is still in an early phase, tech giants have been attracted to its potential to become the world's next greatest innovation.[30]

C. Violent Crimes in Virtual Reality

Violent activities through VR technologies are not unheard of.[31] Meta's own version of its metaverse, Horizon Worlds, is known for such issues.[32] In one instance, a researcher wanted to study user behavior on the platform.[33] Within an hour of entering the virtual space, her avatar was sexually harassed and raped by multiple male avatars.[34] Despite the incident occurring in virtual reality, the researcher reported feeling disoriented when assaulted.[35] When the aggressors touched her, the researcher's controller would vibrate to cause a "physical sensation that was a result of what she was experiencing online."[36] Another metaverse researcher was virtually raped by three to four male avatars in Horizon Worlds—within sixty seconds of joining.[37] After verbally and sexually harassing the researcher,

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[26] Afiq Fitri, *Virtual Worlds, Real Money: Why Big Business Is Investing in the Metaverse*, TECH MONITOR (Jun. 14, 2022, 4:05 PM), https://techmonitor.ai/technology/emerging-technology/metaverse-mergers-acquisitions-investing-virtual.

[27] *See id.*

[28] *See Demystifying the Metaverse*, PWC, https://www.pwc.com/us/en/tech-effect/emerging-tech/demystifying-the-metaverse.html (last visited Apr. 18, 2023).

[29] *See* Fitri, *supra* note 26.

[30] *See* Miura, *supra* note 25.

[31] *See generally* David Hoppe, *Eleven Crimes that Occur in Virtual Reality,* GAMMA LAW (Oct. 7, 2019), https://gammalaw.com/eleven-crimes-that-occur-in-virtual-reality/.

[32] *See Researcher's Avatar Sexually Assaulted on the Metaverse*, KNEWS (May 30, 2022, 4:04 PM), https://knews.kathimerini.com.cy/en/business/researcher-s-avatar-sexually-assaulted-on-the-metaverse.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] Nina Patel, *Reality or Fiction?*, MEDIUM (Dec. 21, 2021), https://medium.com/kabuni/fiction-vs-non-fiction-98aa0098f3b0.

the male avatars proceeded to rape her while taking photos.[38] The researcher described her experience as "surreal" and "a nightmare," and "in some capacity, . . . [her] physiological and psychological response was as though it happened in reality."[39]

Crimes in the forms of physical assault and battery can occur in the metaverse in a similar manner.[40] Murder cases are yet to be recognized; in most platforms that allow "death" of a user's avatar, the avatar is programmed to respawn and this would usually be accepted as part of the platform's intended experience.[41] There is also the underlying question of whether metaverse developers will even consider or find the need to create a "death" feature for current and future projects.[42] However, the issue has resurfaced in the global context as the metaverse continues to advance in sophistication.[43] The World Economic Forum, an international organization dedicated to addressing major economic and social issues worldwide, has facilitated discussions among politicians and business leaders on the question of whether "murder" committed within the metaverse— should the feature exist— can be prosecutable under the law. [44] The United Nations has also been urged to establish "international safety standards for the metaverse," imposing penalties not only for murder but violent crimes in general committed within the metaverse.[45]

III. ANALYSIS

A. Legal Challenges of Regulating Crimes Within the Metaverse

No established legal framework exists that specifically protects users in the metaverse—or the virtual world in general—from violent crimes.[46] Although there

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[38] *Id.*

[39] *Id.*

[40] *See* Patel, *supra* note 37.

[41] *See* Tristan Greene, *The UAE's AI Minister Wants 'Murder' in the Metaverse to be a Real Crime*, NEXT WEB (May 26, 2022, 7:54 PM), https://thenextweb.com/news/uae-ai-minister-wants-murder-metaverse-real-crime.

[42] *See id.*

[43] *See* Sam Shead, *Serious Crime in the Metaverse Should Be Outlawed by the U.N., UAE Minister Says*, CNBC (May 25, 2022, 10:51 AM), https://www.cnbc.com/2022/05/25/metaverse-murders-need-to-be-policed-says-uae-tech-minister.html.

[44] *See id.*

[45] *Id.*

[46] *See generally* Christopher Eberhart, *Metaverse Experts Reveal if You Can Murder in VR – And Whether You Can Be Punished*, N.Y. POST (Apr. 10, 2022), https://nypost.com/2022/04/10/metaverse-experts-reveal-if-you-can-murder-in-virtual-world/.

have been statutes implemented to protect individuals from cyberbullying and online harassment, the criminal law is yet to make a presence.[47]

Difficult challenges exist when proving and measuring the bodily harm caused by violent crimes in the metaverse.[48] One critical example is homicide, which would always require the death of an individual.[49] In the metaverse, virtual murder results in the death of the avatar, not the user.[50] It would be extremely difficult to convict the user for homicide when the victim has not in fact been physically harmed in the real world.[51] Instead, such crimes can first be viewed as "speech or expression; less as physical act against a person."[52] By evaluating the circumstances that surround a virtual criminal incident, the law would decide whether such speech or expression is protected or not.[53] In many cases, emotionally distressing or outrageous speech in the virtual world can be protected by the First Amendment.[54] However, speech that contains legitimate intent and threat to cause harm to an individual is unprotected.[55] It would be up to the courts to determine which categories a virtual violent conduct would fall under, and whether the criminal law would favor the latter view in the future is yet to be determined.

Current laws on violent sexual crimes may also seem insufficient to extend jurisdiction to the virtual world.[56] The definitions of sexual crimes vary by jurisdiction, but they generally share a similar legal framework.[57] In Illinois, criminal sexual abuse requires an act of sexual conduct, which must involve physical contact between the abuser and victim.[58] Although contact may occur inside the metaverse, it would be digital, between the avatars.[59] Some VR technology allows the users to physically feel what their avatars are feeling, but such technology is still under

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[47] *See* Alex M. Samaei, *The Tort Implications of Sexual Assault in Virtual Reality*, SUFFOLK J. HIGH TECH. L. (Dec. 31, 2016), https://sites.suffolk.edu/jhtl/2016/12/31/the-tort-implications-of-sexual-assault-in-virtual-reality/.

[48] *See* Cheong, *supra* note 9, at 482–83.

[49] *See* Ryan Esparza, *"The Way I Felt": Creating a Model Statute to Address Sexual Offenses Which Utilize Virtual Reality*, 4 CRIM. L. PRAC. 25, 32 (2018).

[50] *Id.*

[51] *See id.* at 32–33.

[52] Eberhart, *supra* note 46; *see also* Esparza, *supra* note 49, at 30–31.

[53] *See* Eberhart, *supra* note 46.

[54] Esparza, *supra* note 49, at 30–31; *see also* U.S. CONST. amend. I (protecting the constitutional rights of freedom of speech).

[55] Esparza, *supra* note 49, at 30–31.

[56] *See id.* at 31–33.

[57] *See id.*

[58] 720 Ill. Comp. Stat § 5/11-1.20 (2016).

[59] Gaurav Sarkar, *Why 'Groping' Someone in Virtual Reality is Counted as 'Sexual' Assault*, FEDERAL (Dec. 24, 2021), https://thefederal.com/features/sexual-harassment-is-no-joke-on-internet/.

development and far from prevalent.[60] Furthermore, "there is a long way to go before the force exerted could be considered an intentional touch by another user," meaning that physical sensation through VR technologies may not suffice as physical contact as described in criminal statutes.[61]

However, other areas of law have the potential to address this issue.[62] Because of the interactive and immersive nature of the metaverse, users are highly likely to experience emotional distress from violent crimes.[63] Stanford University's Virtual Human Interaction Lab found that "the same areas of the human brain light up when you have a virtual reality experience as a person does during real world experiences," indicating that users can experience the same emotional distress in the metaverse as they would in the real world.[64]

With this regard, users may find a claim for intentional infliction of emotional distress ("IIED"), although proving emotional distress from the metaverse may still present unique challenges.[65] Whether metaverse conduct would be considered extreme or outrageous is debatable, because however violent and aggressive it may be, the conduct would be targeted at the user's avatar and thus have unclear legal implications.[66] Anonymity in the virtual space is also another issue to be addressed; if the perpetrator-avatar is an untraceable anonymous user, there can be no legal action to be pursued.[67]

Whether a person can sue a perpetrator for IIED in the metaverse is still a controversial legal issue, and this is not surprising considering that the emergence of a sophisticated virtual world like the metaverse is relatively new.[68] However, this area of tort law brings a unique perspective on the convergence of law and virtual violent crimes.[69] An IIED argument is a "loophole" that addresses the real-life consequences of crimes instead of directly challenging the actual crime in the metaverse, and thus could set forth an example for the emergence of criminal law in the future.[70]

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[60] Samaei, *supra* note 47.

[61] *Id.*

[62] *See id.*

[63] *See id.*

[64] *Id.*

[65] *See id.*

[66] *See* Esparza, *supra* note 49, at 31.

[67] *See id.* at 33–34.

[68] *See* Samaei, *supra* note 47.

[69] *See id.*

[70] *See id.*; *see also* Esparza, *supra* note 47, at 30–33.

B. Avatars and "Personhood"

Criminal laws were made to protect real people, not avatars.[71] For an avatar to be protected from violent crimes by law, they must be attributed with "personhood"—the quality of being a human individual—to be covered under the law.[72]

An attributable legal persona—which requires personhood—for avatars remains a controversial debate at this time.[73] This is because avatars are virtual representations of individuals.[74] While they can be programmed to express some degree of human-like behavior, emotions, and personality traits, they are ultimately controlled by their users or creators.[75] Like other forms of advanced technology, avatars are often viewed as tools controlled and created by humans that can be used to facilitate communication and interaction between people; however, they do not have the autonomy or consciousness necessary to be considered as legal persons in the same way as real human individuals.[76]

One of the primary arguments supporting personhood for avatars is their role in representing real-world individuals, making them extensions of their identity.[77] This is in contrast to an analogous idea that it is impossible to obtain two social security numbers to maintain two different identities.[78] Avatars can be perceived as possessing personal identities, often customized by users to mirror their real-life counterparts.[79] These avatars assume significant importance as extensions of users' identities, representing them in virtual realms and allowing them to interact with others in a way that they may not be able to in the physical world.[80]

In the past, it would have been difficult to argue this way; avatars had limited purpose for their existence as they were most commonly used in video games, restricted VR experiences, and online social platforms.[81] This unsophistication has enforced the existing fine line that separates avatars from real humans.

However, the metaverse has the potential to break this line, or at the least draw another.[82] While avatars in virtual worlds and online gaming environments can

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[71] Eberhart, *supra* note 46.

[72] *See* Cheong, *supra* note 9, at 471–89.

[73] *See id.* at 470.

[74] *See id.* at 469–70, 477–80.

[75] *See id.* at 477–80.

[76] *See id.*

[77] Llewellyn J. Gibbons, *Law and the Emotive Avatar*, 11 VANDERBILT J. ENT. & TECH. 899, 905 (2009).

[78] *See generally id.*

[79] *See id.* at 909, 913.

[80] *See id.* at 905, 913.

[81] *See* Esparza, *supra* note 47, at 26; *see also* Eberhart, *supra* note 46.

[82] *See* Esparza, *supra* note 47, at 26.

take the form of two or three-dimensional representations that mimic basic human movements and expressions, we can expect avatars to do much more in the metaverse.[83] A highly possible advancement to avatar technology is interoperability.[84] As the metaverse becomes more interconnected, a single avatar could be designed to represent users across all forms of the metaverse.[85] This would provide users with the opportunity to establish a stronger connection with their avatars that could transition to adequate legal representation in the future.[86]

C. Developer Concerns

Failure to address violent crimes may potentially cause metaverse developers to lose their supporters in the long run.[87]

Victims of these crimes have continuously voiced their concerns about safety within the metaverse.[88] Without adequate regulations to address this issue, safety concerns may impede its user-friendliness and user base.[89] The idea that "misuse of [VR technologies] could cause more realistic harm [against users] with little consequence to the perpetrator" may deter widespread adoption.[90] Several metaverse platforms are already seeing a decrease in their user base.[91] Meta's Horizon Worlds aimed to reach half a million users by the end of 2022, but that number sunk to 300,000 active users. The reported decrease is said to stem from various factors unrelated to the present matter,[92] but given the growing number of incidents of

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[83] *See* Cheong, *supra* note 9, at 469-74.

[84] Dean Takahashi, *Will Interoperable Avatars be Essential for the Open Metaverse?*, VENTUREBEAT (Apr. 2, 2023, 8:45 AM), https://venturebeat.com/games/will-interoperable-avatars-be-essential-for-the-open-metaverse-timmu-toke/.

[85] *Id.*

[86] *See id.*

[87] *See generally* Andrew Chow, *A Year Ago, Facebook Pivoted to the Metaverse. Was It Worth It?*, TIME (Oct. 27, 2022, 3:59 PM), https://time.com/6225617/facebook-metaverse-anniversary-vr/; Yinka Bokinni, *A Barrage of Assault, Racism, and Rape Jokes: My Nightmare Trip Into the Metaverse*, GUARDIAN (Apr. 25, 2022, 6:54 AM), https://www.theguardian.com/tv-and-radio/2022/apr/25/a-barrage-of-assault-racism-and-jokes-my-nightmare-trip-into-the-metaverse; *see also* Cheong, *supra* note 9, at 493.

[88] *See generally* Patel, *supra* note 37.

[89] *See* Landry Signé & Hanna Dooley, *A Proactive Approach Toward Addressing the Challenges of the Metaverse*, BROOKINGS INSTITUTION (Jul. 21, 2022), https://www.brookings.edu/techstream/a-proactive-approach-toward-addressing-the-challenges-of-the-metaverse/.

[90] *See id.*

[91] *See generally* Nick Statt & Janko Roettgers, *Meta's Horizon Worlds Is Shrinking, Jeopardizing Its Metaverse Ambitions*, PROTOCOL (Oct. 18, 2022), https://www.protocol.com/newsletters/entertainment/meta-horizon-worlds-quest-pro.

[92] *See id.*

violent crimes, it is plausible to suggest that these unregulated crimes could play a more critical role in the future.

Many tech, media, and telecom ("TMT") executives are unsure whether to further invest in the metaverse— or invest at all if they have not yet.[93] They acknowledge its potential, but the majority is still hesitant about making huge investments into something that shows a "lack of proven success."[94] On the surface, the metaverse must address its "lack of technology to support experiences, high cost of development, and dearth of appropriate employee skills."[95] With continued progression, virtual crimes and regulation may become another alarming concern that piles on to these investors because of its possible effect on the metaverse's user base.

IV. RECOMMENDATION

Active measures to protect users and their avatars should be implemented to maintain a crime-free environment; otherwise, people will lose trust in the metaverse, resulting in its downfall.[96]

Current legislature does not sufficiently protect users and their avatars from violent crimes in the virtual world, although there is potential for change in the future.[97] As of now, tech companies must focus on methods of both prevention and punishment to deter acts of violence in the metaverse. Meta has already responded by introducing a "safe-boundary" function which prevents avatars from intruding within four feet of other avatars.[98] However, such a function would stifle innovation and limit the immersive element of the metaverse. Users should have the right to feel safe in their virtual space without the use of such a function. It would also be open to mischievous abuse by users, and circumstances may vary for its intended application.[99] Consider a scenario where multiple avatars stand in front of a busy doorway and then activate the safeguard. The avatars then become a material obstacle that prevents other avatars from entering or leaving the area. Here, the safeguard function is used to disrupt the metaverse experience, not protect it.

Developers should strengthen the avatar-user relationship, thereby implicating the existence of its legal persona. Granting avatars personhood would ensure that users are held accountable for their actions in virtual worlds, promoting

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[93] *See* Sheila Chiang, *Metaverse Could Drive up Profits – But Most Businesses May Not Be Ready to Invest Yet*, CNBC (Apr. 2, 2023, 9:55 PM), https://www.cnbc.com/2023/04/03/companies-say-metaverse-can-up-profits-but-are-cautious-to-invest-kpmg.html.

[94] *Id.*

[95] *Id.*

[96] *See* Cheong, *supra* note 9, at 492–493.

[97] *See* Eberhart, *supra* note 46.

[98] *Crime in the Metaverse,* MAZER (Sept. 7, 2022), https://mazerspace.com/crime-in-the-metaverse.

[99] *See id.*

responsible behavior and preventing harmful activities.[100] Currently, many platforms offer the option to create multiple avatars.[101] If tech companies envision a metaverse reflecting the real world, they should consider restricting the number of accounts to one per user. Avatars, like real human individuals, should have unique identification codes connecting that avatar to the user. Without necessarily restricting the customization of the avatar's appearance, the single avatar becomes a true representation of the user. Despite its possible implications on privacy law,[102] this would also help address the issue of anonymity.

Tech companies should then consider creating their own sophisticated "virtual law enforcement" system. This does not mean using avatar policemen to chase down virtual criminals. When users are rightfully reported for committing a violent crime, their conduct should be thoroughly reviewed by a real person enforcing the system. Because the metaverse is entirely digitalized, obtaining monitoring data showing footage or records of the conduct would not be too difficult.[103] When it is determined that an avatar has committed a crime, the user may be banned from entering the metaverse or serve a temporary "sentence" from accessing it. Interpol has already established its own "metaverse division" to experiment and find appropriate investigative methods for policing virtual worlds.[104] The organization has already partnered with the World Economic Forum in an initiative to regulate the metaverse;[105] developers may also find value in partnering with major law enforcement or government agencies. Such partnerships allow these agencies to gather and share industry knowledge on metaverse crimes, helping both parties create a safer, well-regulated environment.

V. CONCLUSION

It may take years, or even decades, for the metaverse to establish its presence. Despite its ongoing development, early-stage metaverse platforms have already shown us that users are threatened by virtual violent crimes. Developers may be at risk of losing their user base, and their investors may become wary and cautious of supporting future projects due to a decline in confidence. Considering the

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[100] *See* Cheong, *supra* note 9, at 470.

[101] *See* Takahashi, *supra* note 84.

[102] *See generally* Mallory Acheson & Jason I. Epstein, *Why the Metaverse Is Tricky for Data Collection and Discovery*, BLOOMBERG L. (Nov. 10, 2022, 3:00 AM), https://www.bloomberglaw.com/bloomberglawnews/us-law-week/X76MDDLK000000?bna_news_filter=us-law-week#jcite.

[103] *See id.*

[104] Shawn Ray, *The Metaverse Is Coming – Who Will Police It?*, POLICE1 (Jan. 30, 2023), https://www.police1.com/investigations/articles/the-metaverse-is-coming-who-will-police-it-ttPcF7hT9wrhfvha/

[105] *Id.*

metaverse's financial investments and groundbreaking nature, developers bear the primary responsibility of ensuring a secure and user-friendly environment.

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BRINGING ACCOUNTING STANDARDS INTO THE MODERN ERA: ANALYZING THE FINANCIAL ACCOUNTING STANDARDS BOARD'S PROPOSED DISCLOSURE REQUIREMENTS FOR DIGITAL ASSETS

❖ Note ❖

*Zack Stutler**

I. INTRODUCTION

Technology's growth over the past decade has permeated all aspects of life.[1] Financial markets have not been isolated from this increasing digitization.[2] More specifically, the introduction of digital assets (crypto-currency, non-fungible tokens, etc.) has taken the world by storm.[3] With the introduction of new assets comes the need for new regulations. While consumer regulations are important, so too are regulations on companies and how they report their ownership of digital assets.[4]

Regulations on companies are important because they increase the transparency of companies as well as look out for the interest of investors and the general public.[5] Without government intervention and regulations, corporations

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[1] *See* Jared Hecht, *How Technology Is Driving Change in Almost Every Major Industry*, FORBES (Nov. 30, 2018), https://www.forbes.com/sites/jaredhecht/2018/11/30/how-technology-is-driving-change-in-almost-every-major-industry/.

[2] *See id.*

[3] *See* James Royal, *Cryptocurrency Statistics 2023: Investing in Crypto*, BANKRATE (Jan. 5, 2023), https://www.bankrate.com/investing/cryptocurrency-statistics/.

[4] *See* FIN. ACCT. STANDARDS BD., PROPOSED ACCOUNTING STANDARDS UPDATE, INTANGIBLES-GOODWILL AND OTHER-CRYPTO ASSETS 17 (2023).

[5] *US GAAP: Generally Accepted Accounting Principles*, CFA INST., https://www.cfainstitute.org/en/advocacy/issues/gaap#sort=%40pubbrowsedate%20descending (last visited Mar. 17, 2023).

would logically operate in profit-maximizing ways that are self-serving.[6] This self-serving nature often lacks an eye for public interest and may promote a lack of disclosure which is not optimal for investors.[7] With this in mind, regulators implement regulations that ensure companies operate in ways that may be in the best interest of the company, but also meet the standards required to ensure investor and general public safety.[8]

Because of the novelty of digital assets, the current regulation on how companies report their ownership of digital assets is underdeveloped.[9] On May 11, 2022, the Financial Accounting Standards Board decided it would add a project to its agenda to research and improve reporting standards for digital assets.[10] Part II of this Note discusses the background of that project and crypto assets, the short history of regulation surrounding the disclosure of digital assets, and the proposed standard changes. Part III analyzes the differences between the proposed standards and the current standards and the benefits of the proposed standards. Part IV of this Note recommends that companies should be required to release an update on their digital asset holdings on a monthly, as opposed to quarterly, basis and disclose the purchase or sale of crypto assets within a specified time frame of the purchase or sale to enhance transparency and information available to investors.

II. BACKGROUND

In May 2022 the Financial Accounting Standards Board (FASB) added a project to its agenda regarding the reporting and disclosure of crypto assets by companies that follow Generally Accepted Accounting Principles (GAAP).[11] The background on FASB and GAAP, a short background on crypto assets, the history of accounting for digital assets, and the proposed standard are discussed in this section.

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[6] *See* MARTIN BRUECKNER, ENCYCLOPEDIA OF CORPORATE SOCIAL RESPONSIBILITY 1921-1927 (Nicholas Capaldi et al. eds., 2013).

[7] *See* Daniel Taylor, *The Lemons Problem: How Less Disclosure Affects Risk Perceptions*, KNOWLEDGE AT WHARTON (June 23, 2015), https://knowledge.wharton.upenn.edu/article/the-lemons-problem-how-less-disclosure-affects-perceptions-of-risk-2/.

[8] CFA INST., *supra* note 5.

[9] Nicola M White, *Tesla's Bitcoin Dump Leaves Accounting Mystery in Its Wake*, BLOOMBERG (July 22, 2022, 12:47 PM), https://www.bloomberg.com/news/articles/2022-07-22/tesla-s-bitcoin-dump-leaves-accounting-mystery-in-its-wake.

[10] FIN. ACCT. STANDARDS BD., ACCOUNTING FOR AND DISCLOSURE OF CRYPTO ASSETS TENTATIVE BOARD DECISIONS TO DATE AS OF FEBRUARY 1, 2023 (2023).

[11] *Id.*

A. What Is FASB and GAAP and how does FASB Operate?

FASB is an independent organization dedicated to establishing financial reporting standards for companies.[12] While it is not a government run organization, the U.S. Securities and Exchange Commission (SEC) has given FASB authority to set accounting standards for public companies.[13] GAAP "are a collection of commonly-followed accounting rules and standards for financial reporting."[14] GAAP are the standards that the FASB has established and the SEC have adopted for publicly traded companies.[15] "The purpose of GAAP is to ensure that financial reporting is transparent and consistent from one organization to another."[16]

FASB has a step based standard setting process.[17] Issues that the board needs to research are brought to the attention of the board.[18] The board then researches the issue and presents a draft of a regulation for public comment.[19] After receiving feedback, the board makes any necessary changes and then publishes the proposed regulation.[20] Much of this analysis is done through a cost-benefit lens to ensure that the burden of the proposed standard on companies is not higher than the benefits the public and investors receive.[21]

On March 23, 2023, FASB published an Exposure Draft with the proposed update to the standards for accounting for Crypto Assets.[22] Comments on the proposal are due to the board by June 6, 2023.[23]

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[12] *About the FASB*, FIN. ACCT. STANDARDS BD., https://www.fasb.org/facts/ (last visited Mar. 17, 2023).

[13] *Id.*

[14] CFA INST., *supra* note 5.

[15] *Id.*

[16] *Id.*

[17] *Standard-Setting Process*, FIN. ACCT. STANDARDS BD., https://www.fasb.org/Page/PageContent?PageId=/about-us/standardsettingprocess.html&isstaticpage=true&bcpath=tff (last visited Mar. 17, 2023).

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Cost-Benefit Analysis*, FIN. ACCT. STANDARDS BD., https://www.fasb.org/Page/PageContent?PageId=/about-us/standardsettingprocess/cba.html&bcpath=tff (last visited Mar. 17, 2023).

[22] FIN. ACCT. STANDARDS BD., *supra* note 4.

[23] *Id.*

B. Crypto Assets

Digital, or crypto, assets are a "digital representation of value or rights which may be transferred and stored electronically."[24] Crypto assets come in different forms, one of which is cryptocurrency such as Bitcoin or Ether.[25] Crypto assets can be used to purchase goods or services, or alternatively they can be purchased as an investment.[26] These assets have become extremely popular,[27] but are highly volatile and risky.[28] Given their high risk, regulators want to increase regulations for investor safety.[29]

C. Previous Disclosure Standards for Digital Assets

Cryptocurrency and digital assets have been around for just over a decade, did not become mainstream until about five years ago.[30] Because of this, there has been relatively little work to determine the appropriate standards for companies to disclose their ownership of digital assets.[31] Up until this point, companies have reported cryptocurrencies and other digital assets as indefinite-lived intangible assets.[32] Indefinite-lived intangible assets are assets that will generate income for a company over an indefinite period and are not tangible, such as a company's brand name or customer relationships.[33] While there is no specific guidance on how to account for digital assets, most of them were put into the category of indefinite-lived intangible assets because they have the major properties of other indefinite-lived

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[24] *Blockchain and Crypto Assets*, EUR. INS. AND OCCUPATIONAL PENSIONS AUTH., https://www.eiopa.europa.eu/browse/digitalisation-and-financial-innovation/blockchain-and-crypto-assets_en (last visited Apr. 14, 2023).

[25] *Types of Crypto Assets*, CANADIAN SEC. ADM'RS, https://www.securities-administrators.ca/investor-tools/crypto-assets/types-of-crypto-assets/ (last visited Apr. 14, 2023).

[26] *See, e.g.*, Andy Rosen, *What Is Cryptocurrency? A Guide for Beginners*, NERDWALLET, https://www.nerdwallet.com/article/investing/cryptocurrency (Mar. 28, 2023).

[27] *See* Royal, *supra* note 3.

[28] *See* Nicole Lapin, *Explaining Crypto's Volatility*, FORBES (Dec. 23, 2021, 6:00 AM), https://www.forbes.com/sites/nicolelapin/2021/12/23/explaining-cryptos-volatility/?sh=2f14d4847b54.

[29] *See* Aditya Narain & Marina Moretti, *Regulating Crypto*, INT'L MONETARY FUND (Sept. 2022), https://www.imf.org/en/Publications/fandd/issues/2022/09/Regulating-crypto-Narain-Moretti.

[30] Evan Jones, *A Brief History of Cryptocurrency*, CRYPTOVANTAGE (Jan. 12, 2023), https://www.cryptovantage.com/guides/a-brief-history-of-cryptocurrency/.

[31] *Executive Summary: Accounting for Crypto Assets*, KPMG, https://frv.kpmg.us/reference-library/2022/crypto-asset-executive-summary.html (last visited Mar. 17, 2023).

[32] *Id.*

[33] Will Kenton, *What are Intangible Assets? Examples and How to Value*, INVESTOPEDIA (Mar. 20, 2022), https://www.investopedia.com/terms/i/intangibleasset.asp.

intangible assets, primarily that they have an indefinite useful life and meet the definition of an intangible asset.[34] Without guidance, companies simply took the most logical path and waited for FASB to provide guidance on a proper way to report these assets.

Under the current practice, and in accordance with indefinite-lived intangible asset standards, crypto assets are reported at their purchase costs.[35] If the value of the assets increases, companies are not allowed to increase the value they report in subsequent periods.[36] Instead, the companies will test the asset annually for what is called impairment.[37] Impairment is simply a permanent reduction in the value of the asset.[38] If the company determines that it is more likely than not that the asset has been impaired, then they will examine the fair value of the asset, compare that value to the value being currently reported by the company, and then the value of the asset will take whichever is lower between the current reported value and fair value.[39]

D. Proposed Disclosure Standard

The proposed standard has four main changes related to accounting for crypto assets.[40] First, companies owning crypto assets will have to record them at fair value and report changes in value during each reporting period.[41] Second, these companies will have to report their "crypto assets measured at fair value separately from other intangible assets."[42] Third, the change in value of these assets will also be reported separately from other assets.[43] Finally, companies will have to report "[t]he name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually significant."[44]

The proposed standard would only apply to companies that purchased crypto assets and carry them on their balance sheet.[45] More companies are beginning to

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[34] KPMG, *supra* note 31.

[35] *Technical Line Accounting for Digital Assets, Including Crypto Assets*, ERNST & YOUNG (June 30, 2022), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/assurance/accountinglink/ey-tl16494-221us-06-30-2022.pdf.

[36] FIN. ACCT. STANDARDS BD., *supra* note 4, at 3.

[37] ERNST & YOUNG, *supra* note 35.

[38] Alicia Tuovila, *What Does Impairment Mean in Accounting? With Examples*, INVESTOPEDIA, https://www.investopedia.com/terms/i/impairment.asp (Aug. 24, 2022).

[39] ERNST & YOUNG, *supra* note 35.

[40] FIN. ACCT. STANDARDS BD., *supra* note 4, at 2.

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.* at 1.

purchase crypto assets and some companies, such as Tesla, already own a significant amount of crypto.[46] This standard would not apply originators or platforms that create crypto assets.[47]

This standard is still subject to change with the comment period and the publication of the final standard,[48] but these four requirements are the main basis of the standard and present a major change from the previous practices.

III. ANALYSIS

The proposed standard provided by the Exposure Draft is a significant change from the earlier standard because it provides a standard specifically for crypto assets.[49] This section will distinguish the proposed standard from the current standard, look at the benefits of the proposed standard, and discuss how the proposed standard furthers the goals of FASB and GAAP.

A. Comparing the Current and Proposed Standards

Each of the four notable changes discussed in the background section is a significant change from the current standard that better fits the nature of crypto assets.[50] The four major differences between the current standard and the proposed standard are that under the new standard, companies are required to measure crypto assets at fair value, present their total value of crypto assets independently of other assets, present the gains and losses on those assets independently, and disclose the specific crypto assets they own a significant amount of.[51]

1. Fair Value Measurement Standard

Under the proposed standard, companies would be required to report their crypto holdings at fair value.[52] This may seem like the logical thing to do, but it is not the current practice for companies following traditional reporting standards for indefinite-lived intangible assets as described in the Background section.[53]

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[46] *See* Benzinga, *10 Public Companies with Largest Bitcoin Holdings in 2023*, MKT. INSIDER (Mar. 6, 2023, 8:33 AM), https://markets.businessinsider.com/news/stocks/10-public-companies-with-largest-bitcoin-holdings-in-2023-1032147256.

[47] FIN. ACCT. STANDARDS BD., *supra* note 4, at 20.

[48] *See* FIN. ACCT. STANDARDS BD., *supra* note 17.

[49] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 7-16.

[50] *Id.* at 3.

[51] *Id.* at 2.

[52] *Id.*

[53] *See supra* Section II.C.

This is an important change because the current standard does not make sense when accounting for crypto assets given their nature. Traditional indefinite-lived assets are things such as land and trade names.[54] While these items may change in value over time, they are less volatile than many financial assets.[55] Crypto assets differ significantly in this aspect.[56] Cryptocurrency is highly volatile, and prices fluctuate significantly over short time periods.[57] The current standards lead to a distortion between the value reported by companies and the fair value of the crypto assets that companies own because companies are not able to increase the carrying value they report for the asset.[58] By switching to the proposed standard, companies would be required to report a more accurate value of assets that the company owns.[59] Because of this, the proposed standard of reporting crypto assets at fair value each reporting period makes much more sense given the nature of crypto assets.

2. Presenting Total Crypto Ownership Independently

The proposed standard would require companies to disclose their total ownership of crypto assets as a separate value from other intangible assets.[60] Currently, companies can report their ownership of crypto assets under indefinite-lived intangible assets without specifically listing the amount that is attributable to crypto assets.[61] While some companies that do own digital assets currently list the amount of digital assets owned, they are not forced to and can include the value with other items if they so choose.[62] Mandating the individual reporting is important to make clear how much of the company is exposed to the volatility of crypto and other digital assets.[63]

3. Independent Gains and Losses

The third difference is that companies will have to report their gains and losses on digital assets separately from gains and losses in other areas.[64] Currently,

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[54] *See, e.g.*, Kenton, *supra* note 33.

[55] *See* Sean Ross, *Has Real Estate or the Stock Market Performed Better Historically?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/052015/which-has-performed-better-historically-stock-market-or-real-estate.asp (Jul. 27, 2022).

[56] *See* Lapin, *supra* note 28.

[57] *Id.*

[58] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 3.

[59] *See id.* at 1.

[60] *See id.* at 26.

[61] *Id.*

[62] White, *supra* note 9.

[63] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 26.

[64] *Id.* at 2.

companies will have impairment losses on digital assets if the value of the assets decreases, but the impairment does not have to explicitly state that it is due to a decrease in digital asset value.[65] Companies can report a single value for impairment that represents impairments for all indefinite-lived intangible assets the company owns.[66] The proposed standard would enhance the transparency and clarity for investors to see specifically where gains and losses are coming from.[67] Since the crypto assets change value more often and more drastically,[68] it makes sense for companies to have to disclose the gains and losses of these assets separately.

4. Disclosure of Specific Crypto Assets

The fourth and final major difference is that companies will have to list the name, amount, cost, and value of specific crypto assets that they own significant amounts of and will have to list the "aggregate fair values and cost bases of the crypto asset holdings that are not individually significant."[69] As with the second change, companies do not have to individually report their owning of crypto assets, let alone the specific assets that they are holding.[70] This change increases transparency for investors and allows investors to better know the financial situation of the company.[71] These four changes have important benefits over the current reporting standard.

B. Benefits of the Proposed Standard

Going through the four major differences in the change of standards, by requiring companies to disclose their ownership of digital assets at fair value, the value that companies will disclose will be a more accurate representation of the value of digital assets that companies own.[72] The current standard presents an issue for two reasons.

First, under the current standard, any increase in the value of the assets would not be disclosed and would thus understate the true value of assets owned by a company.[73] This understatement may hurt a company by making the company's returns and financial situation look worse than it truly is because it displays a crypto

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[65] White, *supra* note 9.

[66] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 26.

[67] *See id.* at 26-27.

[68] *See* Ross, *supra* note 55.

[69] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 2.

[70] *Id.* at 26.

[71] *Id.* at 1.

[72] *See id.* at 2.

[73] *See id.* at 3.

asset value lower than the fair value of the crypto assets.[74] The worse a company's financial position looks, the more it discourages investors from investing in the company.[75] This issue will also affect a company's ability to access credit because banks analyze a company's financial position before giving out loans or lines of credit.[76]

Second, when the value of the held crypto assets is above the amount reported, investors could be surprised if the value of the asset decreases significantly over a short amount of time. Since the value that investors see is less than the fair value,[77] the company is more exposed to changes in the price of the digital assets than investors expect. Further, with how volatile cryptocurrency is,[78] it is important for investors to know the full extent of exposure that the company has to digital asset volatility because investors should know how risky their investment is. The proposed standard removes this issue and allows investors to better know where the company stands with regards to the value of digital assets it owns.[79]

The second element of the proposed standard also improves investor transparency and better represents the financial situation of the company. Since companies do not have to report their ownership of digital assets separately from other intangible assets under the current standard,[80] it creates a similar issue as discussed above. If companies opt to disclose their digital assets combined with other indefinite-lived intangible assets instead of a separate line for digital assets, investors get a distorted view of the company.[81] Given how volatile crypto assets are,[82] when crypto assets are not disclosed separately from other indefinite-lived intangible assets investors may not know that the company has a large amount of its indefinite-lived intangible assets that are highly volatile. By making companies separate the digital assets from the rest of the indefinite-lived intangible assets, it allows investors to know the true risk portfolio of a company's assets.

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[74] *See, e.g.*, Chris Hamilton, *What Does Understatement Mean in Accounting*, CHRON, https://smallbusiness.chron.com/understatement-mean-accounting-33138.html (last visited Apr. 13, 2023).

[75] *See, e.g.*, Miranda Marquit, *Stock Picking: 7 Things You Must Know About a Company*, U.S. NEWS (Feb. 22, 2013), https://money.usnews.com/money/blogs/the-smarter-mutual-fund-investor/2013/02/22/stock-picking-7-things-you-must-know-about-a-company.

[76] *See, e.g.*, *Do Banks Look at a Company's Balance Sheet or Income Statement When Extending Credit?*, CHRON, https://smallbusiness.chron.com/financial-projections-investors-look-business-plan-60908.html (Sept. 15, 2020).

[77] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 3.

[78] Lapin, *supra* note 28.

[79] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 1.

[80] *Id.* at 26.

[81] *See id.*

[82] Lapin, *supra* note 28.

This argument also supports the third element of the proposed standard, making companies disclose their earnings and losses from digital assets separately from the rest of the indefinite-lived intangible assts.[83] Under the current standard, investors may not know which assets are the reason for impairments when a company reports impairment losses.[84] By requiring separate disclosures for gains and losses from the digital assets,[85] it allows investors to know if digital assets or other less volatile assets are the reason for losses. Under the proposed standards, investors can better understand where the losses and gains of a company are coming from[86] and make investment decisions better suited to their personal preferences.

The fourth element of the proposed standard mandates a more detailed disclosure than simply the amount of crypto assets the company owns.[87] This requirement works with the other requirements to further enhance transparency and allows investors to know specifically what crypto assets the company owns.[88]

All four elements of the proposed standard work in furtherance of the goals of GAAP. The main elements of the proposed standard all are aimed at increasing standardization in an area that currently lacks specific guidance.[89] FASB is taking away the choice companies currently have on how to present their holdings of crypto assets and has created this proposal to have a standardized reporting structure that allows for easier comparison between companies and increases transparency for investors and outsiders analyzing a company's financial situation.[90]

IV. RECOMMENDATION

FASB implementing the proposed standard is more than just a logical development. The proposed standard better fits the nature of digital assets, improves standardization, and increases transparency for investors regarding the business operations of a company while better representing a company's financial position.[91]

When establishing reporting standards, establishing transparency between a business and its investors as well as the general public should be a major goal.[92] This proposed standard achieves this goal. The proposed standard is an excellent starting point towards enhancing disclosure transparency in an area that has not had

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[83] FIN. ACCT. STANDARDS BD., *supra* note 4, at 2.

[84] *See id.* at 5.

[85] *Id.* at 2.

[86] *See id.* at 1.

[87] *Id.* at 2.

[88] *See id.* at 1-3.

[89] *Id.* at 1.

[90] *See id.* at 1-3.

[91] *See id.*

[92] *See Our Goals*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/our-goals (last visited Apr. 14, 2023).

specifically tailored regulations on reporting.[93] The proposed standards allow investors to generally understand the full scope of a company's investment into digital assets.[94] By understanding the true nature of a company's assets, investors have a better understanding of the risk and financial situation of the company they are investing in.[95]

While these proposed standards are a good start, there is room for improvement. The first area that could use improvement is an increase in the frequency that companies report their gains and losses on crypto assets. Publicly traded companies are required to report four times each year,[96] once at the end of each of their first three fiscal quarters,[97] and then a larger report at the end of their fiscal year.[98] While this frequency may be adequate for informing investors on most information, the frequency does not seem adequate when there are large values of assets that are highly volatile.

Cryptocurrencies are highly volatile and subject to significant losses over short periods.[99] For example, in June 2022, Bitcoin fell 37%.[100] This significant of a decrease can have effects on the solvency of a business and the frequency of volatility supports companies having to report their gains and losses on digital assets more often that the current requirement of four times a year. A requirement to report gains and losses on a monthly basis could mitigate this issue without overburdening the companies that own crypto assets. While there may be significant value changes over the course of a month, since the proposed regulation requires companies to disclose specifically which crypto assets and how much of those crypto assets the company owns,[101] individuals would be able to track the value of the crypto assets that the company owns. Increasing the requirement to be every two weeks or every week may become too much of a burden on the companies while keeping the requirement the same as it is and requiring quarterly disclosures may overburden investors that want to follow the value of a company's crypto assets. Thus, a monthly disclosure requirement balances this burden and aligns with the cost-benefit lens that FASB uses when determining new requirements.[102]

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[93] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 1.

[94] *See id.*

[95] *See* Jason Fernando, *Balance Sheet: Explanation, Components, and Exmaples*, INVESTOPEDIA, https://www.investopedia.com/terms/b/balancesheet.asp (July 5, 2022).

[96] 17 C.F.R. § 240.13a-13 (2022).

[97] *Id.*

[98] *Id.* at § 240.13a-1 (2023).

[99] Lapin, *supra* note 28.

[100] *See, e.g.*, Jimmy He, *Brutal Month for Bitcoin as June Ends with Biggest Drop in 11 Years*, COINDESK (July 1, 2022, 11:56 AM), https://www.coindesk.com/markets/2022/07/01/brutal-month-for-bitcoin-as-june-ends-with-biggest-drop-in-11-years/.

[101] *See* FIN. ACCT. STANDARDS BD., *supra* note 4, at 2.

[102] *See* FIN. ACCT. STANDARDS BD., *supra* note 21.

Another potential improvement is to require companies to disclose the purchase or sale of a significant value of crypto assets within, for example, a week of when the purchase or sale occurs. Because companies are only required to make quarterly reports,[103] the purchase and sale of crypto assets in between these periods may not be disclosed to investors until the end of the quarter. During the three months between disclosures, companies may purchase or sell significant sums of crypto assets.

If investors are unaware of these significant changes within a short time of them occurring, the investors may invest in the company without the knowledge that the company is more heavily invested in crypto assets than their most recent disclosure suggests. Because the company may be more heavily invested in crypto than the investor knows and these assets are highly volatile,[104] the investor may be taking a larger risk than they wanted to or knew they were taking.

To prevent the requirement from being unreasonable and requiring companies to report every purchase they make, the requirement could be limited to certain circumstances. A circumstance that would require reporting could be when the company is purchasing crypto assets and does not currently own any. This informs investors that the company is beginning to invest in crypto assets. Another important circumstance could be for purchases or sales that are more than 10% of the currently owned amount. This informs investors that the company is significantly increasing or decreasing its crypto holdings. These limitations prevent overburdening companies with reporting requirements while allowing investors to know when the companies are making significant changes to their crypto holding practices.

V. CONCLUSION

As technology continues to evolve and influence businesses, new regulations are important for continuing to protect investors and ensure transparency in company reporting.[105] The implementation of the proposed standard is important because the proposed standard was specifically tailored to fit the nature of crypto assets.[106] Thus, the proposed standard can better align required practices with the goals of GAAP and FASB. The proposed standard for digital asset reporting is a strong step in standardizing effective reporting and increasing transparency. But, based on how the proposed standards work in the coming years, additional changes, such as increasing the frequency of crypto asset reporting and requiring disclosures of significant crypto asset purchases or sales when they occur, may further increase transparency and benefit investors and outsiders in the long run.

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[103] 17 C.F.R. § 240.13a-13 (2022).

[104] Lapin, *supra* note 28.

[105] *See* U.S. SEC. AND EXCH. COMM'N, *supra* note 92.

[106] *See* FIN. ACCT. STANDARDS BD., *supra* note 4.

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TELEMENTAL HEALTH TAKES CENTER STAGE: HOW PANDEMIC-ERA WAIVERS OPENED THE DOOR TO BETTER MENTAL HEALTH CARE

❖ Note ❖

*Jabari Turner**

I. INTRODUCTION

Millions of Americans were stuck in their houses during the COVID-19 pandemic.[1] The rising death tolls, financial insecurity, and growing uncertainty increased anxiety, depression, and a surge in emergency department visits for mental health conditions.[2] Federal and state-level licensing alongside permit waivers allowed many Americans needing mental health care, access to telemental health services.[3] As a result, Americans had more options in and out-of-state that were unavailable before the pandemic.[4] During the pandemic, federal agencies waived previous telehealth restrictions.[5] Moreover, in most states, through executive orders, out-of-

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[1] *See* Joseph Guzman, *90 Percent of Americans Now Staying Home to Prevent Coronavirus Spread*, HILL (Mar. 27, 2020), https://thehill.com/changing-america/well-being/prevention-cures/489813-majority-of-americans-staying-home-as-much-as/.

[2] *See infra* Part III.

[3] *See* Rachel B. Goodman & Thomas B. Ferrente, *COVID-19: States Waive In-State Licensing Requirements for Health Care Providers*, FOLEY & LARDNER LLP (Mar. 17, 2020), https://www.foley.com/en/insights/publications/2020/03/covid-19-states-waive-licensing-requirements.

[4] *See id.*

[5] *See id.*

state mental health providers in good standing were permitted to provide telemental services to patients.[6]

Telehealth gives patients and providers better access, options, and overall healthcare treatment and management without needing to be physically present.[7] In addition, it gives providers more continuity of care, and better overall healthcare management of their patients.[8]

Telemental health shares these goals.[9] After the pandemic, some states and federal agencies made permanent telehealth changes.[10] Currently, Medicare has no geographic restrictions for behavioral and mental health telehealth services.[11] Additionally, in 2022, Delaware signed legislation enabling out-of-state practitioners to provide service to Delaware residents so long as they are in good standing in all practicing jurisdictions.[12] However, many states suspended or let pandemic-era waivers expire without implementing new legislation, particularly for telemental health care.[13] As a result, the current state of telehealth, particularly telemental health, is a regression to pre-pandemic policies. Pre-pandemic telemental health policies operate in contrast to the goals of telehealth and ignore the ongoing demand for

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[6] *See U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19*, FSMB, https://www.fsmb.org/siteassets/advocacy/pdf/states-waiving-licensure-requirements-for-telehealth-in-response-to-covid-19.pdf (last visited Mar. 23, 2023) (state orders generally used "good standing" to refer to a practitioner not facing any "disciplinary or adverse action").

[7] *See* Josh Sherman*, Notes: Double Secret Protection: Bridging Federal and State Law to Protect Privacy Rights for Telemental and Mobile Health Users*, 67 DUKE L.J. 1115, 1116 (2018).

[8] *See* Sherman, *supra* note 6; *see also* David Pratt, *Telehealth and Telemedicine in 2015*, 25 ALB. L.J. SCI. & TECH. 495, 508 (2015).

[9] *See* Sherman, *supra* note 6.

[10] *See* Brian Joseph, *States Making Pandemic Telehealth Policy Changes Permanent*, LEXISNEXIS (Mar. 4, 2022), https://www.lexisnexis.com/community/insights/legal/capitol-journal/b/state-net/posts/states-making-pandemic-telehealth-policy-changes-permanent

[11] *Telehealth Policy Changes After the COVID-19 Public Health Emergency*, HRSA (Mar. 22, 2023, 2:40 PM), https://telehealth.hhs.gov/providers/policy-changes-during-the-covid-19-public-health-emergency/policy-changes-after-the-covid-19-public-health-emergency#:~:text=Permanent%20Medicare%20changes,-Federally%20Qualified%20Health&text=There%20are%20no%20geographic%20restrictions,accepted%20as%20an%20originating%20site.

[12] *See* DEL. LAWS, c. 484 (2022).

[13] *See* Joseph, *supra* note 9; *see also* Rebecca Pifer, *As Cross-State Telemedicine Waivers Expire, Virtual Care Advocates Focus on Long-Term Policy Changes*, HEALTHCAREDIVE (June 21, 2022), https://www.healthcaredive.com/news/cross-state-telemedicine-waivers-expire-virtual-care-advocates-focus/625389/.

telemental health care. Furthermore, such policies restrict patients' options in choosing the optimum mental health care.[14]

To this end, Part II of this Note will explain telehealth, telemental health, and federal and state waivers. Part III will discuss the federal and state waivers that affected telemental health during the pandemic and its impact. This article then argues in Part IV that states should (1) temporarily extend or re-issue waivers until state legislatures have permanent solutions regarding telemental health and (2) adopt cross-state telemental licensure reform, allowing patients to have the optimum options, access, and care for their needs. Part V will conclude.

II. BACKGROUND

A. What Does "Telehealth" Mean Today?

Frequently, telehealth interchanges with "telemedicine," "mobile health" (mHealth), "electronic health" (eHealth), and "virtual care."[15] For clarity, telehealth is an umbrella term for using telecommunications and technologies for healthcare services in clinical and non-clinical settings.[16] Telehealth then has subsets that narrow certain aspects of the service. MHealth and eHealth are examples of telehealth services used in clinical and non-clinical capacities. Mhealth is the use of mobile devices in providing health services.[17] EHealth refers to using "web-enabled systems and processes" for healthcare services such as electronic medical records.[18]

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[14] Justin Lo et al., *Telehealth Has Played an Outsized Role Meeting Mental Health Needs During the COVID-19 Pandemic,* KAISER FAM. FOUND. (Mar. 15, 2022), https://www.kff.org/coronavirus-covid-19/issue-brief/telehealth-has-played-an-outsized-role-meeting-mental-health-needs-during-the-covid-19-pandemic/ (telemental health has given more access for patients in seeking care).

[15] *See What Is the Difference Between Mhealth, Ehealth, Telehealth, and Telemedicine*, SBMA, https://www.sbmabenefits.com/what-is-the-difference-between-mhealth-ehealth-telehealth-and-telemedicine/ (last visited Mar. 20, 2023).

[16] *See Telehealth*, NIH, https://www.nibib.nih.gov/science-education/science-topics/telehealth (last visited Mar. 20, 2023); *see also Frequently Asked Questions*, HEALTHIT.GOV, https://www.healthit.gov/faq/what-telehealth-how-telehealth-different-telemedicine#:~:text=While%20telemedicine%20refers%20specifically%20to,in%20addition%20to%20clinical%20services (last visited Mar. 20, 2023).

[17] *See* Robert S. H Istepanian, *Mobile Health (m-Health) in Retrospect: The Known Unknowns*, 19 INT. J. ENVIRON. RES. PUB. HEALTH (2022).

[18] Maria Helena da Fonseca et al., *E-Health Practices and Technologies: A Systematic Review from 2014 to 2019,* 9 HEALTHCARE (BASEL) (2021).

Clinical telehealth services and telemedicine are the same. Telemedicine refers to using telecommunications for health care solely in a clinical capacity.[19] Virtual care is a sub-subcategory of telemedicine that involves the clinical use of technology for patients and healthcare provider interactions.[20] Non-clinical telehealth services include "provider training, administrative meetings, and continuing medical education."[21] Non-clinical positions, like many jobs during the pandemic, also worked remotely, taking on a telehealth role.[22]

B. What Is "Telemental Health"?

Telemental health is a subcategory of telehealth that narrows its focus to mental health services. For clarity, telemental health is the umbrella term of using telecommunications and technologies for mental health services in clinical and non-clinical capacity.[23] Most notably, "telepsychiatry" and "teletherapy" are examples of telemental clinical services.[24] The American Psychiatric Association defines "telepsychiatry" as "providing a range of services including psychiatric evaluations, therapy . . . patient education, and medication management."[25] Teletherapy can be categorized as virtual care or a subset under telemental health services.[26] The practice

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[19] *See Frequently Asked Questions*, *supra* note 15; *see also* Sayed E. Wahezi et al., *Telemedicine and Current Clinical Practice Trends in the COVID-19 Pandemic*, 35 BEST PRACT. & RES. CLIN. ANAESTHESIOL (2021).

[20] *See* Cindy (Zhirui) Li et al., *Connecting the World of Healthcare Virtually: A Scoping Review on Virtual Care Delivery,* 9 HEALTHCARE (BASEL) (2021).

[21] *See Frequently Asked Questions*, *supra* note 15.

[22] Heather Gilmartin et al., *Assessing the Impact of Remote Work During COVID-19 on Clinical and Translational Scientists and Staff in Colorado*, 5 J. CLIN. TRANSL. SCI (2021).

[23] *See What Is Telemental Health?*, NIH, https://www.nimh.nih.gov/health/publications/what-is-telemental-health (last visited Mar. 20, 2023); *see also* Donald M. Hilty et al., *The Effectiveness of Telemental Health: A 2013 Review,* 19 TELEMED. J. E. HEALTH (2013).

[24] *See What Is Telepsychiatry?*, APA, https://www.psychiatry.org/patients-families/telepsychiatry (last visited Mar. 20, 2023); *see also* Victoria Clayton, *Telepsychiatry vs. Teletherapy: What's The Difference?*, FORBES (Dec. 6, 2022), https://www.forbes.com/health/mind/telepsychiatry-vs-teletherapy/ ("Teletherapy and telepsychiatry are mental telehealth services that . . . facilitate communication between mental health professionals and their patients.)

[25] *What Is Telepsychiatry?*, *supra* note 23.

[26] Claire Imber, *How the Pandemic Changed HR's Views on Virtual Care*, HEALTH JOY (Apr. 29, 2023, 10:00 PM), https://www.healthjoy.com/blog/benefits/telehealth/pandemic-changed-virtual-care (using teletherapy as a subset of virtual care); Rebecca Appleton et al., *Telemental health: A Public Mental Health Perspective*, BMC HEALTH SERV RES (Jan. 25, 2023) (using teletherapy under the umbrella branch telemental health).

involves counseling through "video, phone calls, or online apps."[27] Finally, like telehealth, telemental health has non-clinical capacities: administrative work, distant learning, and research.[28]

C. What are Federal and State Waivers?

Governmental waivers refer to a governing body agreeing to temporarily relinquish a right or declaring that people do not have to follow a particular rule or law.[29] Commonly, the executive branch, composed of administrative agencies, can issue waivers.[30] Waivers then typically temporarily "modify" or "waive" existing law.[31] Concerning, telemental service, executive orders, and administrative waivers are the most applicable. During the pandemic, state and federal executive orders and administrative agencies issued waivers on different statutes and regulations throughout state and federal law.[32]

Congress allows agencies the authority to issue waivers for statutes and regulations independent of the President.[33] Additionally, the President, as the head of the executive branch, can direct federal agencies to issue waivers. For example, The Stafford Act provides legal authority for the federal government to aid in emergencies.[34] During the pandemic, the President announced an emergency declaration under the Stafford Act.[35] As a result, federal agencies were directed and

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[27] *Telehealth for Behavioral Health Care*, HEALTH RESOURCES & SERV ADMIN, https://telehealth.hhs.gov/providers/best-practice-guides/telehealth-for-behavioral-health/individual-teletherapy (last visited Mar. 20, 2023).

[28] Dines Bhugra et al., *Telemental Health: A Public Mental Health Perspective*, OXFORD TEXTBOOK (Sept. 1, 2018) https://doi.org/10.1093/med/9780198792994.003.0056.

[29] *See Waiver,* COLLINS, https://www.collinsdictionary.com/us/dictionary/english/waiver#:~:text=Word%20forms%3A%20waivers&text=A%20waiver%20is%20when%20a (last visited Mar. 20, 2023).

[30] *See* Joel Aberbach & Mark Peterson, *The Executive Branch (Institutions of American Democracy)* 508 (2005).

[31] *See Coronavirus waivers & flexibilities,* CMS, https://www.cms.gov/coronavirus-waivers (last visited Mar. 20, 2023).

[32] *See id.*

[33] *See* Peter L. Strauss et al., *Gellhorn and Byse's Administrative Law Cases and Comments*, 11th ed. 12 (2011)

[34] *See* Lance Gable, *Evading Emergency: Strengthening Emergency Responses Through Integrated Pluralistic Governance*, 91 OR. L. REV. 375, 396 (2012) ("[T]he Stafford Act authorizes the President to declare an 'emergency' or 'major disaster'. . . . [o]nce one of these declarations has been made, the federal government may provide resources.").

[35] *The Stafford Act Emergency Declaration for COVID-19*, CRS, https://crsreports.congress.gov/product/pdf/IN/IN11251 (2020).

had the authority by the executive order to issue waivers aiding in the emergency.[36] Federal agencies began waiving sections of laws concerning eligible practitioners, prescribed controlled substances, and telehealth requirements.[37]Resulting in temporarily expanded telehealth access.[38]

Generally, state administrative agencies are delegated authority by their respective legislatures.[39] Most states have a general law that allows the state agency to waive or modify regulations.[40] After a declaration or executive order by the state's governor, state administrative agencies can generally "waive" or "modify" state law regulated by their respective agency.[41] For example, in 2020, the "COVID-19 Executive Order No.7," issued by the governor of Illinois expanded telehealth services for residents and protected healthcare providers in response to COVID-19.[42] Illinois's administrative agency, the Illinois Department of Financial and Professional Regulation, then modified regulations to allow out-of-state providers not licensed in Illinois to provide care healthcare to Illinois residents.[43]

III. ANALYSIS

A. Waivers Affecting Telemental Health During the Pandemic

The increase and availability of telemental services during the pandemic were largely due to the combination of stay-at-home orders that confined residents to

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[36] *See COVID-19 Emergency Declaration Blanket Waivers for Health Care Providers*, CMS (Oct. 23, 2022); Press Release, U.S. DEP'T of HEALTH & HUMAN SERV, *OCR Announces Notification of Enforcement Discretion for Telehealth Remote Communications During the COVID-19 Nationwide Public Health Emergency* (Mar. 17, 2020), https://public3.pagefreezer.com/content/HHS.gov/31-12-2020T08:51/https://www.hhs.gov/about/news/2020/03/17/ocr-announces-notification-of-enforcement-discretion-for-telehealth-remote-communications-during-the-covid-19.html; *COVID-19 FAQ*, DEA, https://www.deadiversion.usdoj.gov/faq/coronavirus_faq.htm (last visited Mar. 20, 2023).

[37] *Id.*

[38] CMS News and Media Group, *CMS Waivers, Flexibilities, and the Transition Forward from the COVID-19 Public Health Emergency*, CMS.GOV (Feb. 27, 2023), https://www.cms.gov/newsroom/fact-sheets/cms-waivers-flexibilities-and-transition-forward-covid-19-public-health-emergency.

[39] States typically have some form of an Administrative Procedure Act that gives state administrative agencies power to waive or modify rules and regulations. *See, e.g.*, 5 ILL. COMP. STAT. ANN. 100; CAL. GOV'T CODE § 11340; N.Y. A.P.A LAW § 301.

[40] *Id.*

[41] *Id.*

[42] ILL. EXEC. ORDER NO. 2020-09 (Mar. 19, 2020), https://www2.illinois.gov/Documents/ExecOrders/2020/ExecutiveOrder-2020-09.pdf.

[43] *See U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19*, *supra* note 5.

their homes alongside multiple modifications and waivers of laws and regulations on the federal and state level.[44] On January 30, 2019, the CDC's Health and Human Services Secretary, Alex Azar, declared "the novel coronavirus (2019-nCoV) a public health emergency."[45] At that time, the virus was confirmed to have spread to only two people in the United States.[46] However, by March, the United States had "surpassed all other nations to rank first in numbers of cases."[47] This also coincided with most states issuing mandatory stay-at-home orders.[48] Federal agencies regulate federal laws concerning telemental service such as HIPPA, The Ryan Haight Act of 2008, and HITECH.[49] On the state level, generally, states waived comparable state-level regulations and laws to relieve practitioners of state licensure and permit requirements.[50]

1. Federal Waivers

The federal waivers that had the most impact on telemental service on the federal level were by the U.S. Department of Health and Human Services ("HHS"), the Drug Enforcement Agency ("DEA"), and the Centers for Medicare and Medicaid Services ("CMS").[51]

First, the DEA has powers under The Ryan Haight Act of 2008 to regulate prescribed controlled substances via telemedicine.[52] In response to the pandemic, the

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[44] Julia Shaver, *The State of Telehealth Before and After the COVID-19 Pandemic*, 49 PRIM CARE (2022), https://doi.org/10.1016%2Fj.pop.2022.04.002.

[45] *U.S. Declares Coronavirus a Public Health Emergency, CDC Updates Guidance,* AM. HEALTH ASS'N (Jan. 31, 2020), https://www.aha.org/news/headline/2020-01-31-us-declares-coronavirus-public-health-emergency-cdc-updates-guidance#:~:text=Health%20and%20Human%20Services%20Secretary,be%20quarantined%20for%20two%20weeks.

[46] Press Release, CDC, *CDC Confirms Person-to-Person Spread of New Coronavirus in the United States* (Jan. 30, 2020), https://www.cdc.gov/media/releases/2020/p0130-coronavirus-spread.html#:~:text=The%20Centers%20for%20Disease%20Control,with%20this%20new%20virus%20here.

[47] James M. Schultz, *Pandemic March: 2019 Coronavirus Disease's First Wave Circumnavigates the Globe*, 14 DISASTER MED PUBLIC HEALTH PREP (2020).

[48] *See* Amanda Moreland et al., *Timing of State and Territorial COVID-19 Stay-at-Home Orders and Changes in Population Movement — United States, March 1–May 31, 2020*, 69 MMWR (2020).

[49] *See* Deborah R. Farringer, *A Telehealth Explosion: Using Lessons from the Pandemic to Shape the Future of Telehealth Regulation*, 9 TEX. A&M L. REV. 1, 23 (2021).

[50] *Id.*

[51] *Id.*

[52] *See* Kierin Bernard, *Telemedicine, and The Ryan Haight Act: An Analysis of the Ryan Haight Act's Statutory Purpose, its Inadvertently Negative Impact on the Telemedicine Industry, and the Future of Telemedicine*, 10 WAKE FOREST J.L. & POL'Y S.S. 59, 59; *see also COVID-19 FAQ*, *supra* note 35 (The "DEA is

DEA issued a temporary order waiving the requirement that telemedicine practitioners must be registered in the state the patient resides. [53] As a result, telepsychiatry psychiatrists could now prescribe appropriate medications for patients who were not in the state the psychiatrist resided. [54]

Second, the HHS, specifically The Office for Civil Rights, enforces and regulates The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), and Health Information Technology for Economic and Clinical Health ("HITECH").[55] The Office waived penalties for healthcare providers utilizing "everyday communication technologies that serve patients."[56] As a result, telemental providers could now conduct virtual care or teletherapy through commonly used platforms such as "Apple FaceTime, Facebook Messenger video chat, Google Hangouts video, Zoom, or Skype."[57]

Finally, the CMS is a federal agency tasked with providing healthcare coverage to over 100 million Americans through Medicare, Medicaid, the Children's Health Insurance Program, and the Health Insurance Marketplace.[58] The agency brought about several waivers pertinent to the telemental health services. First, the agency under the authority of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) waived the requirement under law for certain telehealth services requiring video technology.[59] Therefore, under telemental health services, psychologists could "provide many of their typical services by audio-only telephones" to Medicare and Medicaid users.[60] Second, CMS waived the requirement that when an out-of-state practitioner is practicing in another state, they must also be

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permitted to waive practitioners' general registration requirements by regulation when consistent with the public health and safety.").

[53] *See COVID-19 FAQ*, *supra* note 35.

[54] *See* Nancy Rowe & Sara F. Gibson, *Another Pandemic Silver Lining: Rural Patients Benefit from Relaxed Remote Prescribing Rules,* ARIZONA TELEMEDICINE PROGRAM (Dec. 17, 2020) https://telemedicine.arizona.edu/blog/another-pandemic-silver-lining-rural-patients-benefit-relaxed-remote-prescribing-rules.

[55] *See* U.S. DEP'T of HEALTH & HUMAN SERV, *supra* note 35.

[56] *Id.*

[57] *Id.*

[58] *See* Centers for Medicare and Medicaid Services, USA.GOV, https://www.usa.gov/federal-agencies/centers-for-medicare-and-medicaid-services#:~:text=The%20Centers%20for%20Medicare%20and,and%20the%20Health%20Insurance%20Marketplace (last visited Mar. 20, 2023).

[59] *See COVID-19 Emergency Declaration Blanket Waivers for Health Care Providers*, *supra* note 35 (The CMS also waived the requirements "which specify the types of practitioners that may bill for their services when furnished as Medicare telehealth services from the distant site.").

[60] Office of Health Care Financing, *Phone Only Telehealth Services for Medicare During COVID-19*, APA (Jun. 4, 2020), https://www.apaservices.org/practice/clinic/covid-19-telehealth-phone-only.

licensed within that state.[61] Instead, the practitioner had to be (1) an enrolled practitioner in a Medicare program, (2) licensed to practice within the state of their enrollment, (3) conducting services in a state where there is an emergency, (4) and "not affirmatively excluded from practice in the state or any other state that is part of the 1135 emergency area."[62] Notably, the CMS licensing waiver does not affect state and local licensure requirements.[63] However, most states then waived their state and local licensure requirements.[64]

5. State Waivers During the Pandemic

Federal waivers by administrative agencies do not affect each state's regulations and licensing restrictions for practitioners. Therefore, states would also have to waive telemental health restrictions for practitioners to be able to practice. Before the pandemic, telemental health services were partially prevented due to each state's licensing regulations.[65] However, state-level licensure waivers across America occurred during the pandemic. As a result, states began temporarily waiving licensure requirements for out-of-state practitioners conducting telemental health services on in-state residents.[66] By the middle of the pandemic, most states during the pandemic adopted a similar waiver.[67] Generally, the waiver provided that out-of-state practitioners could provide services, such as telemental health services, within the state so long as they have (1) an active license/certification/or registration in another state, (2) and are in good standing in the state they are registered to practice.[68] States

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[61] *See COVID-19 Emergency Declaration Blanket Waivers for Health Care Providers*, *supra* note 35.

[62] *Id.*

[63] *Id.*; Taylor Lodise, *"Let's talk about it": New Jersey Needs to Codify Its Temporarily Relaxed Licensure Requirements For Telemental Health Providers*, 74 RUTGERS U.L. REV. Comments 219, 222.

[64] David Goguen, *States Allow Doctors to Practice Across State Lines During COVID-19 crisis*, THE HOSPITALIST (Apr. 1, 2020), https://www.the-hospitalist.org/hospitalist/article/219995/coronavirus-updates/states-allow-doctors-practice-across-state-lines.

[65] Lisa V. Parciak, *The Future Cannot Come Soon Enough: How Federal Regulation Of Telepsychiatry Is Necessary To Create Greater Access To Mental Health Services During A Time When Psychiatrists Are In Short Supply*, 122 W. VA. L. REV. 477, 488 (2019) (additional barriers to telemental services pre-pandemic were privacy concerns for telepsychiatry and reimbursement policies under private and public health insurers).

[66] *See* Goodman, *supra* note 3; *see also* Lodise, *supra* note 62.

[67] *See* Lodise, *supra* note 62.

[68] *See Id.; U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19*, *supra* note 5.

then made alterations to these requirements. For example, states such as Maine, Virginia, and Utah placed time requirements on the status of the license.[69]

B. Telemental Services Impact During the Pandemic

The need for telemental services existed before the pandemic but was exacerbated when the pandemic ensued.[70] Before the pandemic, rural areas lacked overall access to healthcare, including mental health services.[71] However, during the pandemic, the relaxed licensing, and regulations of telemental services allowed rural residents to utilize the services the most. A study showed that 55% of rural patients utilized telemental services compared to 35% in urban areas. [72]

Moreover, studies showed depressive symptoms tripled largely due to pandemic-induced factors such as "lower social resources, lower economic resources, and greater exposure to stressors" such as job loss.[73] Studies also showed telemental services "for common mental health problems surged 16 to 20-fold during the first year of the COVID-19 pandemic."[74] Simultaneously, telemental service use rapidly increased during the pandemic. For example, a Kaiser Family Foundation study found that before the pandemic telemental health "represented less than 1% of outpatient care."[75] However, during the peak of the pandemic telemental health "represented 40% of mental health and substance use outpatient visits."[76]

Among patients covered by private insurers, a study "found that the COVID-19 pandemic was associated with a rapid increase in telehealth services for mental health conditions."[77] Telemental services also led to a "slight increase in total

[69] *See U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19, supra* note 5 (Maine and Virginia required a license in good standing for the five and ten years; Utah required a minimum of ten years of professional experience).

[70] *See* Parciak, *supra* note 64; Sherman, *supra* note 6; Allison N. Winnike & Bobby Joe Dale III, *Rewiring Mental Health: Legal and Regulatory Solutions for the Effective Implementation of Telepsychiatry and Telemental Health Care*, 17 HOUS. J. HEALTH L. & POL'Y 21, 38 (2017).

[71] *See* Sherman, *supra* note 6

[72] Lo, *supra* note 13.

[73] Catherine K. Ettman et al., *Prevalence of Depression Symptoms in US Adults Before and During the COVID-19 Pandemic*, 3 JAMA (2020).

[74] Press Release, RAND, Mental Health Telehealth Services Increased During Pandemic; Treatment Rates Increased for Some Disorders (Jan. 6, 2023), https://www.rand.org/news/press/2023/01/06.html.

[75] Lo, *supra* note 13.

[76] *Id.*

[77] Ryan K. McBain, *Mental Health Service Utilization Rates Among Commercially Insured Adults in the US During the First Year of the COVID-19 Pandemic*, 4 JAMA (2023).

utilization for anxiety disorders and stability overall."[78] Regarding Medicare users, the HHS found a massive increase in telemental use of behavioral health providers during the pandemic, with it having the "highest telehealth utilization relative to other providers."[79] The agency found that in 2020, "telehealth visits comprised a third of total visits to behavioral health specialists."[80] Similar increases in the use of telemental services were also found for Medicaid users.[81]

IV. RECOMMENDATION

A. Temporary Waiver Until Permanent Telemental Reform

First, states should temporarily reinstate waivers affecting telemental health services until permanent legislation is formed addressing the continuous need for increased mental health services. Some states have recognized the continuous need for mental health services post-pandemic and temporarily passed legislation bringing back telemental health waivers. For example, in 2023, Vermont signed legislation temporarily allowing out-of-state healthcare practitioners to provide service until a permanent solution is formed.[82] However, after the pandemic, most states let waivers that temporarily allowed out-of-state practitioners to utilize telemental services expire without subsequent legislation.[83] A recent survey by a mental health company, found that "70% of therapists reported that they had to stop seeing a client who moved to a different state."[84]

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[78] *Id.*

[79] Press Release, CENTERS for MEDICARE & MEDICAID SERV., *New HHS Study Shows 63-Fold Increase in Medicare Telehealth Utilization During the Pandemic* (Dec. 3, 2021), https://www.cms.gov/newsroom/press-releases/new-hhs-study-shows-63-fold-increase-medicare-telehealth-utilization-during-pandemic.

[80] *Id.*

[81] *See* Madeline Guth, *Telehealth Delivery of Behavioral Health Care in Medicaid: Findings from a Survey of State Medicaid Programs*, KAISER FAM. FOUND. (Jan. 10, 2023), https://www.kff.org/72edicaid/issue-brief/telehealth-delivery-of-behavioral-health-care-in-medicaid-findings-from-a-survey-of-state-medicaid-programs/ ("[B]ehavioral health, especially mental health, remained a top service category with high telehealth utilization among Medicaid enrollees.").

[82] An act relating to extending COVID-19 health care regulatory flexibility (Acts of 2023, No. 4) (Vt. 2023).

[83] *See U.S. States and Territories Modifying Requirements for Telehealth in Response to COVID-19*, *supra* note 5 (states such as Illinois, Arkansas, California, Connecticut, Hawaii and many more waivers expired from 2021-2023); Pifer, *supra* note 12.

[84] Harry Ritter, *How Cross-state Licensure Reform Can Ease America's Mental Health Crisis*, STAT (Mar. 8, 2023). https://www.statnews.com/2023/03/08/cross-state-licensure-reform-telehealth-ease-mental-health-crisis/.

More states should recognize that the need for mental health services has increased. As the CEO of the APA stated in 2022, "[t]he national mental health crisis continues."[85] A 2022 COVID-19 practitioner impact survey of psychologists found there was still a high demand for treatment for "trauma- and stressor-related disorders and substance use disorders."[86] Moreover, the survey reported increased in treatment for depression, trauma, and substance use.[87] Not only has the demand for treatments increased, but the demand has also increased in certain populations. Psychologists surveyed reported an increased in mental health services for teenagers, young adults, and healthcare workers.[88] The demand for telehealth services has not decreased post-pandemic but increased.[89] Therefore, letting telemental waivers expire removes a large subset of mental health services that were previously available when the need was not as big as the present day. Reducing services for Americans who need mental health services even more than during the pandemic contrasts with the initial state and federal executive orders' goals allowing telemental services to accommodate the increased demand.

B. Telemental Health Cross-State Licensing Reform

Second, a permanent solution to the increased need for mental health services, unequal access, and giving patients the ability to have more options to choose their optimum care is telemental health cross-state licensing reform. Cross-state licensure can occur through a state-by-state licensure adoption of a general standard of requirements for licensing regarding telemental health practitioners. This concept is not new to the mental health field, considering the Psychology Interjurisdictional Compact ("PSYPACT"), which is an interstate agreement that allows "psychologists in participating jurisdictions to practice across state lines without having to get licensed."[90] Cross-state licensure would aid in addressing the continuous need for mental health services after the pandemic and maximize patients' options, care, and access.

The general model most states adopted during the pandemic works as a starting point for cross-state licensure reform. [91] The practitioners must have (1) an active license, certification, or registration in another state (2) and be in good

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[85] *See* Press Release, AMERICAN PSYCHOLOGICAL ASS'N, *Increased Need for Mental Health Care Strains Capacity* (Nov. 15, 2022), https://www.apa.org/news/press/releases/2022/11/mental-health-care-strains.

[86] *Id.*

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] Ritter, *supra* note 83; *see also* Joseph, *supra* note 9.

[91] *See* AMERICAN PSYCHOLOGICAL ASS'N, *supra* note 84.

standing in the state they are registered to practice.[92] Since most states have already temporarily adopted this model during the pandemic, it presents an easier transition into states making the model permanent legislation. Several states have acknowledged this. Notably, in 2022, Delaware signed legislation generally adopting this standard. Moreover, in 2023, Idaho passed legislation that adopted similar requirements to the standard above for telemental health providers.[93] Other states have yet to adopt the standard but are addressing a telemental health service need by not requiring practitioners to be in-state to provide service.[94] For example, in 2023, Virginia and Tennessee passed legislation that exempted practitioners who provided telehealth care exclusively from the requirement of having to be physically present or have a physical address within the state.[95]

V. CONCLUSION

The COVID-19 pandemic exposed a gaping need for mental health care in America.[96] The pandemic allowed states and federal governments to reflect on how best address the growing need for mental health services. Telemental health services provide a solution to the need of millions of Americans who struggle with depression, substance abuse, and the spectrum of mental health conditions that many deal with alone. This article recommends that legislatures must now face the reality of mental health in America and proactively bring solutions that are not merely temporary but permanent.[97] Stagnant legislation and temporary waivers only prolong a permanent need for mental health services. For millions of Americans, their mental health is neither stagnant nor temporary but permanent and changing. The proliferation of telemental health access is a solution to an ever-fluid, constantly changing mental health landscape in America.

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[92] *See* Lodise, *supra* note 62.

[93] *See* 2022 IDAHO SESS. LAWS, CH. 142.

[94] *See Trending in Telehealth: March 20 – 27, 2023*, NAT'L L. REV. (Apr. 1, 2023), https://www.natlawreview.com/article/trending-telehealth-march-20-27-2023.

[95] *Id.*

[96] *See supra* Part III.

[97] *See supra* Part IV.

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LARGE LANGUAGE MODELS AND ETHICAL PITFALLS: TESTING THE LEGAL LIMITS OF "ROBOLAWYERING"

❖ Note ❖

*Lee Walter**

I. INTRODUCTION

Over the past several months, advanced machine learning algorithms called "large language models" (LLMs) have led to the creation of a variety of AI-powered legal software services.[1] LegalZoom leverages a simple LLM to interpret user responses to online questionnaires and generate boilerplate forms for estate planning and new business registration.[2] EU-based LegalAi uses the technology to provide prelitigation assessments of lawsuit validity to consumers.[3] And Casetext provides document drafting and review for attorneys.[4] But by far the buzziest and highest profile of these large language models is Open AI's ChatGPT (short for "generative pre-trained transformer"). Launched in 2015, ChatGPT has rapidly become synonymous with LLMs, and many legal tech companies have already integrated ChatGPT into their platforms.[5] Most recently, Casetext announced a contract with Am Law 20 firm DLA Piper to provide a ChatGPT-powered legal large language

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[1] *See* Adam Zewe, *Solving a Machine-Learning Mystery*, MIT NEWS (Feb. 7, 2023), https://news.mit.edu/2023/large-language-models-in-context-learning-0207.

[2] *Hello, We're LegalZoom*, LEGALZOOM, https://www.legalzoom.com/about-us (last visited Mar. 18, 2023).

[3] *Case Resolution Platform*, LEGALAI, https://www.legalai.io/ (last visited Mar. 18, 2023).

[4] *The Legal AI You've Been Waiting For*, CASETEXT, https://casetext.com/cocounsel/?utm_medium=paidsearch&utm_source=google&utm_campaign=brand-research&utm_content=_&utm_term=casetext (last visited Mar. 18, 2023).

[5] *Id.*

model it calls "CoCounsel," which can draft a variety of legal documents and which the company claims "has the potential to save up to 60% of attorneys' time."[6]

These developments have excited practitioners and unnerved regulators, as the potential use cases for LLMs in the legal field range from glorified document template fetchers to full-on "robo-lawyers." Use cases describing how LLMs like ChatGPT could interact with the legal field, or indeed how artificial intelligence could interact with society in general, fall into three categories.[7] The terminology of each model reflects the role humans would ultimately play in an ideal end state of human-LLM interaction: 1) human in-the-loop, 2) human on-the-loop, and 3) human out-of-the-loop.[8]

In the first model, where humans are "in-the-loop," LLMs are used in the legal field largely as they can be used today, as a starting point for research or responses to basic legal questions.[9] This might involve summarizing caselaw for attorney review, or drafting part of a document based on an attorney's inputs. In the second, "on-the-loop" model, LLMs can perform any legal work so long as it is signed off on by a practicing attorney.[10] In this model, LLMs could be used to draft

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[6] *Top Global Law Firm DLA Piper Announces Addition of CoCounsel to Enhance Practice and Client Services*, CASETEXT (Mar. 23, 2023), https://casetext.com/blog/law-firm-dla-piper-announces-casetext-cocounsel/.

[7] Shana Lynch, *AI in the Loop: Humans Must Remain in Charge*, STANFORD UNIVERSITY HUMAN-CENTERED ARTIFICIAL INTELLIGENCE (Oct. 17, 2022), https://hai.stanford.edu/news/ai-loop-humans-must-remain-charge; Sundar Narayanan, *Human-in-the-Loop or on-the-Loop is Not a Silver Bullet. Evaluate Their Effectiveness*, MEDIUM (Jan. 3, 2022), https://medium.com/mlearning-ai/human-in-the-loop-or-on-the-loop-is-not-a-silver-bullet-evaluate-their-effectiveness-82f37835d765; Arne Wolfewicz, *Human-in-the-Loop in Machine Learning: What is it and How Does it Work?*, LEVITY AI (Nov. 16, 2022), https://levity.ai/blog/human-in-the-loop; Junzhe Zhang and Elias Bareinboim, *Can Humans be Out of the Loop?*, PROCEEDINGS OF MACHINE LEARNING RESEARCH, vol. 140:1–22, 2022, https://causalai.net/r64.pdf.

[8] This "loop" language is primarily used in the context of the military. For example, Congress recently considered a bipartisan resolution mandating that humans remain "in-the-loop" in decisions to use the nation's nuclear weapons. *See* Elizabeth Elkind, *AI Banned from Running Nuclear Missile Systems Under Bipartisan Bill*, FOX NEWS (Apr. 28, 2023), https://www.foxnews.com/politics/ai-banned-running-nuclear-missile-systems-under-bipartisan-bill. However, the classifications are equally applicable to any use case. *See* Shana Lynch, *AI in the Loop: Humans Must Remain in Charge*, STAN. U. HUMAN-CENTERED ARTIFICIAL INTELLIGENCE (Oct. 17, 2022), https://hai.stanford.edu/news/ai-loop-humans-must-remain-charge; *see also* Sundar Narayanan, *Human-in-the-Loop or on-the-Loop is Not a Silver Bullet. Evaluate Their Effectiveness*, MEDIUM (Jan. 3, 2022), https://medium.com/mlearning-ai/human-in-the-loop-or-on-the-loop-is-not-a-silver-bullet-evaluate-their-effectiveness-82f37835d765; Arne Wolfewicz, *Human-in-the-Loop in Machine Learning: What Is it and How Does it Work?*, LEVITY AI (Nov. 16, 2022), https://levity.ai/blog/human-in-the-loop; Junzhe Zhang and Elias Bareinboim, *Can Humans be Out of the Loop?*, PROCEEDINGS OF MACHINE LEARNING RSCH., vol. 140:1–22, 2022, https://causalai.net/r64.pdf.

[9] *See CoCounsel Is Powered by OpenAI's GPT-4, the First AI to Pass the Bar*, CASETEXT (Mar. 14, 2023), https://casetext.com/blog/cocounsel-powered-by-openai-gpt-4/.

[10] *See* Zhongxiang Sun, *A Short Survey of Viewing Large Language Models in Legal Aspect*, ARXIV (Mar. 17, 2023), https://arxiv.org/pdf/2303.09136.pdf.

complete legal documents (e.g., a complaint for a matter before a small claims court), but a barred attorney would need to review the documents before signing off on and filing them with a court. In the final and most controversial model, where humans are entirely "out-of-the-loop," algorithmically powered "robo-lawyers" could provide the full range of legal services, including everything from simply responding to legal questions submitted on a website to listening to a fact pattern from a client, determining what claims that client has against which entities, drafting and filing a complaint and any necessary motions, and even performing settlement negotiations or oral arguments, all without the need for input from a barred attorney.[11] Companies like DoNotPay have gotten in legal trouble with state prosecutors for potential unauthorized practice of law (UPL) violations in pursuing this model, but it is this model that DoNotPay and other legal LLM developers are working towards.[12]

All of this raises an important question: just how far can LLMs go in enhancing legal service provision before running afoul of UPL or other legal ethics rules? Through no fault of their own, many articles written in the last few years on the subject have already been overcome by the rapid advancement of LLMs in the legal space.[13] In this article, I will analyze which of the above three models is likely to best comport with UPL and other ethics laws with regard to the provision of LLM-powered legal services.

In Part II, I describe the state of machine learning and generative AI in both the legal field and in academia generally. In Part III, I analyze state law, federal law, and relevant court rules to determine the extent to which generative AI can be used in the legal profession without breaking the law. I conclude that existing ethics rules and caselaw draw the legal line somewhere between in-the-loop and on-the-loop augmentations by LLMs, and full out-of-the-loop legal service provision almost certainly violates ethics rules in *nearly* every circumstance. In Part IV, I list recommendations for legal service providers to follow so as not to use generative AI illegally.

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[11] Bobby Allyn, *A Robot was Scheduled to Argue in Court, then Came the Jail Threats*, NPR (Jan. 25, 2023), https://www.npr.org/2023/01/25/1151435033/a-robot-was-scheduled-to-argue-in-court-then-came-the-jail-threats.

[12] *See* Mandar Karhade, *One AI-Lawyer to Rule Them All: DoNotPay by Joshua Browder*, MEDIUM (Jan. 4, 2023), https://medium.datadriveninvestor.com/one-ai-lawyer-to-rule-them-all-donotpay-by-joshua-browder-d27924c2a2ef?gi=c5cb7e032e88.

[13] *See generally* Thomas Spahn, *Is Your Artificial Intelligence Guilty of the Unauthorized Practice of Law?*, 24 RICH. J.L. & TECH. 2 (2018); *see also* Sean Tu, Amy Cyphert, and Sam Perl, *Limits of Using Artificial Intelligence and GPT-3 in Patent Prosecution*, 54 TEX. TECH L. REV. 255 (2022).

II. BACKGROUND

A. Large Language Model Mechanics

Just how do LLMs like ChatGPT work? Without getting into too much technical detail, LLMs are "trained" by feeding a high volume of text samples into an algorithm, allowing the algorithm to "guess" a string of text a user is trying to make it produce based on the user's prompt.[14] The LLM's responses are sometimes given feedback by human "trainers," which in turn prods the LLM to refine its guess and produce a string of text that the trainers deem is closer to what the user was asking for.[15] ChatGPT researchers use this "supervised learning" to create guardrails designed to prevent ChatGPT from providing responses with illegal or obscene content.[16] As more text is fed to the algorithm, the training and reinforcement process is repeated until the trainers are satisfied the algorithm is sufficiently skilled at "guessing" a string of text the user is trying to make it produce.[17]

This is a key point to keep in mind: in the vast majority of cases, unless it has been explicitly trained to give a certain response to a certain question, there is no actual "reasoning" behind an LLM's responses, legal or otherwise.[18] The LLM is only giving educated guesses about strings of text that should follow from user prompts based on the titanic amount of text it has been "trained" on.[19] So, for example, if asked, "who was the first President of the United States," an LLM will only answer correctly because it has been trained with enough documents to respond to the string of letters in the user's prompt with the letters "W-a-s-h-i-n-g-t-o-n." In ChatGPT's case, its creators claim it has been trained on hundreds of millions of documents.[20] The model also has upwards of 175 billion "parameters," or stored values the LLM relies on to form its "guesses" and that it can independently update as it receives more feedback from its trainers or data from new text sources.[21] This process of probabilistically "guessing" strings of text to use in prompted responses based on text already fed to the algorithm has led some commentators to describe LLMs as

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[14] Adam Zewe, *Solving a Machine-Learning Mystery*, MIT NEWS (Feb. 7, 2023), https://news.mit.edu/2023/large-language-models-in-context-learning-0207.

[15] *Id.*

[16] Will Douglas Heaven, *GPT-4 Is Bigger and Better than ChatGPT – but OpenAI Won't Say Why*, TECH. REV. (Mar. 14, 2023), https://www.technologyreview.com/2023/03/14/1069823/gpt-4-is-bigger-and-better-chatgpt-openai/.

[17] Zewe, *supra* note 14.

[18] *See ChatGPT: What Is it and How Does it Work?*, ENTREPRENEUR (Feb. 16, 2023), https://www.entrepreneur.com/science-technology/chatgpt-what-is-it-and-how-does-it-work/445014#:~:text=ChatGPT%20is%20a%20transformer%2Dbased,ChatGPT%20is%20large%2Dscale.

[19] *Id.*

[20] Leo Gao et al., *The Pile: An 800GB Dataset of Diverse Text for Language Modeling*, ARXIV (Dec. 31, 2020), https://arxiv.org/pdf/2101.00027.pdf.

[21] ENTREPRENEUR, *supra* note 18.

little more than "stochastic parrots," or a highly sophisticated form of "autocomplete" one might find in an online search engine or a smart phone's text messaging apps.[22]

B. Recent Advancements in Generative AI

To say the technology is advancing at breakneck speed is a massive understatement. In the days after its initial release on November 30, 2022, for example, users quickly found holes in ChatGPT's grasp of simple trivia. In response to a 50-question battery posed by SCOTUSblog, the bot incorrectly stated that Justice Ginsburg dissented in the landmark marriage case *Obergefell v. Hodges* and misstated dates of famous arguments before the Court.[23] Today, just six months later, ChatGPT still makes factual errors, but its uses have expanded dramatically.[24] The bot has passed coding interviews for large software companies like Google and Amazon, outperforming every other applicant in less than four minutes at a task where applicants were allotted two hours.[25] The Government Accountability Office and National Institutes of Health have both concluded LLMs like ChatGPT may someday be able to provide more accurate diagnoses of various illnesses than human doctors.[26] The team behind ChatGPT also claims it can score in the ninetieth percentile on the SAT,[27] the ninety-ninth percentile on the Biology Olympiad,[28] and that it can analyze and describe the contents of images.[29] Most importantly, one

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[22] *See ChatGPT: A Big Step Towards True AI, or Autocomplete on Steroids?*, BUSINESS REPORTER, https://www.business-reporter.co.uk/technology/chatgpt-a-big-step-towards-true-ai-or-autocomplete-on-steroids (last visited Apr. 26, 2023).

[23] Debra Cassens Weiss, *ChatGPT Is Asked 50 Questions About Supreme Court; it Got Only 21 Questions Right*, ABA JOURNAL (Jan. 31, 2023), https://www.abajournal.com/news/article/chatgpt-is-asked-50-questions-about-the-supreme-court.-it-got-only-21-questions-right.

[24] *See* Luca De Biase, *GPT4: The Hallucinations Continue*, OECD (Mar. 17, 2023), https://www.oecd-forum.org/posts/gpt4-the-hallucinations-continue.

[25] Emily Dreibelbis, *ChatGPT Passes Google Coding Interview for Level 3 Engineer with 183k Salary*, PCMAG (Feb. 1, 2023), https://www.pcmag.com/news/chatgpt-passes-google-coding-interview-for-level-3-engineer-with-183k-salary.

[26] *Machine Learning's Potential to Improve Medical Diagnosis*, GOV'T ACCOUNTABILITY OFF. (Nov. 10, 2022), https://www.gao.gov/blog/machine-learnings-potential-improve-medical-diagnosis; Yogesh Kumar, Apeksha Koul, Ruchi Singla, and Muhammad Fazal Ijaz, *Artificial Intelligence in Disease Diagnosis: A Systematic Literature Review, Synthesizing Framework and Future Research Agenda*, J. AMBIENT INTEL. AND HUMANIZED COMPUTING, 28 (2022), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC8754556/#:~:text=Artificial%20intelligence%20can%20assist%20providers,discovery%2C%20and%20patient%20risk%20identification.

[27] Kif Leswing, *OpenAI Announces ChatGPT-4, Claims it Can Beat 90% of Humans on the SAT*, CNBC, https://www.cnbc.com/2023/03/14/openai-announces-gpt-4-says-beats-90percent-of-humans-on-sat.html (last visited Mar. 18, 2023).

[28] *GPT-4 is OpenAI's Most Advanced System, Producing Safer and More Useful Responses*, OPENAI, https://openai.com/product/gpt-4 (last visited Mar. 18, 2023).

[29] *Id.*

independent research team found the newest iteration, GPT-4, can already pass the Uniform Bar Exam, administered in 36 states,[30] and earn a score in the ninetieth percentile of test takers.[31]

Perhaps the highest-profile application of ChatGPT in the legal world was consumer advisory firm DoNotPay's attempt to allow the bot to argue in court.[32] Originally founded to help users find and fill out forms to contest minor traffic and small claims court cases, DoNotPay first made waves in the legal world in early 2023 when its founder, Joshua Browder, integrated ChatGPT into the DoNotPay platform and offered a one-million-dollar reward for any attorney that allowed its bot to argue a case before the Supreme Court.[33] Commentators chided DoNotPay for getting ahead of itself in jumping from traffic court to the highest court in the land (and for not knowing basic court rules at SCOTUS banning the use of listening and recording technology like ear buds),[34] and Browder called off the reward when state prosecutors threatened to prosecute him and his company for UPL if DoNotPay ever used a large language model to argue in court.[35] Most recently, consumers filed a class action lawsuit against DoNotPay, claiming it offered subpar legal advice while committing a UPL violation.[36] Other commentators have noted the bot's propensity to generate false statements of fact, called "hallucinations," may expose OpenAI to legal liability.[37] In the months since its release, users have reported ChatGPT falsely

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[30] John Keller, *UBE States: Which States Have Adopted the Uniform Bar Exam?*, BAR PREP HERO, (Feb. 21, 2023), https://barprephero.com/learn/uniform-bar-examination-states/#:~:text=There%20are%2036%20states%20or,Alaska.

[31] Daniel Martin Katz, Michael James Bommarito, Shang Gao, and Pablo David Arredondo, *ChatGPT-4 Passes the Bar Exam*, SOC. SCI. RSCH. NETWORK (Mar. 15, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4389233.

[32] Helen Hwang, *Meet the AI Lawyer That Want to Take on the Supreme Court*, AI BUSINESS (Jan. 16, 2023), https://aibusiness.com/automation/meet-the-ai-lawyer-that-wants-to-take-on-the-supreme-court.

[33] *Id.*

[34] *Entering the Building & Prohibited Item*s, SUPREMECOURT.GOV, https://www.supremecourt.gov/visiting/prohibited-items.aspx (last visited Mar. 18, 2023). Funnily enough, asking ChatGPT itself whether an attorney could wear earbuds during oral arguments before the Supreme Court results in the chatbot correctly responding that no, you may not.

[35] Emma Roth, *DoNotPay Chickens Out on Its Courtroom AI Chatbot Stunt*, THE VERGE (Jan. 25, 2023), https://www.theverge.com/2023/1/25/23571192/donotpay-robot-lawyer-courtroom.

[36] Reuters, *Lawsuit Pits Class Action Firm Against 'Robot Lawyer' DoNotPay*, US NEWS (Mar. 9, 2023), https://www.usnews.com/news/technology/articles/2023-03-09/lawsuit-pits-class-action-firm-against-robot-lawyer-donotpay.

[37] Alex Brogan, *ChatGPT's Legal Timebomb Is Ticking, Microsoft Edge Gets Dall-E, OpenAI Defamation Lawsuit*, LINKEDIN (Apr. 10, 2023), https://www.linkedin.com/pulse/chatgpts-legal-timebomb-ticking-microsoft-edge-gets-dall-e-brogan.

accusing public figures of sexual assault,[38] referencing non-existent news articles,[39] and generating legal citations to non-existent caselaw.[40] But despite these early flaws and controversies, some still see great potential in the technology behind LLMs as it applies to the legal field.[41]

III. ANALYSIS

A. American Bar Association Model Rules

The American Bar Association's Model Rules of Professional Conduct (MRPC) have been adopted by state legislatures in some form in all 50 states and the District of Columbia.[42] Compliance with the MRPC is the first step towards broader approval of the use of LLMs in legal practice. Because of their widespread adoption and their standing as the primary source of ethical rules for barred attorneys in the United States, the MRPC deserve analysis separate from other general state ethics statutes.

Simply put, even were LLMs admitted to "practice law," they must make significant advancements beyond their current capabilities to provide effective legal service in line with MRPC standards. Citing non-existent caselaw and missing legal issues in a fact pattern clearly violate the basic MRPC Rule 1.1 duty of competence.[43] But the duty of competence and many other ethical standards may be violated by any legal professional, and LLMs would obviously need to comply with Rule 1.1 and other duties such as the duty of communication and the avoidance of conflicts of interest.[44] This section will instead only deal with those challenges unique to LLMs. For example, Comment 8 to Rule 1.1 also states that lawyers "should keep abreast of changes in the law and its practice . . . [and] engage in continuing study and

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[38] *See* Pranshu Verma and Will Oremus, *ChatGPT Invented a Sexual Harassment Scandal and Named a Real Law Prof as the Accused*, WASH. POST (Apr. 5, 2023), https://www.washingtonpost.com/technology/2023/04/05/chatgpt-lies/.

[39] *See* Adam Kravitz, *ChatGPT and the Future of Corporate Legal Work: Insights and Hallucinations*, FORDHAM J. CORP. & FIN. L. (Mar. 25, 2023), https://news.law.fordham.edu/jcfl/2023/03/25/chatgpt-and-the-future-of-corporate-legal-work-insights-and-hallucinations/.

[40] *See* Ethan Isaacson, *AI and The Bluebook: Why ChatGPT Falls Short of Traditional Algorithms for Bluebook Legal Citation Formatting*, LAWNEXT (Mar. 26, 2023), https://directory.lawnext.com/library/ai-and-the-bluebook-why-chat-gpt-falls-short-of-traditional-algorithms-for-bluebook-legal-citation-formatting/.

[41] CASETEXT, *supra* note 6.

[42] *See generally Alphabetical List of Jurisdictions Adopting Model Rules*, AM. BAR ASS'N, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/alpha_list_state_adopting_model_rules/ (last visited Mar. 18, 2023).

[43] MODEL RULES OF PROF'L CONDUCT R. 1.1 (2019) [hereinafter *MRPC*].

[44] *Id.* R. 1.4, 1.7.

education."[45] This may be problematic for LLMs, as OpenAI and other LLM developers do not update their models' training data on a rolling basis so as not to inadvertently reenable the models to generate output with objectionable content.[46]

Assuming LLMs are one day sufficiently adept at providing legal services to overcome the high bar of legal competence, many more hurdles must be cleared. Rule 2.1 explicitly condones attorneys offering "relevant moral and ethical considerations in giving advice," noting that "[a]dvice couched in narrow legal terms may be of little value to a client, especially where practical considerations, such as cost or effects on other people, are predominant," and that "moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied."[47] As such, Rule 2.1 also cautions that "[p]urely technical legal advice [] can sometimes be inadequate."[48] Therefore, while they do not strictly require attorneys to dispense moral wisdom, the Model Rules do encourage counseling clients on relevant, non-legal, and potentially moral or ethical concerns when those concerns affect a client's wellbeing or the outcome of the matter. For public relations and liability reasons, however, most commercial LLMs are explicitly trained not to provide moral or ethical opinions.[49] Indeed, it may be difficult for companies to develop an acceptable, universal moral or ethical code for their LLMs to use to provide adequate legal service.

MRPC Rule 5.3 also presents a substantial barrier to the "human-out-of-the-loop" model if companies with LLMs are not licensed in some way to provide legal services. Rule 5.3 states that lawyers working with nonlawyers must "make reasonable efforts to ensure that the [nonlawyer]'s conduct is compatible with the professional obligations of the lawyer," seemingly requiring an "on-the-loop" or "in-the-loop" interaction model.[50]

Finally, the MRPC also prohibit insufficient factual investigation, though the risk of prosecution for violations appears low in practice. Of relevance is MRPC Rule 3.1, which simply states that "[a] lawyer shall not bring or defend a proceeding . . . unless there is a basis in law and fact for doing so that is not frivolous."[51] Discipline for violations of this rule typically involve attorneys who have taken their clients' word on the facts of a legal matter, something which, so long as they remain confined to servers, LLMs are limited in doing as they cannot conduct their own

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[45] *Id.* R. 1.1, Comment 8.

[46] ChatGPT itself has only been trained on documents up to 2021. *See Knowledge Cutoff Date of September 2021*, OPENAI (Feb. 18, 2023), https://community.openai.com/t/knowledge-cutoff-date-of-september-2021/66215.

[47] MRPC R. 2.1, Comment 2.

[48] *Id.*

[49] *See* Jon Christian, *Amazing 'Jailbreak' Bypasses ChatGPT's Ethics Safeguards*, FUTURISM (Feb. 4, 2023), https://futurism.com/amazing-jailbreak-chatgpt.

[50] MRPC R. 5.3(b).

[51] *Id.* R. 3.1.

external factual investigations. However, as observers have noted, Rule 3.1 is rarely enforced.[52]

B. State Definitions of the "Unauthorized Practice of Law"

A particularly relevant question in determining whether the legal profession can adopt an entirely "human-out-of-the-loop" legal service model is whether such an arrangement would constitute UPL.[53] After all, though they may one day achieve a high level of competence in spotting legal issues in fact patterns and generating legal writing, barring a revolutionary change in state legal practice statutes, LLMs cannot graduate from accredited law schools or sit for state bar exams, the most common requirements to practice law across the country.[54] As such, to use an LLM to provide legal services, companies will need to be certain they are not violating UPL statutes.

All 50 states and the District of Columbia have adopted laws stating that engaging in the "practice of law" without a license is illegal.[55] However, though it is seemingly central to the regulation of the legal field, what qualifies as the "practice of law" is vague at best.[56] Though the definition of UPL is largely left to the states, state statutes rarely provide exact definitions, leaving a patchwork of state and federal opinions with inconsistent descriptions of the term.[57]

While it has rarely considered the issue, the Supreme Court has consistently held that what constitutes the "practice of law" is largely to be left to the states, with only very narrow exceptions. In *Brotherhood of R. R. Trainmen v. Virginia ex rel. Va. State Bar*, the Court held that the state of Virginia had a legitimate and legal interest in regulating the practice of law and had the authority to define the practice of law as it pleased, but that barring labor union members from advising other members to seek legal advice if they suffered a work-related injury violated the advising members' first amendment rights.[58] And in *Sperry v. Florida ex rel. Fla. Bar*, the Court held a patent officer with the Patent Office *did* engage in the practice of law in Florida when he prepared and prosecuted patent applications in violation of Florida's UPL statute, but that the state could not enjoin his activities per Patent Office regulations and

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[52] *See* David L. Hudson Jr., *What is a Lawyer's Ethical Duty to Check Out a Client's Claim Before Filing an Action?*, ABA JOURNAL (Apr. 1, 2021), https://www.abajournal.com/magazine/article/election-fraud-cases-highlight-ethics-rules-on-baseless-complaints.

[53] The MRPC govern only the conduct of lawyers and are silent as to what constitutes legal practice. Model Rule 5.5 addresses the unauthorized practice of law, but only in the context of lawyers practicing law in other jurisdictions in which they are not barred. MRPC R. 5.5.

[54] *See Comprehensive Guide to Bar Admission Requirements 2021*, AMERICAN BAR ASSOCIATION, 10–34 (2021), https://www.americanbar.org/content/dam/aba/publications/misc/legal_education/2021-comp-guide.pdf.

[55] R. E. Heinselman, *What Amounts to Practice of Law?*, 111 A.L.R. 19, § II.

[56] *Id.*

[57] *Id.*

[58] Brotherhood of R. R. Trainmen v. Virginia ex rel. Va. State Bar, 377 U.S. 1, 6–7 (1964).

federal patent laws that specifically pre-empt state UPL law when it comes to patent applications.[59]

States have addressed the issue of defining UPL with broad and vague definitions that often do little to clarify its scope. Arizona circularly defines law practice as engaging in "the practice of law or [the] provi[sion] of legal services."[60] Kentucky defines the practice of law as "any service rendered involving legal knowledge or legal advice . . . rendered in respect to the rights, duties, obligations, liabilities, or business relations of one requiring the services."[61] States like Illinois avoid the issue entirely and simply state it is illegal to "practice as an attorney or counselor at law within this State without having previously obtained a license."[62] In a similarly unhelpful example, South Carolina simply bans UPL by saying "[n]o person may either practice law or solicit the legal cause of another person or entity in this State" if they are not licensed.[63] In states like these, LLM providers need to be extra cautious of using software to autonomously provide anything remotely resembling legal services.

In one of the most specific and permissive definitions, Texas defines the practice of law as "the preparation of a pleading or other document . . . including the giving of advice or the rendering of any service requiring the use of legal skill or knowledge, such as preparing a will, contract, or other instrument."[64] This is a typical vague definition, but the Texas statute also explicitly recognizes disclaimers, saying that the practice of law does *not* include "the design, creation, publication, distribution, display, or sale, including . . . sale by means of an Internet web site, of written materials, books, forms, computer software, or similar products *if the products clearly and conspicuously state that the products are not a substitute for the advice of an attorney*."[65] In Texas, then, LLM providers may be able to escape legal liability for UPL simply be providing an adequate disclaimer.

Lastly, while the definitions are vague, when clear UPL violations occur, state disciplinary authorities vigorously enforce UPL statutes, often imposing sanctions on suspended or unauthorized out-of-state attorneys practicing law within their jurisdictions.[66] The Illinois body charged with investigating UPL violations, the Attorney Registration and Disciplinary Commission, notes that these are the most

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[59] Sperry v. Florida ex rel. Fla. Bar, 373 U.S. 379, 383 (1963).

[60] ARIZ. CT. R. 31(a).

[61] KY. CT. R. 3.020.

[62] 705 ILL. COMP. STAT. ANN. 205/1 (West 2018).

[63] S.C. CODE ANN. § 40-5-310 (1976).

[64] TEX. GOVT. CODE ANN. § 81.101(a).

[65] *Id.* § 81.101(c) (emphasis added).

[66] *See, e.g.*, In re Murgatroyd, 741 N.E.2d 719, 719–20 (Ind. 2001); *see also* In re Conduct of Brandt, 10 P.3d 906, 908 (Or. 2000).

common forms of UPL, and that violations involving true amateurs are rare.[67] As such, little caselaw exists that might be relevant to a "unlicensed attorney" like an LLM, or the company that owns it, providing legal services.

C. Federal Definitions of the "Unauthorized Practice of Law"

There is no overarching federal statute defining UPL broadly, but various federal statutes, regulations, and court decisions define UPL in certain edge cases.[68] For example, some federal statutes contain individual definitions of "practice of law"-adjacent terms that are the subject of a great deal of litigation and criminal proceedings. One of the most relevant examples is the oft-cited Bankruptcy Code's definition of "legal advice," defined to include, among other things, advising a debtor whether to file petitions, whether to commence cases, whether their debts will be discharged, and whether the debtor will be able to retain their property in bankruptcy.[69] Citing an increase in UPL violations by scammers targeting undocumented immigrants (so-called "unauthorized practice of immigration law" (UPIL) violations), the Department of Homeland Security (DHS) promulgated rules specifying that individuals may not prepare immigration documents on behalf of another unless they are attorneys or otherwise authorized by DHS to do so.[70] Federal law also raises the important question of where an LLM is housed. That is, special considerations attach if a law firm uses an off-premises model as opposed to one that is stored on-premises on the firm's internal servers. In handling a matter involving a client's medical history, for example, LLM providers and the firms that use them would need to be careful not to inadvertently violate federal medical privacy laws like the Health Insurance Portability and Accountability Act.[71] Firms must be careful, then, only to use LLMs with secure data storage frameworks.

The few federal appellate cases interpreting the definition of the "practice of law" also offer little guidance. The most relevant case, and perhaps the only one sufficiently on point thus far, is *Janson v. LegalZoom.com, Inc.* In *Janson*, class action plaintiffs accused defendant legal form provider of UPL.[72] LegalZoom maintained

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[67] *See How the ARDC Tackles the Unauthorized Practice of Law*, ILLINOIS COURTS (Sept. 27, 2017), https://www.illinoiscourts.gov/News/847/How-the-ARDC-tackles-the-Unauthorized-Practice-of-Law/news-detail/.

[68] *See generally*, What Amounts to Practice of Law?, American Law Reports, 111 A.L.R. 19.

[69] 11 U.S.C. §§ 110(e)(2)(B)(i–iii); *see generally* In re Reynoso, 477 F.3d 1117 (9th Cir. 2007) (upholding unauthorized practice of law conviction for non-lawyers preparing clients' bankruptcy forms).

[70] 8 C.F.R. § 292.1(a); *USCIS Initiative to Combat the Unauthorized Practice of Immigration Law Fact Sheet*, U.S. CITIZENSHIP AND IMMIGRATION SERVICES, https://www.uscis.gov/archive/uscis-initiative-to-combat-the-unauthorized-practice-of-immigration-law-fact-sheet (last visited: Apr. 27, 2023).

[71] 42 U.S.C. § 1320d-6.

[72] Janson v. LegalZoom.com, Inc., 802 F.Supp.2d 1053 (8th Cir. 2011).

(and continues to maintain) a website offering "blank legal forms that customers may download, print, and fill in themselves."[73] At issue were forms offered on the company's internet portal, which LegalZoom used to help customers "prepare [their] legal documents."[74] Importantly, the advertisements contained a disclaimer that "LegalZoom isn't a law firm. They provide self-help services at your specific direction."[75] The named plaintiffs had no interaction with any LegalZoom employees, and they admitted they never believed they were receiving legal advice while using the LegalZoom website.[76]

Ignoring the disclaimer and the fact that users never thought they were receiving legal advice, the court held that while providing true do-it-yourself forms to consumers did not constitute UPL, going a step further and filling a form out based on a customer's responses did.[77] The court noted Missouri statutes defined the practice of law as, in part, "the appearance as an advocate in a representative capacity or the drawing of papers, pleadings or documents or the performance of any act in such capacity in connection with proceedings pending or prospective before any court."[78] The court wrote that when providing blank forms, "[t]he purchaser understood that it was their responsibility to get it right," but that when a company goes a step further and fills out any portion of the form *for* the customer, it does more than sell a "good" in the form of a blank legal document; it impermissibly participates in the "drawing of papers, pleadings, or documents."[79] For states with similar "practice of law" definitions, this presents another potential problem, as LLM providers likely could not use a similar argument that the text generated by the LLM is nothing more than an algorithmic output based on users' prompt text. Put simply: at least one circuit court believes providing software to fill out boilerplate forms based on a users' inputs can count as "practicing law," and at the most basic level, that is all any LLM can do. And if other courts follow the Eighth Circuit's lead, it also may not matter that most LLM providers disclaim that they are providing legal services in their terms of use.

Other jurisdictions have considered only tangentially relevant issues. The Second Circuit held a law school graduate who was not yet licensed did not "offer legal advice" or "practice law" when he filled out forms and wrote letters on behalf of a client.[80] In *Jackson v. United Artists Theatre Circuit, Inc.*, the Nevada District Court held that examination of a witness by a private investigator did not constitute UPL.[81] In another rare finding of UPL, the Third Circuit found a non-attorney defendant

[73] *Id.* at 1054.
[74] *Id.* at 1055.
[75] *Id.*
[76] *Id.* at 1056–57.
[77] *Id.* at 1064.
[78] *Id.* at 1058.
[79] *Id.* at 1064.
[80] Wynns v. Adams, 426 B.R. 457, 462–63 (2d Cir. 2010).
[81] Jackson v. United Artists Theatre Cir., Inc., 278 F.R.D. 586, 596–97 (D. Nev. 2011).

did commit UPL, but only because he signed a contract explicitly stating he had professional legal skills and would participate in litigation on behalf of the plaintiff.[82] And while they are generally not charged with enforcing UPL provisions, both the Federal Trade Commission and the Department of Justice have expressed their support for the District of Columbia's definition, which includes "the provision of professional legal advice or services where there is a client relationship of trust or reliance."[83]

The bottom line is that even providing legal-adjacent services may land LLM providers in hot water. Giving advice on how to handle debts, advising clients on the immigration process (even in good faith), and automatically filling out forms based on user inputs, *even when clients believed they were not receiving legal advice*, have all been found to violate federal UPL laws. As such, LLM providers must take care not only to avoid providing "traditional" legal advice, but also to proactively put guardrails in place to disallow their algorithms from dispensing law-adjacent advice, as well.

D. Court Rules

Lastly, even if a company manages to avoid UPL liability under state and federal law, one other source of law may prove troublesome to LLMs attempting to provide legal services: the Federal Rules of Civil Procedure (FRCP).[84] Even if a company selling LLM-powered legal services only operates in a state where they can provide such services with disclaimers, or if staff attorneys sign off on all legal work performed by an LLM, its lawyers may still not be able to overcome this final hurdle. Specifically, FRCP Rule 11 states that attorneys, in filing pleadings or other written motions, must certify that "to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances," the document is not being filed for an improper purpose, the claims are not frivolous, and the factual contentions are supported by evidence.[85] Such an "inquiry reasonable under the circumstances" has been held to include, at the bare minimum, not relying entirely on the personal knowledge of the client.[86] As LLMs cannot interact with a case beyond fact investigation from the client, their capabilities would need to be vastly expanded to comply with Rule 11's investigatory requirement. This is particularly important as the court noted in *Shrock v. Altru Nurses Registry* that Rule 11 is not to be taken lightly, nor is it up to a judge's discretion to decide whether a violation ought

[82] In re Benninger, 357 B.R. 337, 353 (3d Cir. 2006).

[83] U.S. DEP'T OF JUST., COMMENTS ON REVISED PROPOSED RULE CONCERNING UNAUTHORIZED PRACTICE OF LAW (2009).

[84] FED. R. CIV. P. 2.

[85] *Id.* 11(b).

[86] Shrock v. Altru Nurses Registry, 810 F.2d 658, 661–62 (7th Cir. 1987).

to be punished, as the rule *requires* the court to impose sanctions for Rule 11 violations.[87]

E. General Takeaways and Other Considerations

Three key factors may complicate the LLM-UPL interaction that are not present in many of the cases discussed thus far (save for, perhaps, *Janson*): 1) some LLMs are trained in part by in-house attorneys,[88] potentially opening those companies to legal liability for holding themselves out as providing legal services; 2) LLMs largely have user agreements reminding users that the LLM is not meant to give legal advice and making users agree to relieve the company of legal liability for providing bad legal advice if it does,[89] potentially enabling companies in states like Texas to contract around licensing requirements; and 3) many LLMs are general purpose and not designed specifically to provide legal services, instead functioning more like a very sophisticated search engine,[90] potentially giving LLMs deniability in accusations of UPL when users prompt the models to generate legal advice.

The most interesting and relevant of these three hitches is the first, that some LLMs are trained by licensed attorneys and that, as the models are fed and trained on ever increasing amounts of legal text, the accuracy of their responses will only improve.[91] The stated policy purpose behind most state UPL statutes is not to prevent competition with the state bars, but to protect the unsuspecting public from the incompetent provision of legal services from individuals who have not had formal, rigorous legal training and passed a competency test in the form of a bar exam.[92] Where patent officers, bank employees, realtors, and blank form providers might inadvertently commit UPL under a variety of state and federal statutes *any* time they offer legal services because they are part of the aforementioned individuals

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[87] *Id.* at 661.

[88] *See, e.g.*, *The Legal AI You've Been Waiting For*, CASETEXT, https://casetext.com/cocounsel/ (last visited Apr. 27, 2023) ("Our attorneys and AI specialists spent months developing and repeatedly testing an OpenAI-powered solution tailored to lawyers' needs and reliable and secure enough to meet the highest bar.").

[89] *Terms of Use*, OPENAI (Mar. 14, 2023), https://openai.com/policies/terms-of-use.

[90] Some companies, like OpenAI parent company Microsoft, are working on incorporating LLMs into their search engines. *Introducing the New Bing. Your AI-Powered Copilot for the Web*, MICROSOFT, https://www.microsoft.com/en-us/bing?form=MW00X7&ef_id=_k_CjwKCAjw__ihBhADEiwAXEazJqwgLjw-qjgkNNkcjAQXBiJnSH0KYAouv6A1rpB3eDUaT32lkZh5nhoCeyEQAvD_BwE_k_&OCID=AIDcmmf8m4fdss_SEM__k_CjwKCAjw__ihBhADEiwAXEazJqwgLjw-qjgkNNkcjAQXBiJnSH0KYAouv6A1rpB3eDUaT32lkZh5nhoCeyEQAvD_BwE_k_&gclid=CjwKCAjw__ihBhADEiwAXEazJqwgLjw-qjgkNNkcjAQXBiJnSH0KYAouv6A1rpB3eDUaT32lkZh5nhoCeyEQAvD_BwE&ch (last visited Apr. 27, 2023).

[91] CASETEXT, *supra* note 88.

[92] MRPC R. 5.5, Comment 2; Katz et al., *supra* note 31.

lacking rigorous training, LLMs are being trained by lawyers with vast arrays of legal text and could conceivably surpass average practicing lawyers in the provision of legal services.[93] Indeed, as mentioned above, ChatGPT can already pass the Uniform Bar Exam, and public court records provide a trove of legal text with which to train it to better understand any kind of complaint, brief, motion, or opinion.[94] Still, policy arguments and projections about the future capabilities of LLMs aside, for now the statutory text in most states is clear enough: companies may absolutely not provide "legal services" if those services are not being provided by a company lawyer.

Second, in states like Texas, where individuals can avoid liability simply by informing users of their non-licensed status, LLMs may find a safe harbor so long as they only service Texas residents.[95] However, Texas appears to be the exception that proves the rule, as no other state permits such an arrangement.[96]

Third, it is possible LLMs can shield themselves from *Janson*-type liability (again, in states like Texas) simply by preventing their algorithms from filling out forms on behalf of their users. Again, the Texas statute permits "the design, creation, publication, distribution, display, or sale, including publication, distribution, display, or sale by means of an Internet web site, of written materials, books, forms, computer software, or similar products," so long as those products are clearly marked as not constituting legal advice. However, as, again, LLMs thus far have poor, easily sidestepped guardrails in place, this will require greater attention from companies looking to avoid UPL liability in the future.

IV. RECOMMENDATION

Companies employing LLMs intending to use them to provide anything even approximating legal services are in a difficult spot. By all indications, virtually every state is outwardly hostile to the idea of non-lawyers providing legal services.[97] However, what counts as a "legal service" is not clearly defined, and even when UPL cases do reach the courts, they seem hesitant to find companies employing law-adjacent experts, like realtors and bank officers, liable.[98] Further, any attempt to fill out or draft a legal document on behalf of a client seems likely to provoke sanctions.[99] And even if a company tries to disclaim liability for providing such a basic legal service, they may still run afoul of the FRCP reasonable inquiry requirement.[100] For now, the best course for companies employing LLMs is likely to

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[93] CASETEXT, *supra* note 88.
[94] Katz et al., *supra* note 31.
[95] TEX. GOVT. CODE ANN. § 81.101(c).
[96] *See* Heinselman, *supra* note 55, Table of Cases, Laws, and Rules.
[97] *See generally supra* Section III.b.
[98] *See generally supra* Section III.c.
[99] Janson v. LegalZoom.com, Inc., 802 F.Supp.2d 1053, 1064 (8th Cir. 2011).
[100] *Id.*

avoid using LLMs to provide legal advice directly to consumers and to enhance guardrails preventing users from querying them for legal advice. Any LLM output should be run by company attorneys, and only after those attorneys have a personal consultation with the client in question and performed their own fact investigations. Companies can hope that the past trend of UPL cases rarely reaching the courts will continue, but the high-profile DoNotPay incident makes that possibility seem increasingly distant. In short, the line between UPL and legitimate non-legal business is too poorly drawn, too inconsistently enforced, and too cumbersome to comply with for any LLM provider to try to wade into the field with a truly "out-of-the-loop" model at this point.

V. CONCLUSION

While it may be some time before LLMs are able to provide expert-level legal advice, the technology is improving rapidly, and businesses would do well to keep up with advancements in the field. Policymaking bodies like state legislatures and bar associations should also take note, as LLMs offer one potential tool to improve efficiency and alleviate the massive legal services gap for low-income individuals in the future.[101] Still, anyone interested in using the technology should be cautious, as generative AI seems likely to remain a legal and ethical minefield for some time.

[101] *See* Eric Eckert, *Baylor Law School: '100 Million Americans Can't Afford Legal Services. What Can We Do About It?*, BAYLOR U. (Sept. 15, 2016), https://news.web.baylor.edu/news/story/2016/baylor-law-school-100-million-americans-cant-afford-legal-services-what-can-we-do#:~:text=%22We%20said%2C%20'More%20than,lawyers%20to%20open%20law%20firms (Baylor Law professor estimating that over 100 million Americans cannot afford legal services).