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NATIONAL AIRLINE POLICY

Timothy M. Ravich[*]

The "innovation" of ancillary fees for carry-on baggage, seat selection, and in-flight amenities, to say nothing of the inefficiency of congestion and delays caused by an old aviation infrastructure, has impaired some of the most important promises of airline deregulation for airline passengers. Meanwhile, airline carriers themselves are concerned about passenger fees they must charge, taxes they must bear, an aging air traffic system in which they must operate, and threats they daily confront in the form of national security risks and competition from state-sponsored foreign airlines. These realities suggest that the time is at hand for a national aviation policy.

This Article is the first to evaluate the legal implications of a proposed national aviation policy. An important part of this discussion involves presentation of recent decisional law—including Northwest, Inc. v. Ginsberg and Spirit Airlines, Inc. v. Dep't of Transp.—along with a pending federal case attempting to enforce private passenger rights under RICO. These cases, along with pending legislation purportedly aimed at improving the experience of airline passengers, illustrate a deep disconnect between passengers and airlines, on the one hand, and airlines and aviation regulators, on the other hand.

In all, while a national airline policy may be desirable, the industry's victim narrative advanced in the call for such legislative and regulatory reform is unhelpful. Moreover, the unilateral view that the federal government is both the villain and savior of business realities borne out of deregulation policy deflects and misses an opportunity for airlines themselves to self-

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examine legal and business practices that disappoint and aggravate their customers. In this context, this Article suggests that a national aviation policy is a pro-business initiative more than a pro-customer campaign and invites a multi-lateral approach to reforming national airline service, beginning with the industry and traveling public disabusing themselves of the notion that airline profit is a "dirty word" that should be sacrificed for illusory lower fares

I. INTRODUCTION

In the decade following the violence of September 11, 2001, the U.S. airline industry has lost over $35 billion and nearly a third of its workforce (*e.g.*, 150,000 jobs), due to recession, fuel prices, and industry bankruptcies.[1] Aggravating these business realities is an onerous regulatory regime that diverts nearly twenty percent of a domestic airline ticket in the United States—$61 of a typical $300 roundtrip fare—to the federal government to satisfy seventeen different aviation fees and taxes. The airline industry is unlikely to avoid further excises as Congress recently enacted the Bipartisan Budget Act of 2013, increasing

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1 *Why You Should Want a National Airline Policy*, BLUE TALES (Sept. 24, 2013), http://blog.jetblue.com/index.php/2013/09/24/why-you-should-want-a-national-airline-policy/.

Transportation Security Administration ("TSA") fees at an annual cost of over $1 billion to the airline industry.[2] And, on July 21, 2014, regulators increased a "September 11th Security Fee," costing passengers $5.60 per one-way trip.[3] Denouncing these and other facts and figures, the self-described industry trade organization for the leading airlines in the country, Airlines for America ("A4A"), has called for a National Airline Policy.[4]

Designed to spur economic growth and create more high-paying U.S. jobs,[5] the proposed national airline policy is centered on several priorities: the reduction of aviation taxes, reformation of regulatory burdens on the commercial airline industry, modernization of the national airspace system, enhancement of global competitiveness, and mitigation of jet fuel price volatility.[6] This Article, the first to evaluate the campaign for a national airline policy in the context of existing statutory and decisional law, agrees with the A4A's objectives, but questions the industry's victim narrative (though not necessarily the data) advanced in the call for legislative and regulatory reform of commercial aviation rules and regulations. The unilateral view that the federal government is both the villain and savior of business realities borne out of deregulation policy deflects and misses an opportunity for airlines themselves to self-examine legal and business practices that disappoint and aggravate consumers of commercial air transportation.

Indisputably, the airline industry is taxed aggressively relative to its contribution to the domestic and global economy. A4A effectively makes this argument by noting that commercial aviation generates approximately $1 trillion annually in economic activity and five cents of every dollar in gross domestic product.[7] Despite this contribution and the public good served by commercial aviation, federal levies imposed on the airline industry exceed the rate of government "sin taxes" attached to

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[2] Bipartisan Budget Act of 2013, Pub. L. No. 113-67, 127 Stat. 1165.

[3] *See*, *e.g.*, Adjustment of Passenger Civil Aviation Security Fee, 79 Fed. Reg. 35,462 (June 20, 2014) (to be codified at 49 C.F.R. pt. 1510); *see also* Bill Poling, *DOT's Proposed Rules Draw ire of Most in Travel Industry*, TRAVEL WKLY. (Oct. 5, 2014), *available at* http://www.travelweekly.com/Travel-News/Government/Proposed-rules-draw-ire-of-most-in-travel-industry/.

[4] *See*, *e.g.*, Madhu Unnikrishnan, *Airline Trade Group Lobbies for National Airline Policy*, AV. DAILY, Feb. 29, 2012, at 2012 WLNR 5985765.

[5] Nicholas E. Calio, *Nation Needs a New Airline Policy*, THE HILL (Dec. 4, 2012, 8:00 PM), http://thehill.com/blogs/congress-blog/economy-a-budget/270883-nation-needs-a-new-airline-policy.

[6] AIRLINES FOR AMERICA, 2014 LEGISLATIVE AND REGULATORY PRIORITIES—ENACTMENT OF A NATIONAL AIRLINE POLICY (April 2014).

[7] *Id*.

the purchase of products such as alcohol and cigarettes.[8] While this fact casts the commercial airline industry in a sympathetic light, individual carriers persist in a failed marketing effort that perpetually and artificially depresses air fares while collecting more than $6 billion in revenue over six years in ancillary baggage and reservation charges that consumers despise.[9] In this context, the call for a national airline policy is more complex than a garden-variety protest against "big government" and not as simple as the singling out of a particular industry as A4A supposes. Indeed, the merits of a national airline policy are dubious after actual or perceived business disadvantages endured by the nation's airlines are measured alongside advantages the airline industry has enjoyed under decisional law interpreting the Airline Deregulation Act of 1978.

This Article evaluates the call for a national airline policy as a matter of law and business and aims to expose a mismatch between the letter of existing aviation laws and airline customer service, on the one hand, and the spirit of airline deregulation policy, on the other hand. Existing deregulatory rules are out of sync with industry and consumer wellbeing. As such, rather than framing the state of the commercial airline industry as pitting the federal government against airlines, or as airlines against consumers, this Article takes the position that a proper national airline policy should be a bilateral effort of public and private actors in the commercial aviation sector working to optimize what is, or has become, a public utility. Part II of this Article overviews the statutory framework in which commercial airlines operate. Part III evaluates the major court opinions illustrating the imperfect rights both airlines and passengers have in the deregulated marketplace. Ultimately, this Article suggests that a national aviation policy is a pro-business initiative more than a pro-customer campaign while inviting both the industry and traveling public to disabuse themselves of the notion that airline profit is a "dirty word" that should be sacrificed for illusory lower fares.

II. THE LAW AND POLICY OF AIRLINE DEREGULATION

The commercial airline industry is no more deregulated than a democratic government is unbound by rules. Strictly speaking, airlines

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[8] *Id*.; *see also* United Airlines, *Airlines for America Promotes a National Airline Policy*, Dec. 16, 2013, at https://hub.united.com/en-us/news/company-operations/pages/a4a-promotes-national-airline-policy.aspx.

[9] *Extra Baggage*, AVIATION WK. & SPACE TECH., Aug. 25, 2014, at 19. *See also* David Berg, *DOT's "Transparency of Airline Ancillary Fees" Rulemaking is Bad Policy and Wrong on the Law*, 27 AIR & SPACE LAW. (2014).

are free to compete in the marketplace as a matter of law. Yet, there are few industries more heavily supervised nationally and worldwide than the commercial aviation sector.[10] In the past few years alone, Congress has enacted numerous statutes and regulations to advance safety and security and consumer welfare.[11] For example, in 2010, Congress passed the Airline Safety and Federal Aviation Administration Extension Act (*e.g.*, Airline Safety Act) to address issues of pilot fatigue and crew training and rest requirements.[12] In 2012, the Federal Aviation Administration ("FAA") issued a notice of proposed rulemaking to revise a ratings and certification system for repair stations and air carrier maintenance outfits.[13] In 2013, the FAA revamped its rules on pilot qualification and service and use of crewmembers and aircraft dispatchers.[14] Most recently, the FAA relaxed its rules on the use of portable electronic devices for passengers during taxiing and flight.[15] Indeed, from crew qualifications to passenger seat belt requirements, airline operations are extensively regulated. Moreover, on top of an extensive national framework of statutes, court decisions, advisories and policies, orders, and guidance statements, is a substantial body of international treaties, protocols, annexes, and authorities relating to international aviation operations and economics.[16]

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[10] *See* Peter C. Carstensen, *Evaluating "Deregulation" of Commercial Air Travel: False Dichotomization, Untenable Theories, and Unimplemented Premises*, 46 WASH. & LEE L. REV. 109, 116 (1989) (clarifying: "dichotomization [between regulation and deregulation] is false . . . 'Deregulation' has in fact meant eliminating a few, specific controls while retaining all others. Air travel today, [for example,] as in the past, is totally dependent on the existence and effective operation of such industry specific controls as the FAA's air traffic system.").

[11] *See* Jennifer P. Henry & Mackenzie S. Wallace, *Buried in Regulations*, 43-SPG BRIEF 50 (2014).

[12] *See* Airline Safety and Federal Aviation Administration Extension Act of 2010, Pub. L. No. 111-216, § 212, 124 Stat. 2348, 2362-65; *see also* Flightcrew Member Duty and Rest Requirements, 77 Fed. Reg. 330 (Jan. 4, 2012) (codified at 14 C.F.R. pts. 117, 119, 121); Clarification of Flight, Duty, and Rest Requirements, 78 Fed. Reg. 14,166 (Mar. 5, 2013) (codified at 14 C.F.R. pts. 117, 121).

[13] Repair Stations, 77 Fed. Reg. 30,054 (proposed May 21, 2012) (to be codified at 14 C.F.R. pts. 43, 91, 145).

[14] *See* Pilot Certification and Qualification Requirements for Air Carrier Operations, 78 Fed. Reg. 42,324 (July 15, 2013) (codified at 14 C.F.R. 61, 121, 135, 141, 142); *see also* Qualification, Service, and Use of Crewmembers and Aircraft Dispatchers, 78 Fed. Reg. 67,800 (Nov. 12, 2013) (codified at 14 C.F.R. pt. 121).

[15] Prohibition on Personal Use of Electronic Devices on Flight Deck, 79 Fed. Reg. 8257 (Feb. 12, 2014) (codified at 14 C.F.R. pt. 121).

[16] *See, e.g.*, Convention for the Unification of Certain Rules for International Carriage by Air, May 28, 1999, *reprinted in* S. Treaty Doc. No. 106-45, 1999 WL 33292734 (2000).

While the chief priority of aviation regulators here and abroad centers on safety, customer service issues have dominated the legal and policy landscape in the three decades since enactment of the Airline Deregulation Act of 1978. Indeed, contemporary aviation rules are shaped largely by two events: first, a series of public relations nightmares in the 1990s involving stranded airline passengers, and second, the sequence of national traumas inflicted when commercial jets were hijacked and crashed into the World Trade Center Twin Towers in New York and the Pentagon in Virginia in 2001.

During the late 1990s, airline passengers (among whom are federal legislators themselves) had become frustrated by the broken promises of commercial airline deregulation. They demanded better service as a matter of law, *e.g.*, an airline passenger bill of rights.[17] That largely receded after September 11th as airline passengers focused on matters of life and death rather than pillows and peanuts. In fact, the evolution of aviation law has historically vacillated from passenger convenience to passenger safety.

A. Statutory Origins of Airline Economics

1. The Civil Aeronautics Acts

Modern commercial air transportation derives from airmail service, which began in 1911.[18] By the late 1920s, airplane technology and airmail service were reliable as newly formed "airlines" bid competitively for contract airmail routes pursuant to the Airmail Act of 1925.[19] Congress also passed the Air Commerce Act of 1926,[20] creating

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[17] A blizzard in Detroit that stranded more than two dozen airplanes for up to eleven hours prompted the proposal of various legislation titled "Airline Passengers' Bill of Rights." One bill proposed the imposition of financial liability on airlines for "excessive departure or arrival delay," *i.e.*, a period of time excess of two hours —

> (A) in the case of departure, beginning when the door of an aircraft is closed at an airport and ending when the aircraft takes off from the airport or when the door of the aircraft is open for deplaning of passengers at the airport; and
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> (B) in the case of arrival delay, beginning upon touchdown of an aircraft at an airport and ending when the door of the aircraft is open for deplaning of passengers at the airport.

Airline Passenger Bill of Rights, H.R. 700, 106th Cong. (1999). The penalty for a delay between two and three hours would have been 200 percent of the ticket purchase price, plus another 100 percent for each additional hour (or portion thereof) beyond a three hour delay.

[18] CAMILLE ALLAZ, HISTORY OF AIR CARGO AND AIRMAIL FROM THE 18TH CENTURY (2005).

[19] Air Mail (Kelly) Act, Pub. L. No. 68-359, 43 Stat. 805 (1925).

a substantial role for the federal government to promote air commerce and safety (*e.g.*, aircraft registration and licensing, and pilot medical certification).

In 1930, Congress enacted the Airmail Act of 1930 ("McNary-Watres Act"), which compensated airlines for airmail service on the basis of space instead of weight—an incentive that encouraged the use of aircraft suitable for commercial passenger purposes, not merely mail delivery.[21] A national, market-driven, federally regulated airline transportation system—precursor principles underlying the Airline Deregulation Act of 1978—began to take shape under the McNary-Waters Act through which

> [r]oute certificates were promptly issued on several routes; numerous extensions were granted; routes were consolidated; several carriers were required to carry passengers; new schedules were authorized, partly with an eye to passenger needs; and mail rates were increased to help meet the costs incurred in the transition to passenger service. An elaborate rate formula was established, providing for "variables" in rates, based primarily on amount of mail space reserved in the plane, and taking into account the flying conditions over the particular route, equipment used, and passenger capacity furnished.[22]

Despite this seemingly orderly certification scheme, a congressional committee led by Hugo Black, an Alabama Senator and future Justice of the Supreme Court of the United States, suspected the new airlines were colluding in order to end-run the competitive airmail bidding process.[23] Consequently, President Roosevelt ordered cancellation of all domestic airmail contracts and directed the army to transport airmail.[24] The decision was disastrous as military pilots were not as experienced as early airline pilots, leading Congress to enact the Airmail Act of 1934 ("Black-McKellar Act"),[25] which reestablished private air carriage and a comprehensive system of federal aviation regulation. By 1936, airline

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20 Air Commerce Act of 1926, Pub. L. No. 69-254, 44 Stat. 568.

21 Air Mail Act of 1930, Pub. L. No. 71-178, 46 Stat. 259.

22 Frederick A. Ballard, *Federal Regulation of Aviation*, 60 HARV. L. REV. 1235, 1245-46 (1947).

23 *See generally* Case Comment, *Merger and Monopoly in Domestic Aviation*, 62 COLUM. L. REV. 851, 854-55 (1962).

24 *See* Exec. Order No. 6591, Feb. 9, 1934.

25 Airmail Act of 1934, Pub. L. No. 73-308, 48 Stat. 933.

revenue from passenger traffic exceeded airmail income. Congress then enacted the Civil Aeronautics Act of 1936 ("McCarran-Lea Act"), which consolidated diffuse regulatory responsibility in the Civil Aeronautics Authority,[26] which was later split into the Civil Aeronautics Administration ("CAA") and Civil Aeronautics Board ("CAB").[27]

2. Federal Aviation Act of 1958

The CAA remained in force until the late 1950s, when jurisdictional issues arose between military and civilian airspace and a series of mid-air collisions exposed the need for uniform air space management across the nation.[28] Specifically, in 1956, a Kansas City-bound Trans World Airlines Constellation collided with a Chicago-bound United Airlines DC-7, and fell into the Grand Canyon.[29] In 1957, a Douglas Aircraft Company DC-7 and a United States Air Force F-89 collided near Sunland, California; the fighter plane crashed into nearby mountains while the DC-7 crashed into a junior high school playground, killing three students and injuring seventy others.[30] As a consequence, Congress enacted the Federal Aviation Act of 1958 to replace the Civil Aeronautics Act effective at that time.[31]

The Federal Aviation Act of 1958 was nearly identical to its predecessor law except for its coverage of air safety. It established a "new Federal agency with powers adequate to enable it to provide for the safe and efficient use of the navigable airspace by both civil and military operations."[32] While the Federal Aviation Act of 1958 shifted the CAA's powers to the Federal Aviation Agency (predecessor of today's FAA), the CAB continued to have regulatory authority over interstate air fares and jurisdiction over airline trade practices.[33]

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26 Civil Aeronautics Act, Pub. L. No. 75-706, 52 Stat. 973 (1936).

27 NAT'L ARCHIVES, RECORDS OF THE CIVIL AERONAUTICS BOARD (CAB), *available at* http://www.archives.gov/research/guide-fed-records/groups/197.html (on file with U.S. Nat'l Archives labeled "197.2.2 Records of the Civil Aeronautics Authority (CAA)" in College Park, Md.).

28 *See generally* Justin T. Barkowski, Comment, *Managing Air Traffic Congestion through the Next Generation Air Transportation System: Satellite-Based Technology, Trajectories, and—Privatization?*, 37 PEPP. L. REV. 247, 259 (2010).

29 *See*, *e.g*., David E. Rigney, *Death or Injury to Occupant of Airplane from Collision or Near-Collision with Another Aircraft*, 64 A.L.R. 5th 235 § 9(a) (1998).

30 *Id*.; *see also* Paul Stephen Dempsey, *Compliance and Enforcement in International Law: Achieving Global Uniformity in Aviation Safety*, 30 N.C. J. INT'L L. & COM. REG. 1, 44, n.213 (2004).

31 Federal Aviation Act of 1958, Pub. L. No. 85-726, 72 Stat. 731; *see* Barkowski, *supra* note 28, at 259.

32 H.R. Rep. No. 85-2360, pt. 1, at 1 (1958), *reprinted in* 1958 U.S.C.C.A.N. 3741.

33 *See* § 201, 72 Stat. at 741 (codified as amended at 49 U.S.C. § 1506 (1988)).

The CAB regime continued until the late 1970s, when Congress overhauled the entire commercial aviation marketplace by empowering the carriers themselves to determine and manage core aspects of their business and operation, including air fare, routes, and services. Significantly, the Federal Aviation Act of 1958 did not expressly preempt state regulation of commercial airlines. Like the CAA, the new law contained an express "savings clause" providing that "[n]othing . . . in this chapter shall in any way abridge or alter the remedies now existing at common law or by statute, but the provisions of this chapter are in addition to such remedies."[34] As a result, states were not disallowed from enforcing their own laws, including the regulation of intrastate airfares[35] and the enforcement of laws barring deceptive trade practices.[36] In 1978, however, Congress determined that efficiency, low prices, innovation, variety, and quality would best be promoted by loosening and dismantling federal economic regulation of the nation's air carriers and preventing the states from frustrating these goals by creating economic regulations of their own with respect to the airline industry.[37]

3. Airline Deregulation Act of 1978

Airline deregulation occurred more than thirty years ago when Congress made a policy determination that "maximum reliance on competitive market forces" would best further "efficiency, innovation, and low prices" as well as "variety [and] quality . . . of air transportation services."[38] This represented an about-face for an industry that effectively had operated as a sort of cartel between 1938 and 1978. Prior to deregulation, the federal government controlled core aspects of airline economics, including the rates, routes, and service airlines could offer for public consumption.[39] It did so through the CAB, whose jurisdiction and powers over the business affairs of all commercial airlines were exclusive, including with respect to the grant of operating permits and

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[34] 49 U.S.C. § 1506 (1958) (recodified at 49 U.S.C. § 40120(c).

[35] *See, e.g.*, California v. Civil Aeronautics Bd., 581 F.2d 954 (D.C. Cir. 1978).

[36] *See* Nader v. Allegheny Airlines, Inc., 426 U.S. 290 (1976).

[37] Airline Deregulation Act of 1978, H.R. Rep. 95-211, 95th Cong. 2d Sess. (1978).

[38] 49 U.S.C. app. §§ 1302(a)(4), 1302(a)(9); *see also* Charas v. Trans World Airlines, Inc., 160 F.3d 1259, 1261 (9th Cir. 1999) (citing H.R. Conf. Rep. No. 95-1779, 95th Cong., 2d Sess. 53 (1978)).

[39] The Federal Aviation Administration ("FAA") is the successor authority to the Civil Aviation Authority (by which the Civil Aeronautics Board was referred) pursuant to the Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 98-443, 98 Stat. 1703 (1984).

market entry and anti-competitive practices.[40] In this regulatory climate, airlines were essentially immunized from the type of competition that has occurred in the last two decades, resulting in sweeping mergers and consolidation and the survival of but three major carriers in the United States to date (*e.g.*, American (USAir), United (Continental), Delta (Northwest)).[41]

Interestingly, customer satisfaction was a distinguishing feature of the CAB-regulated commercial airline marketplace. During the years of CAB regulation, consumers ranked airlines at the top of consumer satisfaction and confidence surveys.[42] Nevertheless, deregulatory impulses in the 1970s took hold and ushered in the modern era of airline travel. President Jimmy Carter urged Congress "to enact, without delay, regulatory reform of domestic commercial aviation."[43] The airline industry did not share this call for regulatory overhaul. As one industry observer put it, "[i]t was, after all, the airlines themselves who invited the government to impose regulation in order to save them from competition, and only United among the then trunk carriers supported deregulation in 1978."[44] In any event, Congress enacted the Airline Deregulation Act of 1978, one year after deregulating cargo aviation.[45] Without question, the economic deregulation of the commercial airline industry has democratized air travel and assured consumers generally low fares. Indeed, average prices for domestic routes today are competitive with and even lower than fares (in constant dollars) twenty years ago, according to the Bureau of Transportation Statistics.[46]

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40 *See*, *e.g.*, Domestic Passenger-Fare Level Policies, Domestic Passenger-Fare Structure Policies and Discount Fare Policy, 43 Fed. Reg. 39,522 (Sept. 5. 1978) (codified at 14 C.F.R. pt. 399).

41 The "major" or "legacy" carriers are often distinguished from "low cost carriers" such as Southwest, JetBlue, Allegiant, Frontier, and "ultra low cost carrier" Spirit. Historically, American, Eastern, Transcontinental & Western Air (later TWA), and United Air Lines comprised the "Big Four" or the so-called major or trunk carriers. Two of these carriers are extinct, as are historic airlines such as Pan Am, Braniff, National, Northeast, Piedmont, and Eastern.

42 *See*, *e.g.*, James W. Callison, *Airline Deregulation—Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 964 n.4 (1980).

43 *See* Reduced Federal Regulation of the Domestic Commercial Airline Industry, 13 WEEKLY COMP. PRES. DOCS. 285 (March 4, 1977).

44 Michele McDonald, *Trouble on the Hill; Congress Considers Possible Airline Regulations*, AIR TRANSP. WORLD, June 1, 2001, at 95.

45 Air Cargo Deregulation Act, Pub. L. No. 95-163, 91 Stat. 1278-89 (1977) (codified as amended at 49 U.S.C. §§ 1301-1552 (1982)).

46 DEP'T OF TRANSP., BUREAU OF TRANSP. STATISTICS, ANNUAL U.S. DOMESTIC AVERAGE ITINERARY FARE IN CURRENT AND CONSTANT DOLLARS, *available at*

But, the core legal and economic assumptions and promises of deregulation have failed by most accounts. Competition has given way to industry consolidation. Actually high barriers to entry have supplanted theories of freely contestable markets. Nonstop service to many markets has been replaced with the hub-and-spoke model of operations while some small communities have lost major airline service altogether. In all, neither airline passengers nor airlines themselves are satisfied with the state of commercial airline policy.[47]

Today, more than thirty years after the enactment of federal airline deregulation, the domestic airline industry has shrunk. Every major airline has sought bankruptcy protection (at least once), bringing into question the central assumption of the 1970s deregulation era, *i.e.*, free competition in a market space with few barriers to entry. The persistence of low air fares is regularly cited as proof of the success of airline deregulation, but where base air fares have remained affordable, the overall expense of commercial flying is higher for travelers at particular origins and destinations.[48] This is true despite—or in some cases because of—the emergence of "low-cost" or "ultra-low-cost" alternatives to "legacy" carriers. The "innovation" of ancillary fees for carry-on baggage, seat selection, and in-flight amenities, to say nothing of the inefficiency of congestion and delays caused by an old aviation infrastructure, has impaired some of the most important promises of airline deregulation for airline passengers. Indeed, by the mid-1980s, consumer dissatisfaction with the airline industry had reached crises proportions and the need for executive, legislative, and judicial intervention in the arena of aviation consumer practices presented.

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http://www.rita.dot.gov/bts/airfares/programs/economics_and_finance/air_travel_price_index/html/AnnualFares.html.

[47] *But see* Press Release, J.D. Power, Passengers Tolerate Higher Costs and Fees of Traveling as Airline Satisfaction Continues to Improve, but Still Trails Other Industries (May 14, 2014), *available at* http://www.jdpower.com/press-releases/2014-north-america-airline-satisfaction-study.

[48] Steven A. Morrison & Clifford Winston, *The Remaining Role for Government Policy in the Deregulated Airline Industry*, in DEREGULATION OF NETWORK INDUSTRIES: WHAT'S NEXT? 1, 5 (Sam Peltzman et al., eds., 2000).

B. Decisional Law

1. Airline Consumer Protection under State Tort Law

a. Morales v. Trans World Airlines

In June 1987, the National Association of Attorneys General ("NAAG") commissioned a Task Force of states to study the advertising and marketing practices of the U.S. airline industry in the United States and to evaluate the scope of existing unfair and deceptive airline advertising practices.[49] In terms of airline customer service, the conclusion they reached was a condemnation of the then-nine-year old deregulation policy:

> Consumer dissatisfaction with the airline industry has reached crisis proportions. Federal agencies have focused their attention on airline scheduling problems, on-time performance, safety, and other related issues, but have not addressed airline advertising and frequent flyer programs. Unchecked, the airlines have engaged in practices in these areas that are unfair and deceptive under state law. The individual states through NAAG can play an important role in eliminating such practices . . . .[50]

Consequently, the NAAG adopted Air Travel Industry Enforcement Guidelines containing standards governing the content and format of airline advertising, the awarding of premiums to regular customers ("frequent flyers"), and the payment of compensation to passengers who voluntarily yield their seats on overbooked flights.[51]

The NAAG Guidelines did not create any new laws or regulations regarding the advertising practices or other business practices of the airline industry, but merely explained in detail how existing state laws would apply to airfare advertising and frequent flyer programs.[52] For example Section 2 of the Guidelines governed print advertisements of fares, requiring "clear and conspicuous disclosure [defined as the lesser of one-third the size of the largest typeface in the ad or ten-point type] of restrictions such as" limited time availability, limitations on refund or exchange rights, time-of-day or day-of-week restrictions, length-of-stay

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49 Morales v. Trans World Airlines, Inc., 504 U.S. 374, 379 (1992).

50 *Id.* at 418-19.

51 *Id*. at 379, Appendix.

52 *See id.* at 407.

requirements, advance-purchase and round-trip-purchase requirements, variations in fares from or to different airports in the same metropolitan area, limitations on breaks or changes in itinerary, limits on fare availability, and "[a]ny other material restriction on the fare."[53] Section 2.2 imposed similar restrictions on broadcast advertisements of fares; and section 2.3 required billboard fare ads to state clearly and conspicuously "substantial restrictions apply" if there were any material restrictions on the fares' availability.[54] The Guidelines further mandated that an advertised fare be available in sufficient quantities to "meet reasonably foreseeable demand" on every flight on every day in every market in which the fare is advertised; if the fare was not available on this basis, the ad would have to contain a "clear and conspicuous statement of the extent of unavailability."[55] Section 2.5 required that the advertised fare include all taxes and surcharges; round-trip fares, under Section 2.6, would disclose at least as prominently as the one-way fare when the fare was only available on round trips; and Section 2.7 prohibited use of the words "sale," "discount," [or] 'reduced'" unless the advertised fare was available only for a limited time and was "substantially below the usual price for the same fare with the same restrictions."[56]

The U.S. Department of Transportation ("DOT") and the Federal Trade Commission challenged the Guidelines on preemption and policy grounds; nevertheless, the attorneys general of seven states sent a memorandum to the major airlines announcing that they intended to sue, asserting that "it has come to our attention that although most airlines are making a concerted effort to bring their advertisements into compliance with the standards delineated in the . . . Guidelines for fare advertising, many carriers are still [not disclosing all surcharges]."[57]

In response, the airlines themselves filed suit in federal district court seeking a declaration that state regulation of fare advertisements was preempted under the Airline Deregulation Act and requesting an injunction restraining any state action in conjunction with the Guidelines that would regulate airline rates, routes, or services, or airline advertising and marketing.[58] Given the likelihood of success on preemption grounds, the federal district court ruled in favor of the airlines and issued a preliminary injunction.[59] The Fifth Circuit Court of Appeals affirmed,

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53 *Id*.
54 *Id*.
55 *Id*.
56 *Id*.
57 *Id.*
58 *Id*. at 380.
59 *Id.*

after which the district court enjoined the states from taking "any enforcement action" which would restrict "any aspect" of respondents' fare advertising or operations relating to rates, routes, or services.[60] The Court of Appeals once again affirmed and the Supreme Court of the United States granted *certiorari*.[61]

Justice Scalia, writing for the majority, addressed the issue of whether the Airline Deregulation Act preempted the states from prohibiting allegedly deceptive airline fare advertisements through enforcement of their general consumer protection statutes.[62] Beginning with the language of the deregulation statute, the Court recognized that Congress had intended to expressly preempt states from "enact[ing] or enforc[ing] any law, rule, regulation, standard, or other provision having the force and effect of law relating to rates, routes, or services of any air carrier."[63]

Focusing on the phrase "relating to," the Court concluded that the guidelines impermissibly established binding requirements as to how tickets could be marketed if they were to be sold at given prices.[64] In doing so, the Court reasoned that "state restrictions on fare advertising have the forbidden significant effect upon fares."[65] Moreover, the Court offered a defense of the very marketing practices that state attorneys general regarded as deceptive:

> Although the State insists that [the Guideline is] not compelling or restricting advertising, but is instead merely preventing the market distortion caused by "false" advertising, in fact the dynamics of the air transportation industry cause the guidelines to curtail the airlines' ability to communicate fares to their customers. The expenses involved in operating an airline flight are almost entirely fixed costs; they increase very little with each additional passenger. The market for these flights is divided between consumers whose volume of purchases is relatively insensitive to price (primarily business travelers) and consumers whose demand is very price sensitive indeed (primarily pleasure travelers).

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60 *Id.*
61 *Id.*
62 *Id*. at 383.
63 *Id*. at 384.
64 *Id*.
65 *Id*. at 388.

> Accordingly, airlines try to sell as many seats per flight as possible at higher prices to the first group, and then to fill up the flight by selling seats at much lower prices to the second group (since almost all the costs are fixed, even a passenger paying far below average cost is preferable to an empty seat). In order for this marketing process to work, and for it ultimately to redound to the benefit of price-conscious travelers, the airlines must be able to place substantial restrictions on the availability of the lower priced seats (so as to sell as many seats as possible at the higher rate), and must be able to advertise the lower fares.
>
> The Guidelines severely burden their ability to do both at the same time: The sections requiring "clear and conspicuous disclosure" of each restriction make it impossible to take out small or short ads, as does (to a lesser extent) the provision requiring itemization of both the one-way and round-trip fares.
>
> Since taxes and surcharges vary from State to State, the requirement that advertised fares include those charges forces the airlines to create different ads in each market. The section restricting the use of "sale," "discount," or "reduced" effectively prevents the airlines from using those terms to call attention to the fares normally offered to price-conscious travelers.[66]

Finally, although it broadly interpreted the Airline Deregulation Act with respect to state regulation of airline economics, the Court explained that not all state actions that "relate to" rates, routes, or services were preempted:

> In concluding that the NAAG fare advertising guidelines are pre-empted, we do not, as Texas contends, set out on a road that leads to pre-emption of state laws against gambling and prostitution as applied to airlines. Nor need we address whether state regulation of the nonprice aspects of fare advertising (for example, state laws preventing obscene depictions) would similarly "relat[e] to" rates; the connection would obviously be far more

66 *Id*. at 389-90.

> tenuous . . . "[s]ome state actions may affect [airline fares] in too tenuous, remote, or peripheral a manner" to have pre-emptive effect. In this case . . . "[t]he present litigation plainly does not present a borderline question, and we express no views about where it would be appropriate to draw the line."[67]

Significantly, the Court concluded that its "decision does not give the airlines *carte blanche* to lie to and deceive consumers; the DOT retains the power to prohibit advertisements which in its opinion do not further competitive pricing."[68]

b. Spirit Airlines, Inc. v. Dep't of Transp.

In 2009, federal aviation lawmakers codified a rule entitled "Enhancing Airline Passenger Protections."[69] Effective April 29, 2010, air carriers were required to adopt contingency plans for hours-long tarmac delays, develop and publish customer service plans, and respond to consumer problems.[70] Through the new rule, DOT would consider continued delays on flights that are chronically late to be unfair and deceptive in violation of federal law. The rule was designed to "mitigate hardships for airline passengers during lengthy tarmac delays and otherwise to bolster air carriers' accountability to consumers."[71]

Importantly, despite its creation of rights for passengers—in substance the same or similar rights demanded a decade earlier in the call for an airline passengers' bill of rights—the rule made clear that no enforcement mechanism by passengers themselves existed. Indeed, the rule contains a particular provision entitled "Unfair and Deceptive Practice," stating "[a]n air carrier's failure to comply with the assurances required by this rule and as contained in its Contingency Plan for

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67 *Id*. at 390.

68 *Id.*

69 *See* Enhancing Airline Passenger Protections, 14 C.F.R. § 259 (2009).

70 *Id*.

71 For domestic flights, each "Contingency Plan for Lengthy Tarmac Delays" must provide an assurance that an air carrier will not permit an aircraft to remain on the tarmac for more than three hours unless the pilot-in-command determines there is a safety-related or security-related reason (*e.g*., weather, a directive from an appropriate government agency) why the aircraft cannot leave its position on the tarmac to deplane passengers; or air traffic control advises the pilot-in-command that returning to the gate or another disembarkation point elsewhere in order to deplane passengers would significantly disrupt airport operations. There are similar requirements for international flights. Additionally, for all domestic or international flights, air carriers are required under the rule to provide adequate food and potable water, operable lavatory facilities, and medical attention, if needed. *See* 14 C.F.R. § 259.4.

Lengthy Tarmac Delays will be considered an unfair and deceptive practice within the meaning of 49 U.S.C. 41712."[72] The provision concludes by stating that violations are "subject to enforcement action *by the Department*."[73] Thus, there was (and is) no private right of action for airline passengers for any violation of the "enhanced" passenger protection rules.[74] Airline passengers can complain to the government about their negative flight experience, but no direct judicial right or remedy against the airline exists. Despite this virtual immunity from direct passenger consumer action by operation of law, certain airlines persisted in attacking the government itself as a bad actor when it came to airfares and pricing.

Spirit Airlines led an effort by several airlines to challenge three of the DOT's passenger protection rules—the Airfare Advertising Rule, the Refund Rule, and the Post-Purchase Price Rule.[75] First, under the Airfare Advertising Rule, the DOT had regulated airfare advertising since 1984 by requiring airlines to disclose the "entire price to be paid by the customer to the air carrier."[76] Airlines may advertise the pre-tax price of tickets provided that the advertisement clearly discloses the amount of the tax.[77] For example, an airfare advertisement of "$167 base fare + $39 taxes and fees" is permissible even though consumers are left to compute the final price themselves—$206.[78] Citing consumer confusion, the DOT revised this policy to require airlines to state the total final price (*e.g.*, $206).[79] While airlines could still itemize their air fare (*e.g.*, the amount of the base fare, taxes, and other charges), the Airfare Advertising Rule disallowed airlines from displaying these price components

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72 14 C.F.R. § 259.4(f).

73 *Id*. (emphasis added).

74 *But see* 14 C.F.R. § 259.7 (requiring airlines to "make available the mailing address and e-mail or web address of the designated department in the airline with which to file a complaint about its scheduled service [and . . . to] acknowledge in writing receipt of each complaint regarding its scheduled service to the complainant within 30 days of receiving it and shall send a substantive written response to each complainant within 60 days of receiving the complaint. A complaint is a specific written expression of dissatisfaction concerning a difficulty or problem which the person experienced when using or attempting to use an airline's services.").

75 *See* Spirit Airlines, Inc. v. Dep't of Transp., 687 F.3d 403 (D.D.C. 2012).

76 *See* Statements of General Policy, 49 Fed. Reg. 49,440 (Dec. 20, 1984) (codified as amended at 14 C.F.R. § 399.84(a)).

77 *See* Enhancing Airline Passenger Protections, 75 Fed. Reg. 32,318, 32,327 (June 8, 2010) (explaining DOT enforcement policy regarding the 1984 rule).

78 *Spirit Airlines, Inc.*, *supra* note 75, at 408-09.

79 *See* Enhancing Airline Passenger Protections, 76 Fed. Reg. 23,110, 23,166 (Apr. 25, 2011) (amending 14 C.F.R. § 399.84(a)).

"prominently" or "in the same or larger size as the total price."[80] The airlines argued that "DOT provides no explanation [for] why the prominent disclosure of taxes and fees would be confusing to consumers," and that DOT acted arbitrarily and capriciously by "requir[ing] airlines to prominently and conspicuously disclose airline-imposed fees but . . . bury[ing] in fine print the taxes and fees that the government itself imposes on air transportation."[81]

The DOT responded that it "reasonably declined to allow the airlines to state, with equal prominence, the breakdown of that figure as between base fare, airline-imposed fees, and government taxes and fees" and clarified that its prohibition on prominently stating taxes "'means that the break-out of per-person charges cannot be in a more prominent place on a web page or in a print advertisement than the total advertised fare.'"[82] The United States Court of Appeals for the District of Columbia agreed, reasoning that

> nothing in the Airfare Advertising Rule requires airlines to hide the taxes—or, as Spirit's website puts it, the 'Government's Cut.' It just requires that the total, final price be the most prominently listed figure, relying on the reasonable theory that this prevents airlines from confusing consumers about the total cost of their travel. This limited imposition hardly amounts to an arbitrary exercise of DOT's statutory authority to prevent 'unfair or deceptive practice[s],' under 49 U.S.C. § 41712(a).[83]

The court also refused a First Amendment challenge of the Airfare Advertising Rule, concluding that without "doubt that DOT's final rule, which requires the total, final price to be the most prominently listed figure is 'reasonably related to the [government's] interest in preventing deception of consumers."[84] According to the court, the Airfare Advertising Rule did not "prohibit airlines from saying anything; it just requires them to disclose the total, final price and to make it the most prominent figure in their advertisements."[85] To make its point, the district court produced a screenshot of a sample flight advertised by Spirit's website and evaluated it as follows:

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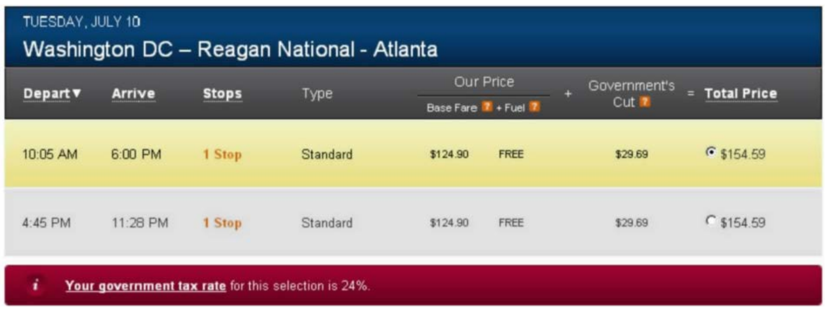
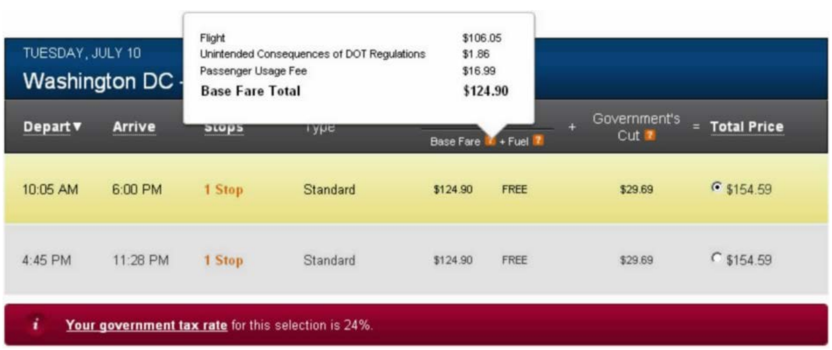
80 *Id*.
81 *Id.*
82 *Spirit Airlines, Inc.*, *supra* note 75, at 411.
83 *Id*.
84 *Id*. at 414-15.
85 *Id*. at 414.

Spirit's website prominently displays "Our Price"—broken down into "Base Fare + Fuel"—and then adds, with a plus sign, "Government's Cut," which is displayed clearly and separately, and then finally provides, in slightly larger font, the "Total Price." The website also separately states, underlined and in bold, the "government tax rate" for each flight price quote, so that consumers know the tax burden in both absolute and relative terms.



Moreover, a bright orange link (in the form of a question mark) appears next to each of those price components—*i.e.*, "Base Fare," "Fuel," and "Government's Cut"—and if one clicks that link, the site provides a further breakdown of what makes up the cost of airfare. For example, the base fare on domestic flights generally includes the cost of "Flight," a "Passenger Usage Fee," and what Spirit labels a fee for the "Unintended Consequences of DOT Regulations."[86]



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86 *Id.*

Given this, the district court resolved that:

> All of this demonstrates what the rule's text already tells us: the rule is aimed at providing accurate information, not restricting it. Nothing in the rule prohibits the airlines from separately alerting the public to the taxes imposed on air transportation . . .
>
> The airlines can even call attention to taxes and fees in their advertisements; what they cannot do is call attention to them by making them more prominent than the total, final price the customer must pay.[87]

The district court also rejected Spirit's challenge to the Refund Rule.[88] Under that rule, airline passengers may cancel reservations made a week in advance of the flight without penalty for twenty-four hours.[89] Spirit argued that the rule violated the Airline Deregulation Act and its prohibition on the regulation of airfares.[90] The district court disagreed, reasoning that "the rule has nothing to do with airfares. Instead, it regulates cancellation policies on the basis of a finding that existing practices were deceptive and unfair under 49 U.S.C. § 41712."[91] As such, the Refund Rule—developed as part of a systematic effort aimed at preventing unfair and deceptive practices—was not arbitrary or capricious as the airline contended.[92]

Finally, Spirit challenged the so-called Price Rule as arbitrary and capricious.[93] The rule itself prohibits airlines from increasing the price of travel post-purchase. The district court considered "whether DOT appropriately prohibited airlines from raising the price of airline tickets, carry-on luggage, or the first two checked bags after customers buy their tickets."[94] The airline contended that the basis for the rule—a concern that "some air tour operators were burying consumer notices about the possibility of price increases in their conditions of carriage"—had no relationship to raising the price of an optional service before a consumer purchases it—especially given that "under the status quo, airlines are prohibited from increasing prices without first giving consumers notice

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87 *Id.*
88 *Id.* at 416.
89 *Id.*
90 *Id.*
91 *Id.*
92 *Id.*
93 *Id*. at 410.
94 *Id.*

prices could go up."[95] In addition, Spirit argued that "a passenger can protect himself against future price increases by purchasing optional services at the same time as (or as soon as possible after) he purchases his ticket."[96] But, the district court noted, it was reasonable and evidence-based that "the DOT saw this as a classic bait and switch.[97] It found that when consumers purchase airline tickets, they assume that the price they pay for extra bags at the airport will be the price advertised when they bought their ticket.[98] Thus, DOT concluded, increasing the price of these very commonly purchased and practically necessary services (like the ability to carry bags onto the flight) amounts to an unfair practice."[99]

2. Contract Principles Applied to Airline Consumer Protection

a. American Airlines, Inc. v. Wolens

Soon after *Morales*, the Supreme Court again considered the preemptive effect of the Airline Deregulation Act in *American Airlines, Inc. v. Wolens*.[100] There, the Court evaluated the applicability of the Airline Deregulation Act within a tort as well as a contract context. Litigation in *Wolens* arose from a complaint that modifications made to American Airlines' AAdvantage program devalued credits that frequent flyer program members had earned.[101] Program changes included the imposition of capacity controls (limits on seats available to passengers obtaining tickets with AAdvantage credits) and blackout dates (restrictions on dates credits could be used).[102] While the passenger plaintiffs conceded that American Airlines had reserved the right to change AAdvantage terms and conditions, they sued for injunctive relief by challenging the retroactive application of such modifications as violative of the Illinois Consumer Fraud and Deceptive Business Practices Act.[103]

The Illinois Supreme Court rejected the claim, reasoning injunctive relief would involve the regulation of an airline's current rendition of services, a matter preempted by the Airline Deregulation Act.[104]

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95 *Id.* at 417.
96 *Id.*
97 *Id.*
98 *Id.*
99 *Id*.
100 *See* Am. Airlines, Inc. v. Wolens, 513 U.S. 219 (1995).
101 *Id*. at 225.
102 *Id.*
103 *Id*.
104 *See* Wolens v. Am. Airlines, Inc., 589 N.E.2d 533, 536 (Ill. 1992).

However, the state's high court did not dismiss the passengers' actions for monetary damages arising from allegations of breach of contract and violation of the Illinois consumer fraud act because federal airline deregulation policy disallowed "only those State laws and regulations that specifically relate to and have more than a tangential connection with an airline's rates, routes or services."[105] Given *Morales*, American Airlines petitioned for *certiorari*, asserting that the Illinois court had ruled inconsistently with Supreme Court precedence by narrowly construing the preemptive effect of the Airline Deregulation Act.[106]

Writing for the majority, Justice Ginsburg considered the scope of the Airline Deregulation Act, and specifically its application to the state-court suit brought by the airline's frequent flyer program participants, challenging the airline's retroactive changes in terms and conditions of the program.[107] The Court compared the Illinois consumer fraud act to the NAAG guidelines in *Morales* in that it "serves as a means to guide and police the marketing practices of the airlines [and] does not simply give effect to bargains offered by the airlines and accepted by airline customers."[108] The Court concluded that the deregulation act preempted the claims under the Consumer Fraud Act given the text of the preemption clause and "the congressional purpose of deregulation policy to leave largely to the airlines themselves, and not at all to states, the selection and design of marketing mechanisms appropriate to the furnishing of air transportation services."[109]

Next, American argued, and the Supreme Court agreed, that "Congress could hardly have intended to allow the States to hobble [competition for airline passengers] through the application of restrictive state laws."[110] Consequently, Justice Ginsberg concluded that,

> [w]e do not read the ADA's preemption clause . . . to shelter airlines from suits alleging no violation of state-imposed obligations, but seeking recovery solely for the airline's alleged breach of its own, self-imposed undertakings . . . .A remedy confined to a contract's terms simply holds parties to their agreements—in this

105 *Wolens*, *supra* note 100, at 225-26.
106 *Id.*
107 *Id*. at 228.
108 *Id.*
109 *Id*. at 220.
110 *Id.* at 228 (citing Brief for Petitioner at 27, Am. Airlines, Inc. v. Wolens, 513 U.S. 219 (1995) (No. 93-1286), 1994 WL 242545).

> instance, to business judgments an airline made public about its rates and services.[111]

The airline resisted this, not by arguing that its contracts lack legal force, but by identifying the DOT as the exclusively competent monitor of the airline's undertakings.[112] The United States maintained that the DOT had neither the authority nor the apparatus required to superintend a contract dispute resolution regime.[113]

The Court acknowledged that after Congress dismantled the regime by which the CAB set rates, routes, and services, lawmakers indicated no intention to establish a new administrative process for DOT adjudication of private contract disputes.[114] The Supreme Court agreed that it was not "plausible that Congress meant to channel into federal courts the business of resolving, pursuant to judicially fashioned federal common law, the range of contract claims relating to airline rates, routes, or services. The [Airline Deregulation Act] contains no hint of such a role for the federal courts."[115] In this respect, the Airline Deregulation Act differs from other federal statutes that employ almost identical verbage (*i.e.*, ERISA), but that channel civil actions into federal courts, under a comprehensive scheme, detailed in the legislation, designed to promote "prompt and fair claims settlement."[116] Ultimately, the *Wolens* Court ruled that the Airline Deregulation Act permits state-law-based court adjudication of routine breach-of-contract claims—a conclusion supported by Congress' retention of the FAA's saving clause:

> The ADA's preemption clause, § 1305(a)(1), read together with the FAA's saving clause, stops States from imposing their own substantive standards with respect to rates, routes, or services, but not from affording relief to a party who claims and proves that an airline dishonored a term the airline itself stipulated. This distinction between what the State dictates and what the airline itself undertakes confines courts, in breach-of-contract actions, to the parties' bargain, with no enlargement or enhancement based on state laws or policies external to the agreement.

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111 *Id*. at 228.
112 *Id*. at 231.
113 *Id*.
114 *Id*. at 232.
115 *Id*.
116 *Id*. at 232 (quoting Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 54 (1987)).

> American suggests that plaintiffs' breach-of-contract and Consumer Fraud Act claims differ only in their labels, so that if Fraud Act claims are preempted, contract claims must be preempted as well. But a breach of contract, without more, "does not amount to a cause of action cognizable under the [Consumer Fraud] Act and the Act should not apply to simple breach of contract claims." The basis for a contract action is the parties' agreement; to succeed under the consumer protection law, one must show not necessarily an agreement, but in all cases, an unfair or deceptive practice.
>
> In closing, this case presents two issues that run all through the law. First, who decides (here, courts or the DOT, the latter lacking contract dispute resolution resources for the task)? On this question, all agree to this extent: None of the opinions in this case would foist on the DOT work Congress has neither instructed nor funded the Department to do.
>
> Second, where is it proper to draw the line (here, between what the ADA preempts, and what it leaves to private ordering, backed by judicial enforcement)?
>
> Justice Stevens reads our *Morales* decision to demand only minimal preemption; in contrast, Justice O'Connor reads the same case to mandate total preemption. The middle course we adopt seems to us best calculated to carry out the congressional design; it also bears the approval of the statute's experienced administrator, the DOT. And while we adhere to our holding in *Morales*, we do not overlook that in our system of adjudication, principles seldom can be settled "on the basis of one or two cases, but require a closer working out."[117]

The precedence of *Wolens* found application in 2007, after hundreds of airline passengers were stranded aboard nine JetBlue Airways airplanes on the snow-covered tarmac of New York's JFK International Airport for almost 10 hours.[118] To stave off Congressional action and repair its public image, JetBlue subsequently announced its own

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[117] *Id.* at 234-35.

[118] *See*, *e.g.*, Timothy M. Ravich, *Re-Regulation and Airline Passengers' Rights*, 67 J. AIR L. & COM. 935 (2002).

"Customer Bill of Rights," setting out self-imposed penalties and "major" rewards for passengers inconvenienced beyond a "reasonable" amount of time.[119] Subject to its own Contract of Carriage, JetBlue's "Customer Bill of Rights" undertook several contractually binding requirements:

> JetBlue Airways is dedicated to bringing humanity back to air travel. We strive to make every part of your experience as simple and as pleasant as possible. Unfortunately, there are times when things do not go as planned. If you're inconvenienced as a result, we think it is important that you know exactly what you can expect from us. That's why we created our Customer Bill of Rights. These Rights will always be subject to the highest level of safety and security for our customers and crewmembers.
>
> **GENERAL INFORMATION**
>
> JetBlue will notify customers of delays, cancellations and diversions. Notification may be given in any of the following forms: via jetblue.com, telephone, flight information display system, airport announcement, onboard announcement, email or text message. ***
>
> **CANCELLATIONS**
>
> All customers whose flight is cancelled by JetBlue will, at the customer's option: Receive a full refund OR Reaccommodation on the next available JetBlue flight at no additional charge or fare. If JetBlue cancels a flight within 4 hours of scheduled departure and the cancellation is due to a *Controllable Irregularity*, JetBlue will also issue the customer a $50 Credit good for future travel on JetBlue. ***
>
> **ACCOMMODATION DURING ONBOARD GROUND DELAYS**
>
> JetBlue will provide customers experiencing an onboard ground delay with 36 channels of DIRECTV®*, food

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119 *See, e.g.*, Jeff Bailey, *Chief "Mortified" by JetBlue Crisis*, N.Y. TIMES, Feb. 19, 2007, at A1.

> and drink, access to clean restrooms and, as necessary, medical treatment. JetBlue will not permit the aircraft to remain on the tarmac for more than three hours unless the pilot-in-command determines there is a safety or security-related reason for remaining on the tarmac or Air Traffic Control advises the pilot-in-command that returning to the gate or another disembarkation point elsewhere in order to deplane would significantly disrupt airport operations. JetBlue will provide free movies on flights that are greater than two hours in duration for customers whose flight is delayed more than 3 hours after scheduled departure. ***
>
> **OVERBOOKINGS**
>
> (As defined in JetBlue's Contract of Carriage)
>
> Customers who are involuntarily denied boarding shall receive $1,300.[120]

This and other customer-friendly initiatives were undermined in late 2014, when JetBlue's Board of Directors reportedly decided not to renew the contract of its CEO Dave Barger. The reason was cheered by Wall Street because

> Barger kept the focus on the customer, preferring not to add baggage fees or seats to aircraft even when most other U.S. carriers adopted both practices . . . In arguing this summer for a CEO change, Cowen & Co. analyst Helane Becker wrote, "JetBlue is an overly brand-conscious and customer-focused airline, which has resulted in lagging fundamentals."[121]

The cold message was not lost in an editorial that remarked, "Sadly, being loved by your customers is not enough for JetBlue's board of directors."[122] Indeed, such corporate decisions further disconnect the pro-passenger narrative of national airline policy advocates from actual boardroom decisions.

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[120] *See* JETBLUE AIRWAYS BILL OF RIGHTS (Aug. 2012), http://www.jetblue.com/about/ourcompany/promise/index.html.

[121] Brian Sumers, *Profit vs. Brand*, AVIATION WK. & SPACE TECH., Sept. 29, 2014, at 24.

[122] Editorial, *Raw Deal for JetBlue's CEO*, AVIATION WK. & SPACE TECH., Oct. 13, 2014, at 58.

b. Northwest, Inc. v. Ginsberg

Almost contemporaneously with efforts by the legislature to amplify the range of airline passenger rights and by the executive to discipline the airline industry from an anti-trust perspective, Justice Alito reinforced the preemptive power of the Airline Deregulation Act in the realm of airline economics in *Northwest, Inc. v. Ginsberg*.[123] In that case, Northwest Airlines terminated Rabbi S. Binyomin Ginsberg's membership in its WorkPerks Airline Partners Program. Members of the program accumulated and redeemed "miles" for tickets and service upgrades with Northwest Airlines and its partner carriers.[124]

Ginsberg became a member of the frequent flyer program in 1999, achieving the highest level of membership—"Platinum Elite"—in 2005.[125] In 2008, however, the airline terminated Ginsberg's membership on the basis of a provision in the WorldPerks agreement that provided that "[a]buse of the . . . program (including improper conduct as determined by [the airline] in its sole judgment) may result in cancellation of the member's account."[126] The airline informed Ginsberg his "Platinum Elite" status was being revoked by telephone and confirmed in a letter:

> [Y]ou have contacted our office 24 times since December 3, 2007 regarding travel problems, including 9 incidents of your bag arriving late at the luggage carousel . . .
>
> Since December 3, 2007, you have continually asked for compensation over and above our guidelines. We have awarded you $1,925.00 in travel credit vouchers, 78,500 WorldPerks bonus miles, a voucher extension for your son, and $491 in cash reimbursements . . . .
>
> Due to our past generosity, we must respectfully advise you that we will no longer be awarding you compensation each time you contact us.[127]

In response to a request by Ginsberg to clarify his status, an airline representative stated by e-mail that, "[a]fter numerous conversations with not only the Legal Department, but with members of the WorldPerks

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123 Northwest, Inc. v. Ginsberg, 134 S.Ct. 1426 (2014).
124 *Id.* at 1426.
125 *Id*.
126 *Id.*
127 *Id.* at 1427.

department, I believe your status with the program should be very clear."[128] Ultimately, Ginsberg brought a class action suit in the United States District Court for the Southern District of California, claiming that the airline had ended his membership as a cost-cutting measure related to the airline's merger with Delta Air Lines.[129] In addition to suing for negligent and intentional misrepresentation, Ginsberg averred that Northwest breached the terms of its loyalty program by revoking his "Platinum Elite" status without valid cause and further violated the duty of good faith and fair dealing.[130] Ginsberg sought $5 million, together with a demand for injunctive relief restoring his WorldPerks status and prohibiting Northwest from future revocations of membership.[131]

The federal district court rejected Ginsberg's tort claims, as well as his allegations of breach of the covenant of good faith and fair dealing, as preempted by the Airline Deregulation Act.[132] The district court reasoned that all of Ginsberg's claims "related to" Northwest's rates and services, falling squarely within the ambit of the deregulation statute.[133] The remaining claim—for breach of contract—also was dismissed because Ginsberg had failed to identify any material breach given that the frequent flyer agreement gave the airline sole discretion to determine whether a participant had abused the program.[134] Ginsberg appealed and the Ninth Circuit Court of Appeals reversed.

On appeal, in a unanimous opinion, the Supreme Court considered whether the Airline Deregulation Act preempted a state law claim for breach of the implied covenant of good faith and fair dealing. As a preliminary matter, the Court rejected the argument that the preemptive language in the Airline Deregulation Act applied only to legislation enacted by a state legislature and regulations issued by a state administrative agency and not to a common-law rule like the implied covenant of good faith and fair dealing.[135] Finding that "[i]t is routine to call common-law rules 'provisions,'" the Court found that state common law rules "comfortably fall within the language" of the preemption provision of the Airline Deregulation Act, *i.e.*, "law[s], regulation[s], or other provision[s] having the force and effect of law."[136] The Court further determined that exempting common-law claims would also

[128] *Id*.
[129] *Id.*
[130] *Id*.
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id*.
[135] *Id*. at 1429.
[136] *Id.* (citing 49 U.S.C. § 41713(b)(1)).

disserve the central purpose of airline deregulation policy (*e.g.*, eliminate federal regulation of rates, routes and services) by supporting state laws that would effectively undo policies designed to have airline rates, routes, and services set by market forces.[137] Indeed, "[i]f all state common-law rules fell outside the ambit of the ADA's pre-emption provision, [there would be no] need in *Wolens* to single out a subcategory of common-law claims, *i.e.*, those based on the parties' voluntary undertaking, as falling outside that provision's coverage."[138]

In focusing on Ginsberg's contract specifically, the Court applied *Wolens* to hold that his claims were and would be pre-empted insofar as they sought to enlarge the contractual obligations voluntarily undertaken by the contracting parties.[139] Under Minnesota law (which controlled Ginsberg's dispute), the implied covenant of good faith applied to every contract and was a state-imposed obligation—a covenant around which parties could not contract or otherwise disclaim.[140] Ginsberg lost, therefore. While the Court ultimately rejected Ginsberg's claim, the airline pressed the court to go further, asking for a finding that all claims relating to an implied covenant of good faith and fair dealing, no matter the content of the law of the relevant jurisdiction, are pre-empted."[141] The airline claimed that, "[i]f pre-emption depends on state law . . . airlines will be faced with a baffling patchwork of rules, and the deregulatory aim of the ADA will be frustrated."[142] The Court rejected the argument, finding that

> the airlines have means to avoid such a result. A State's implied covenant rules will escape pre-emption only if the law of the relevant State permits an airline to contract around those rules in its frequent flyer program agreement, and if an airline's agreement is governed by the law of such a State, the airline can specify that the agreement does not incorporate the covenant. While the inclusion of such a provision may impose transaction costs and presumably would not enhance the attractiveness of the program, an airline can decide

137 *Id.*
138 *Id*.
139 *Id*. at 1426.
140 *Id*. at 1432.
141 *Id.* at 1433.
142 *Id*.

> whether the benefits of such a provision are worth the potential costs.[143]

Meanwhile, Justice Alito reasoned that the Court's ruling was helpful to airline passengers:

> Our holding also does not leave participants in frequent flyer programs without protection. The ADA is based on the view that the best interests of airline passengers are most effectively promoted, in the main, by allowing the free market to operate. If an airline acquires a reputation for mistreating the participants in its frequent flyer program (who are generally the airline's most loyal and valuable customers), customers can avoid that program and may be able to enroll in a more favorable rival program.
>
> Federal law also provides protection for frequent flyer program participants. Congress has given the Department of Transportation the general authority to prohibit and punish unfair and deceptive practices in air transportation and in the sale of air transportation, 49 U.S.C. § 41712(a), and Congress has specifically authorized the DOT to investigate complaints relating to frequent flyer programs. Pursuant to these provisions, the DOT regularly entertains and acts on such complaints.[144]

Thus, *Ginsberg*, like *Morales*, would appear to presume (in spite of contrary evidence) market choice, equate the value of different airlines' frequent flier programs and networks, and gloss over the fact that the DOT—but not airline passengers themselves—are afforded authority to pursue a remedy for provable wrongs.

C. RICO to the Rescue?

Ironically, Spirit Airlines—the unsuccessful plaintiff in an action attacking DOT rules forbidding it from prominently disclosing government taxes and fees added to airfare[145]—is now a so-far-

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143 *Id.*

144 *Id.*; *see also* U.S. DEP'T OF TRANSP., FILE A CONSUMER COMPLAINT http://www.dot.gov/airconsumer/file-consumer-complaint (last updated Nov. 13, 2013).

145 *See infra* Part II.B.1.b.

unsuccessful defendant accused of hiding fees from its passengers. In *Ray v. Spirit Airlines, Inc.*,[146] a class of airline passengers has brought a putative federal class action lawsuit against the airline on the basis of the Racketeer Influenced and Corrupt Organizations Act ("RICO"),[147] alleging that Spirit Airlines conducted an enterprise by means of racketeering activity, *e.g.*, mail and wire fraud involving the concealment and misrepresentation of airfares and user fees. While the United States District Court for the Southern District of Florida dismissed the action on the basis or preemption, the Eleventh Circuit Court of Appeals vacated that decision:

> Because federal laws do not preempt other federal laws, subsequent legislation could preclude Plaintiffs' claims only if Congress had repealed the provisions of RICO, at least insofar as they authorized Plaintiffs' actions. Congress did not do so expressly through the Airline Deregulation Act of 1978 (ADA) . . . [a]nd we find no 'repeal by implication' because Congress has not exhibited the requisite clear and manifest intent. The ADA explicitly preempted state laws but, notably, said nothing about any federal cause of action. Moreover, a saving clause found in the ADA did not disturb any other remedies provided by law. Quite simply, the two laws are not irreconcilably in conflict, nor was the ADA clearly intended as a substitute for RICO. Applying the strong presumption against implied repeals, we are constrained to conclude that RICO supplements, rather than subverts, federal regulation of air carriers.[148]

In reaching this conclusion, the court recognized at least one other circumstance in which a federal court found that a RICO action was not precluded by airline deregulation policy. Cancellation fees charged for flights in the months following September 11, 2001 was the issue in *All World Prof'l Travel Servs., Inc. v. Am. Airlines, Inc.* where a federal district court in California recognized that a travel agency could have complained to the DOT about an airline's conduct, but was not required to submit a RICO-type mail and wire fraud claim to the DOT.[149] On this

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146 Ray v. Spirit Airlines, Inc., --- F.3d ---- (2014), 2014 WL 4699445, at *1 (11th Cir. 2014).

147 Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68 (2013).

148 *Ray*, 2014 WL 4699445, at *1.

149 All World Prof'l Travel Servs., Inc. v. Am. Airlines, Inc., 282 F. Supp. 2d 1161 (C.D. Cal. 2003).

basis, the Eleventh Circuit Court of Appeals wrote that, "we agree with the *All World* court that civil RICO claims predicated on mail and wire fraud are not precluded by the ADA simply because they involve fraud arising out of pricing, fees, and advertising in the airline industry."[150]

The *Ray* case is remarkable in that civil lawsuits arising under RICO are seldom used to address consumer complaints against the airline industry. As the Eleventh Circuit's opinion indicates, only one case relates RICO and the Airline Deregulation Act of 1978. The theory being tested in *Ray* appears to be a novel one as applied to airline airfare advertising specifically, and an infrequently litigated theory as applied to the Airline Deregulation Act generally. As a practical matter, traveling under RICO to vindicate alleged violations of airline passengers' rights is not surprising considering that few private rights of action exist for the direct use of airline passengers under the Airline Deregulation Act. While consumers might complain to the DOT for issues relating to airline fares or services, it is usually up to the DOT to enforce penalties. Thus, though still at the pleading stage, *Ray* (taking the lead of *All World Prof'l Travel, Inc.*) might establish RICO as a viable strategy for travelers to end-run decades-long frustration with federal passengers' rights laws that expressly limit or extinguish private causes of action arising from airline prices, routes, and services.[151]

The fact that courts currently have to step in as customer dispute resolution centers is troubling, and *Ray* may be a case of be careful what you wish for. A victory in that case (however probable or improbable) might compensate a certain class of airline passengers and reward their counsel. But, the commercial airline market will react, possibly in the form of higher fares and ancillary fees. Moreover, the case highlights inconsistencies between talking points broadcast under the banner of a national airline policy and actual airline customer service and conduct. For that matter, where lawmakers are passing specious laws that protect airline passengers without also affording passengers any direct rights, the plaintiff bar will continue to think creatively about getting their clients their day in court; for their part, airlines and defense counsel would be well-served to understand that legal victories may be public relations nightmares.[152]

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150 *Ray*, *supra* note 145, at *8.

151 *Civil RICO Action Over Spirit Fees Ready to Take Off*, DAILY BUS. REV., Oct. 6, 2014, *available at* http://www.dailybusinessreview.com/id=1202672444302?.

152 *Id*.

III. ANALYSIS

The call for a national airline policy is a marketing campaign that minimizes airline-centric business goals in customer-friendly talking points. Who is for reducing taxes? Or reforming regulatory burdens? Who isn't? What consumer or airline is adverse to a modernized air traffic system and stabilized energy prices? Nobody. The concept of a globally competitive U.S. airline industry is a consensus issue in America, too. Thus, in a significant way, the hallmarks of a proposed national airline policy do little to build value or trust between carrier and customer. Indeed, the call for a national airline policy smacks of a tired industry tactic of looking to the government to get out of the way when it comes to how airlines treat their customers (good and bad), but inviting the government to get involved (under the heading of customer service) when it comes to how regulators treat the industry itself.

For example, in September 2014, A4A issued a press release applauding bi-partisan legislation introduced "to protect airline customers from higher passenger security taxes, which are unlawfully being collected by the federal government."[153] In announcing its support, the A4A framed the government's actions in the least favorable way, casting the airline as the champion of its passengers without identifying whom (if anybody) would protect customers from airline practices:

> Since its inception, the passenger security tax was assessed on a per-enplanement basis, and capped at a maximum of $5 for a one-way trip (maximum two enplanements) or $10 for a round-trip itinerary. Last year, as part of the bipartisan budget deal to reduce the deficit, Congress simplified the fee structure by creating a flat $5.60 fee per one-way trip, regardless of the number of enplanements. Congress made this change against the backdrop of the existing round-trip cap and expected it to remain in place.
>
> The Hudson/Richmond bill addresses the Administration's misinterpretation of congressional intent and restores the cap. This bill also is in line with the intent of the Chairs of the Senate and House Budget Committees, Sen. Patty Murray (D-WA) and Rep. Paul

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153 Press Release, Airlines for America, A4A Commends Introduction of Hudson/Richmond Bill to Protect Travelers from Unjust Passenger Tax Hike (Sept. 5, 2014), *available at* http://www.canadianshipper.com/press-releases/story.aspx?id=1003254132.

> Ryan (R-WI), and Speaker John Boehner, who affirmed that Congress did not intend to change the definition of a round-trip cap. The federal government is collecting more than $1 billion in additional passenger security taxes from airline customers – and the revenue is not even being used for security.[154]

Importantly, claims of government overreach or inefficiency should not deflect attention away from the manner in which the airlines themselves are nickel-and-diming their customers. The airline industry's call to optimize customer service as the basis for a national airline policy is specious. This is particularly so given the adverse consumer positions airlines regularly take in the courtroom—from small claims courts all the way up to the Supreme Court of the United States.

The precedents detailed above—from *Morales* and *Spirit Airlines, Inc.*, on the tort side, to *Wolens* and *Ginsberg*, on the contract side—promote deregulation policy, but at the expense of overall industry health. Aggregately, the cases are losers for both airlines and their customers in the United States. Net, customers lost in *Morales* and *Ginsberg*, and the airlines lost in *Spirit Airlines, Inc.* and *Wolens*. While *Morales* and *Wolens* insulate carriers from federal and state economic regulation, they also reveal a dysfunctional marketplace in which core customer rights are irremediable because Congress has not given passengers any private right of action while DOT regulators micromanage basic business practices respecting the publication of government taxes and fees on airfares.[155] "[I]mprovements in efficiency, innovation, and low prices" are hard to come by in this environment.

The cases featured in this Article also cast doubt on the efficacy of a national airline policy by evidencing a deep distrust among carriers, passengers, and state and federal aviation officials. *Morales* and *Spirit Airlines, Inc.*, taken together, are remarkable in this regard. In one case (*Morales*), the state of the marketplace worsened to such a degree that state officials felt compelled to require the airline industry to publish basic information for the benefit of their customers. In another case (*Spirit Airlines, Inc.*), it was the industry that fought (and lost in its efforts) to spotlight the amount of government taxes and fees on airfares

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154 *Id.*

155 *See* Real Transparency in Airfares Act of 2014, S. 2290, 113th Cong. (May 5, 2014) (increasing the maximum financial penalty (to be imposed by the federal government) for unfair and deceptive practices relating to advertising of the costs of air transportation); *see also A4A Applauds House Action to Increase Airfare Transparency*, AIRLINES FOR AMERICA (July 28, 2014), http://www.airlines.org/news/a4a-applauds-house-action-to-increase-airfare-transparency/.

to the detriment of airlines and their passengers. Meanwhile, *Wolens and Ginsberg* illustrate the degree to which the airline industry will go to restrict the contractual terms and leverage of their customers. In all of these cases, the consumer's market power, choice, and rights are minimized and restricted while the airline industry's economic liberties are impeded—the exact opposite of what airline deregulators envisioned.

The negative relationships between business-and-customer and business-and-regulator in *Morales*, *Wolens*, *Spirit Airines, Inc.*, and *Ginsberg* also is striking, casting doubt on any efforts to cooperatively arrive at a national airline policy that enhances the interests of all stakeholders in commercial aviation. Indeed, the tone of A4A's campaign for a national airline policy seems to perpetuate an unhealthy policy of blame shifting.

In all, deregulation principles applicable to the airline industry—borne out of the very same deregulatory impulse that perhaps contributed to energy deregulation and corporate frauds like Enron, banking deregulation, and the Great Recession of 2008—invite serious reconsideration. As aviator and United States Bankruptcy Judge (Southern District of Florida) A.J. Cristol has observed:

> Yes, we have lower fares on certain routes [but it is] because the airline industry, like the United States Congress, is unable to understand that if you sell your product for less than it costs you, you have a deficit. At the same time, we have astronomical airfares on other routes.
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> Robert Crandall, the former president and CEO of American Airlines, used to make a speech where he opened up by asking his audience "How much did a Hershey Bar cost in 1945?" Members of the audience would volunteer, "a quarter," "a dime." Crandall would then point out that in 1945 you could buy a Hershey Bar for a nickel. A new Chevrolet could be purchased for $900. Roundtrip airfare from New York to Paris was $700.
>
> Today a Hershey bar is as much as a buck. A new Chevy Camero is listed out as Chevy $33,600, and roundtrip airfare? New York to Paris can be $500 to $600, sometime less.

> Crandall's point is simple . . . Most airfares are too low. Airlines charge too much for first and business class and far too little for coach or economy . . . Each year they continue to lose more and more money and they try to make it up with charges for your suitcase or your seat assignment . . . .
>
> In the irrational airline industry of today, the doctrine is sell your seats at a loss and make it up on volume. A few quarters ago, Delta announced a huge loss. Their solution: Reduce fares . . . and Pricing: It goes from the sublime to the ridiculous.[156]

IV. CONCLUSION

Seemingly and substantively lost in the call for a national airline policy is the customer. The A4A's proposal for government support of the industry is large on general themes, but small on details, including specifics about any direct benefits to airline passengers themselves. True, a reduction in federal taxes and a loosened regulatory environment for airlines might result in lower fares for airline passengers. So too might a modernized air traffic system and stabilized energy prices translate into airline consumer savings. And, a regulatory structure that "will enable our country's airline industry to reclaim its mantle as the global pacesetter" may produce yet-imagined benefits.[157] Unclear is whether or how any revamped commercial airline legal regime will treat the airline passenger as anything more than a third party beneficiary or bystander who is literally along for the ride, however. The operative statutory law effecting airline deregulation policies, including recent court opinions over the last two decades (*e.g.*, *Morales*, *Wolens*, *Spirit Airlines*, *Inc.*, and *Ginsberg*)—and the recent, almost desperate effort to secure passengers rights under RICO (*Ray*)—provide scant optimism that a new national framework for commercial airline operations will put the customer in a prominent position. To this point, the law gives few if any

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156 Hon. A.J. Cristol, United States Bankruptcy Judge, Southern District of Florida, Guest Lecture at the University of Miami School of Law (Sept. 12, 2013) (recording available at http://www.law.miami.edu/webcast/video.php?location=Departments&stream=Aviation_Economics_(Judge_Cristol_Guest_Lecture)_September_12_2013.mp4&width=480&height=270&page=).

157 Gary Kelly, *America Needs a National Airline Policy*, CENTERFORAVIATION.COM (Sept. 8, 2014), http://centreforaviation.com/members/direct-news/america-needs-a-national-airline-policy-185910.

rights to airline passengers directly; and, where passenger protections and rights do exist, Congress has not provided for a private right of action, but only empowered passengers with the right to complain to a federal agency empowered to effect a discretionary penalty.[158] Going forward, and in the absence of a serious and voluntary effort by the airline industry as a whole to differentiate and improve their customer service offerings beyond an artificially low price laden by ancillary fees, a national airline policy should delineate direct and not merely derivative customer service upgrades—otherwise, re-regulation may be in the offing.[159]

158 For a discussion of pending federal rulemaking on passenger protections from a variety of perspectives (*e.g.*, distribution, consumer, industry, and regulatory) see Volume 27, Number 3 of AIR AND SPACE LAWYER (November 2014).

159 *See*, Ravich, *supra* note 118; *see also* Anita Mosner, *DOT's Rulemaking is a Step Toward Reregulation*, 27 AIR & SPACE LAW. (2014).

Unaffordable Justice: The High Cost of Mandatory Employment Arbitration for the Average Worker

Lisa A. Nagele-Piazza*

Although the use of arbitration provisions in collective bargaining agreements and executive employment contracts serve a beneficial purpose for workers and employers alike, the growing use of mandatory, pre-dispute arbitration agreements in non-unionized employment settings stands as an obstacle for employees to vindicate their statutorily prescribed civil rights. In particular, by forcing workers to share in the unique costs of arbitration, employees may be deterred from bringing otherwise meritorious claims. Given the federal policy favoring arbitration, and in the absence of legislation banning mandatory employment arbitration agreements, it is essential for arbitration service providers and drafters of arbitration clauses to provide for employer paid arbitration expenses, all remedies that would be available to the employee in court, and the selection of a neutral arbitrator to ensure fairness for the average worker.

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I. INTRODUCTION

Arbitration has become a favorable method of resolving employment related conflicts without tying up the resources of the courts[1] and is often viewed as fast, efficient, and less costly than litigation.[2] It may also minimize hostilities between parties that seek to continue their relationship after the dispute is resolved because it is less formal and may be less adversarial than litigation.[3]

Arbitration and mediation are alternative dispute resolution ("ADR") mechanisms. Mediation is a *non-binding* process wherein a neutral third-party assists the disputing parties in reaching a "mutually agreeable solution."[4] Arbitration differs from mediation in that the neutral third-party (or a panel of three neutrals) renders a decision that is *binding* on the disputing parties.[5] While an arbitrator decides matters based on the evidence and arguments presented by each side of the disagreement, arbitration is typically less formal than judicial proceedings.[6]

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1 *See* Erin O'Hara O'Connor et. al., *Customizing Employment Arbitration*, 98 IOWA L. REV. 133, 140 (2012).
2 *See* RICHARD A. BALES, COMPULSORY ARBITRATION: THE GRAND EXPERIMENT IN EMPLOYMENT 8-9 (1997).
3 *Id.* at 9-10.
4 BLACK'S LAW DICTIONARY 1003 (8th ed. 2004).
5 *See* BLACK'S LAW DICTIONARY 112 (8th ed. 2004).
6 *See* DENNIS R. NOLAN, LABOR AND EMPLOYMENT ARBITRATION IN A NUTSHELL 1 (2d ed. 2007).

Arbitration has been the foremost method of dispute resolution involving labor related matters under collective bargaining agreements ("CBA") since the 1960s Supreme Court decisions in the *Steelworkers Trilogy*.[7] In these seminal cases, the Supreme Court created a presumption that employer-union disputes were arbitrable and determined that the role of courts in CBA disputes was limited.[8] These decisions encouraged unions and employers to generate an internal system for resolving disputes based on the terms of their CBA.[9]

Although arbitration became the predominant dispute resolution format for unionized workers, arbitration agreements in non-union settings were virtually nonexistent until relatively recently.[10] Historically, private, non-union employment was governed by the employment-at-will doctrine, which provides that both the employer and the employee have the right to terminate the employment relationship at any time and for any legal reason, without any liability.[11] Therefore, there were few potential disputes that could arise from the average employment relationship, and employers had little need for arbitration agreements.[12] While employment-at-will is still the presumption in the private workplace today, both federal and state statutes have been enacted that provide added protections for employees.[13] These statutes include Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990, as well as various state civil rights, fair employment, and workers' compensation statutes.[14]

As these laws evolved and private employees gained new rights in the workplace, employers sought to minimize their exposure to costly litigation by requiring employees to sign mandatory, pre-dispute agreements to arbitrate as a condition of employment.[15] Employers may find arbitration preferable to litigation because they perceive juries in a trial to be unpredictable and more likely to decide the case based on

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7 *See generally* United Steelworkers of Am. v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960); United Steelworkers of Am. v. Enter. Wheel and Car Corp., 363 U.S. 593 (1960); United Steelworkers of Am. v. Am. Mfg. Co., 363 U.S. 564 (1960); *see also* BALES, *supra* note 2, at 6.

8 *See* BALES, *supra* note 2, at 6.

9 *See id.* at 20.

10 *See* NOLAN, *supra* note 6, at 330-31.

11 *See id.* at 330.

12 *See id.* at 331.

13 *See id.*

14 *See* U.S. Equal Emp't Opportunity Comm'n, *Federal Laws Prohibiting Job Discrimination Questions and Answers*, EEOC.GOV (Nov. 21, 2009), http://www.eeoc.gov/facts/qanda.html; *see also* CAL. GOV'T CODE § 12900 (West 2012).

15 *See* THOMAS E. CARBONNEAU, EMPLOYMENT ARBITRATION 2 (2d ed. 2006).

emotions or sympathy toward the employee, whereas neutral arbitrators are perceived as more likely to decide the case based on its merits.[16] Further, employers view arbitration as faster, less formal, and less costly than litigation.[17] Additionally, employers may be able to avoid expensive class action lawsuits through arbitration agreements.[18]

Mandatory arbitration agreements also receive judicial support.[19] Courts were already overburdened when they experienced an influx of employment rights claims.[20] Thus, if arbitration was the standard for resolving these disputes, the courts could set standards in test cases while private dispute resolution proceedings could handle the majority of the cases.[21]

On the contrary, many employee advocates view arbitration as disadvantageous to nonunionized workers.[22] Employees are often forced to agree to arbitration or lose their jobs, and since agreements are usually non-negotiable and drafted by the employer, the agreements may be one-sided or inherently designed to favor the employer.[23] Further, if an agreement obligates the employee to split the cost of arbitration, the employee either may be unable to bring the claim or decide that the risk of personal expense is too high to justify bringing an otherwise meritorious claim.[24]

This Article explores the unique dilemma faced by employees who are obligated to sign mandatory, pre-dispute arbitration agreements as a condition of employment, and specifically focuses on how cost-splitting provisions serve as a barrier to the vindication of statutory rights. Federal and state court opinions on cost-splitting provisions vary greatly from intensive *ad hoc* analyses to *per se* rules disallowing their use. Although voluntary, post-dispute agreements to arbitrate are preferable to ensure

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16 *See* BALES, *supra* note 2, at 9.

17 *See id.*

18 *See generally* AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1751-52 (2011) (finding that (1) a "switch from bilateral to class arbitration sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment"; (2) "class arbitration *requires* procedural formality"; and (3) class arbitration greatly increases risks to defendants; therefore, an arbitration agreement that disallowed class actions could not be held unconscionable under state law) (emphasis in original)).

19 *See* BALES, *supra* note 2, at 8-9.

20 *See id.*

21 *See id.*

22 *See id.* at 9.

23 *See id.*

24 *See* Armendariz v. Found. Health Psychcare Servs., Inc., 6 P.3d 669, 687 (Cal. 2000).

fairness,[25] ultimately, if an employer is going to mandate arbitration, the agreement should: (1) allow employees to vindicate statutory rights, to the fullest extent prescribed by law, without incurring substantial fees and (2) minimize arbitrator bias (or perceived bias) toward the employer where the employer has paid for and determined the guidelines for the arbitration process. In the absence of a clearly-defined national standard that safeguards employees, courts and arbitration service providers must set criteria for arbitration agreements that ensure fairness for employees.

A. Distinguishing Between Labor and Employment Arbitration

To start, this Article must distinguish between the long-established use of arbitration in collective bargaining and the unique challenges that the individual employee in a non-union environment faces when he or she is required to arbitrate a claim.[26] In the unionized labor setting, arbitration is commonly viewed as a swift and cost effective means of resolving disputes related to the CBA.[27] In labor arbitration, the employee-grievant is provided with a union representative who likely has experience dealing with company management, arbitrators, and other grievants.[28] Further, the employee's share of the arbitration costs is paid from union dues.[29] Therefore, arbitration is not cost-prohibitive to the grievant, and the likelihood of arbitrator bias is minimized by the union representative's familiarity with individual arbitrators and the shared cost of arbitration between the union and the company.[30]

In contrast, the non-unionized employee likely has little or no experience with the arbitration process, other than the matter at hand.[31] Moreover, as a "one-time player," the employee has no knowledge of individual arbitrators and their potential biases.[32] Unlike union-represented workers, individual employees do not typically have funds allocated to pay for arbitration proceedings.[33] Thus, when positioned against the employer, who may have previous dealings with specific arbitrators and has the finances to fund the arbitration process, the

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25 *See Policy Statement on Employment Arbitration*, NAT'L ACAD. OF ARBITRATORS (May 20, 2009), http://naarb.org/due_process.asp.

26 *See* Reginald Alleyne, *Arbitrators' Fees: The Dagger in the Heart of Mandatory Arbitration for Statutory Discrimination Claims*, 6 U. PA. J. LAB. & EMP. L. 1, 13-14 (2003).

27 *See id.* at 14-15.

28 *See id.* at 15.

29 *See id.* at 32.

30 *See id.* at 14-15.

31 *See* Clyde W. Summers, *Mandatory Arbitration: Privatizing Public Rights, Compelling the Unwilling to Arbitrate*, 6 U. PA. J. LAB. & EMP. L. 685, 689-90 (2004).

32 *See id.* at 690.

33 *See* NOLAN, *supra* note 6, at 347.

employee is placed in a precarious position with the cards stacked against him.[34]

As a result, it is essential for courts and ADR service providers to develop standards that enable employees to vindicate their statutory rights and receive damage awards that remedy the immediate injury and deter future violations of anti-discrimination laws.

B. *The White Collar vs. the Wage Worker's Agreement*

It is also important to make the distinction between the contemporary use of mandatory employment arbitration and the traditional form of employment arbitration agreements, which were freely negotiated contracts between employers and sophisticated, sought-after professionals with bargaining power.[35] High-level employees and executives often negotiate employment agreements that included salary and bonus compensation, benefits, incentive plans, and termination provisions.[36] These agreements also address certain duties the executive may owe the company, such as a duty not to compete or disclose trade secrets and a duty to maintain confidentiality.[37] Thus, there are various potential disputes that may prompt the *employer* to bring a claim against the executive employee.

These duties arise out of the nature of the executive's position and are often irrelevant to the average employee's job responsibilities.[38] The average employee is generally in a weaker bargaining position than the employer, and arbitration agreements are presented on a "take it or leave it" basis as a condition of initial or continued employment.[39] Thus, this type of arbitration agreement is a unilateral contract of adhesion, meaning that employees must accept a set of standard terms, dictated by the employer, without the opportunity to negotiate.[40]

Courts have found that an offer of new employment or the continuation of existing employment in an "at-will" environment is

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34 *See* Summers, *supra* note 31.

35 *See* Armendariz v. Found. Health Psychcare Servs., Inc., 6 P.3d 669, 690 (Cal. 2000); *see also* O'Connor, *supra* note 1, at 136-38.

36 *See* Randall Thomas, et al., *Arbitration Clauses in CEO Employment Contracts: An Empirical and Theoretical Analysis*, 63 VAND. L. REV. 957, 960-61 (2010); *see also* Trigg v. Little Six Corp,, No. E2013-01929-COA-R9-CV, (Tenn. Ct. App. July 28, 2014) (arbitration clause was part of a chief engineer's negotiated employment agreement that included a $1.5 million buyout of his equity in the company, a $154,472 annual salary and a $50,000 severance package).

37 *See* Thomas, *supra* note 36, at 969; O'Connor, *supra* note 1, at 167-68.

38 *See Armendariz*, 6 P.3d at 694.

39 *See* CARBONNEAU, *supra* note 15, at 2.

40 BALES, *supra* note 2, at 122.

sufficient consideration for the mandatory agreement.[41] If an employee does not wish to be bound to arbitration, he or she may find employment elsewhere.[42] Critics of this reasoning bring to light the fact that in reality, this is not a viable option, as most workers cannot afford to forgo a job opportunity based on a requirement to arbitrate disputes.[43] Moreover, if every employer in a particular industry imposes a similar arbitration obligation, than there are no meaningful options for workers who do not wish to be bound by such conditions.[44]

While low-wage earning employees are the most disadvantaged by mandatory arbitration when there is a cost-splitting provision in the agreement, all but a few highly compensated professionals are likely to be discouraged from bringing a claim to arbitration when faced with potentially high fees, especially when they have recently been terminated from employment.[45] Thus, the traditional use of freely-negotiated, executive-level arbitration agreements are markedly different than mandatory, non-negotiable, pre-dispute arbitration agreements that employees at all levels of the organization are required to sign as a condition of employment. This Article focuses on the latter.

C. The Added Costs of Arbitration

There are some costs that are similar in both arbitration and litigation proceedings. For example, an employee will pay a filing fee in both fora. Presently the cost for filing a claim in federal court is $350 plus a $50 administrative fee,[46] whereas organizations such as the American Arbitration Association ("AAA") charge employees a $200 filing fee.[47] There are other costs in both litigation and arbitration that are not required but are typical expenses, such as attorneys' fees; however, there are additional charges in arbitration that are not a part of the litigation process.

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41 *See* Tinder v. Pinkerton Security, 305 F. 3d 728, 734 (7th Cir. 2002) ("Wisconsin recognizes that, because at-will employees are free to quit their jobs at any time, at-will employees give adequate consideration for employer promises that modify or supplant the at-will employment relationship by remaining on the job."); In re Halliburton Co., 80 S.W. 3d 566, 572-73 (Tex. 2002) (holding that a worker's continued employment constituted acceptance of a binding arbitration agreement where he had clear notice of the changes to his at-will employment contract)*; see also* NOLAN, *supra* note 6, at 363.

42 *See id.* at 359.

43 *See Armendariz*, 6 P.3d at 690.

44 *See* Alleyne, *supra* note 26, at 23-24.

45 *See* NOLAN, *supra* note 6, at 347.

46 *See Forms and Fees*, U.S. COURTS, www.uscourts.gov/FormsAndFees/Fees.aspx (last visited Sept. 27, 2014).

47 AM. ARBITRATION ASS'N, EMPLOYMENT ARBITRATION RULES & MEDIATION PROCEDURES 32 (Nov. 1, 2009).

In arbitration, the employee may be required to pay fees in advance of the proceedings, as well as substantial costs at the conclusion of the process, which would be unheard of in a courtroom. For example, arbitrators charge the parties an hourly rate or *per diem* fee, whereas a judge's salary would never be invoiced to the parties. In addition to the arbitrator's fees, parties to an arbitration proceeding are required to pay for room rentals, stenography, administrative fees, and the arbitrator's travel expenses. By the time the matter is resolved, arbitration costs and fees can amount to thousands of dollars, as one estimate shows the average cost of arbitrating an employment claim is approximately $20,000.00.[48] In contrast, while litigation can be expensive, there are no *required* fees beyond the initial filing fee, and thus employee-claimants likely will not experience the same cost barriers in litigation as they may in arbitration.

II. THE EVOLUTION OF EMPLOYMENT ARBITRATION

The Federal Arbitration Act ("FAA") governs arbitration agreements that involve maritime trade and interstate commerce.[49] While the FAA excludes "contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce,"[50] courts have construed this narrowly to exclude certain transportation workers and not contracts of employment generally.[51] Thus, courts have upheld arbitration agreements that apply to employment relationships and have maintained a "liberal federal policy favoring arbitration agreements."[52]

Prior to the 1990s, it was generally accepted that arbitration agreements did not prevent employees from asserting common law or statutory claims.[53] This was based on the Supreme Court's decision in *Alexander v. Gardner-Denver Co.*, which held that that an arbitration provision in a CBA did not preclude an employee from bringing a claim under Title VII of the Civil Rights Act of 1964.[54] In relevant part, the Supreme Court explained:

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48 *See* Morse Barnes-Brown Pendleton, *Should Employers Require the Workplace Disputes be Arbitrated?*, http://www.mbbp.com/resources/employment/arbitration.html (last visited April 3, 2014).

49 *See* 9 U.S.C. § 1 (2012).

50 *Id.*

51 *See* Tenney Eng'g, Inc. v. United Elec. Radio & Mach. Workers of Am., (U.E.) Local 437, 207 F.2d 450, 453 (3d Cir. 1953); *see also* BALES, supra note 2, at 44.

52 Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

53 NOLAN, *supra* note 6, at 331.

54 *See* Alexander v. Gardner-Denver Co., 415 U.S. 36, 48-49 (1974).

> In submitting his grievance to arbitration, an employee seeks to vindicate his contractual right under a collective-bargaining agreement. By contrast, in filing a lawsuit under Title VII, an employee asserts independent statutory rights accorded by Congress. The distinctly separate nature of these contractual and statutory rights is not vitiated merely because both were violated as a result of the same factual occurrence.[55]

Accordingly, employment rights under the common law, as well as state and federal statutes, were considered separate from the CBA.

In 1991, the seminal non-union employment arbitration case, *Gilmer v. Interstate/Johnson Lane Corp.,* created a distinction between statutory claims that were outside of the CBA, as in *Gardner-Denver*, and arbitrations agreements that specifically included statutory claims arising out of the employment relationship.[56] Gilmer, an employee of Interstate, was required as a condition of employment to register with the New York Stock Exchange ("NYSE").[57] In his application with the NYSE, Gilmer had to sign an agreement to arbitrate any employment-related disputes, including claims arising out of the termination of his employment.[58] Interstate discharged Gilmer when he was sixty-two years old, and he subsequently filed a claim under the Age Discrimination in Employment Act ("ADEA") with the Equal Employment Opportunity Commission ("EEOC") and eventually filed a suit in federal district court.[59] Based on the arbitration agreement Gilmer signed in his NYSE application, Interstate moved to dismiss the federal court claim and compel arbitration.[60]

Gilmer argued, among other things, that arbitration was not an adequate forum to vindicate statutory employment rights.[61] The Supreme Court struck down this argument based on the standard set in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, which held that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than judicial, forum."[62]

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55 *Id.* at 49-50.
56 *See* Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 35 (1991).
57 *See id.* at 23.
58 *See id.*
59 *See id.* at 23-24.
60 *See id.* at 24.
61 *See id.* at 26-27.
62 Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 26 (1991) (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).

The Supreme Court distinguished *Gilmer* from *Gardner-Denver* in three ways: (1) the *Gardner-Denver* arbitration agreement, based on the CBA, did not include statutory claims; (2) since the *Gardner-Denver* case involved a CBA, where employees were represented by a union in the arbitration proceedings, "an important concern . . . was the tension between collective representation and individual statutory rights," which was not applicable in *Gilmer*; and (3) *Gardner-Denver* was not decided under the FAA, "which reflects a 'liberal federal policy favoring arbitration agreements.'"[63]

Even though the *Gilmer* arbitration agreement was not considered a "contract of employment" because it was part of the NYSE application, court decisions following *Gilmer* involved an array of employment arbitration cases, including claims under the Americans with Disabilities Act ("ADA"), Fair Labor Standards Act ("FLSA), and Family Medical Leave Act ("FMLA").[64] Since the case law has been generally favorable toward mandatory arbitration in employment disputes, workplace relationships covered by mandatory arbitration agreements have grown to represent between twenty-five-percent and thirty-three-percent of non-union workers.[65]

Some employers have taken advantage of the policy favoring arbitration by creating agreements that put workers at a distinct disadvantage. One of the most extreme examples of an employer stacking the arbitration process in its favor can be found in *Hooters of America, Inc. v. Phillips*.[66] In this case, Hooters required its staff to sign a mandatory arbitration agreement that required employees to follow certain rules, such as providing notice to the company with specific details regarding the nature of the claim and providing lists of witnesses

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63 *Id.* at 35 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 625 (1985)).

64 *See* Durkin v. Cigna Prop. & Cas. Corp., 942 F. Supp. 481 (D. Kan. 1996) (compelling arbitration of a claims supervisor's Title VII, ADA, ADEA and state law claims); Hampton v. ITT Corp., 829 F. Supp. 202 (S.D. Tex. 1993) (finding employment arbitration agreements enforceable for FLSA claims); Reese v. Commercial Credit Corp., 955 F. Supp. 567 (D.S.C. 1997) (holding that an employee's FMLA and ADA claims were within the scope of arbitration).

65 *See* Theodore J. St. Antoine, An Arbitrator Looks at ADR in the Coming Decade, ABA Labor and Employment Law Section ADR in Labor and Employment Law Committee Midwinter Meeting, at 2 (2013) (citing Alexander J. S. Colvin, Labor & Employment ADR in a Portable Employment World: Moving Away from Employer Promulgated ADR?, ABA Section of Labor & Employment Law, ADR in Labor and Employment Law Committee Midwinter Meeting, Program Materials, Tab L (2012), available at, http://www.americanbar.org/content/dam/aba/events/labor_law/2013/02/adr_in_labor_employmentlawcommitteemidwintermeeting/s.authcheckdam.pdf).

66 Hooters of Am., Inc. v. Phillips, 173 F.3d 933 (4th Cir. 1999).

and summaries of each witness' knowledge of the events.[67] Hooters, on the other hand, was not required to provide any pleadings or notices.[68] Further, as if to eliminate all objectivity, employees had to choose arbitrators from a list of Hooters approved arbitrators.[69] In the *Hooters* case, the Fourth Circuit found that Hooters' rules were "so one-sided that their only purpose [was] to undermine the neutrality of the proceeding."[70] Thus, the entire agreement was held to be invalid.[71]

In other cases, where employers placed limitations on statutory rights and remedies, courts have deemed arbitration clauses invalid. For example, in *Circuit City Stores, Inc. v. Adams*, employees were obligated to sign an arbitration agreement that limited the amount of damages an employee could be rewarded to an amount much less than prescribed by statute.[72] The agreement stated that "back pay is limited to one year, front pay to two years, and punitive damages to the greater amount of front pay and back pay awarded or $5000."[73] On the other hand, the applicable statute had no such limits on back and front pay and included punitive damages.[74] Applying California contract law to the arbitration agreement, the Ninth Circuit found these limitations on statutory rights to be unconscionable.[75]

While courts have found clauses in arbitration agreements that are heavily one-sided or force employees to forfeit statutorily prescribed remedies to be invalid, courts are inconsistent in their rulings on other matters that serve as more subtle obstacles for employees to vindicate their rights. Among those obstacles are cost-splitting clauses, which force employees to share in the expense of arbitration and have the potential to create a significant barrier for employees to bring their claims.[76]

III. FEDERAL COURT RULINGS ON COST PROVISIONS

Where federal statutes are the subject of a claim, courts have evaluated the effect of cost-splitting provisions on an employee's ability to vindicate rights in accordance with the federal anti-discrimination

67 *See id.* at 938.
68 *See id.*
69 *See id.* at 938-39.
70 *Id.* at 938.
71 *See id.* at 941.
72 *See* Circuit City Stores, Inc. v. Adams, 279 F.3d 889, 893 (9th Cir. 2002).
73 *See id.* at 891.
74 *See id.* at 894.
75 *See id.* at 896.
76 *See* Alleyne, *supra* note 26, at 4-5.

scheme. Since the Supreme Court's decision in *Gilmer*, lower courts are not free to hold that mandatory employment arbitration agreements are categorically unenforceable.[77] However, federal courts have not construed *Gilmer* to dictate that every employment arbitration agreement or all of its provisions must be held valid.[78] Federal courts may deem an arbitration agreement unenforceable if the employee must "forgo the substantive rights afforded by the statute," instead of simply deferring "to resolution in an arbitral, rather than a judicial, forum."[79] Motions to compel arbitration may be denied if the applicable federal statute intended to exclude arbitration as a forum or if the arbitration agreement requires the party to waive certain statutory rights.[80]

In *Gilmer*, the employee was not required to pay any of the arbitration expenses, thus the Supreme Court did not address whether an employer may require employees to share in the arbitration cost.[81] In a decision that followed *Gilmer*, *Green Tree Financial Corp.-Alabama v. Randolph*, the Supreme Court held, where the mandatory arbitration agreement was silent on the payment of arbitration fees, "[t]he 'risk' that [the claimant] will be saddled with prohibitive costs is too speculative to justify the invalidation of an arbitration agreement."[82] While the Court in *Green Tree* did find the burden is on the party seeking to invalidate the agreement to show the likelihood of incurring prohibitive expenses, the Court did not determine how much of a showing is required.[83] Consequently, lower courts remain divided on the issue and have developed various tests that differ greatly between jurisdictions.

A. The Case-by-Case Approach to Evaluating Cost-Sharing Agreements

Since arbitration includes unique expenses that are not a part of court proceedings, some employers create arbitration agreements that split these fees between the parties. When determining whether a cost-sharing clause in an arbitration agreement is valid, courts have created various fact intensive tests that are applied on a case-by-case basis. For example, in *Bradford v. Rockwell Semiconductor, Inc.*, the Fourth Circuit developed an analysis that evaluated the cost-splitting clause on a

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77 *See id.* at 20.

78 *See, e.g.*, Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465 (D.C. Cir. 1997).

79 Mitsubishi Motors Corp. v. Soler Chrysler–Plymouth, Inc., 473 U.S. 614, 628 (1985); *accord In re* Poly-Am., L.P., 262 S.W.3d 337, 349 (Tex. 2008).

80 *See Poly-Am.*, 262 S.W.3d at 349 (citing Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 26 (1991); *Mitsubishi Motors Corp.*, 473 U.S. at 628.

81 *See* Alleyne, *supra* note 26, at 20.

82 Green Tree Fin. Corp.-Ala. v. Randolph, 531 U.S. 79, 91 (2000).

83 *See id.* at 92.

subjective basis, focused on the individual employee's circumstances.[84] This test analyzes the following factors: (1) the employee's ability to pay the fees and costs; (2) the estimated difference between the cost of arbitration and litigation; and (3) "whether that cost differential is so substantial as to deter the bringing of claims."[85] In other words, this test analyzes the cost of arbitration and the employee's ability to pay for it against the cost of litigation and the employee's ability to pay for it.[86] This test may determine that a manager earning $100,000.00 per year would not be deterred by the cost of arbitration whereas a factory worker earning minimum wage would be significantly dissuaded. This leaves a large gray area for courts to determine where to draw the line on what is "so substantial" as to become a barrier to the individual employee.

Furthermore, the Fourth Circuit's test requires a substantial amount of information at the start of the process that may not be readily available to the employee. Accordingly, the Sixth Circuit determined that the *Bradford* test was deficient because "requiring the plaintiff to come forward with concrete estimates of anticipated or expected arbitration costs asks too much at this initial stage in the proceedings" since "such average figures may appear 'too speculative' to support a finding that the costs are prohibitively expensive, even though the plaintiff has no other evidence of the cost."[87]

As a means to overcome the speculative nature of the expense analysis in the *Bradford* approach, some courts have instituted a *post hoc* judicial review of the expenses, reasoning that the court will have before it the actual expenses and arbitration award.[88] However, critics of this approach claim that "the *post hoc* judicial review approach places plaintiffs in a kind of 'Catch 22'"[89] because they cannot argue prior to the arbitration proceeding that it is prohibitively expensive, since they are unaware of what the actual costs will be, yet they cannot argue after arbitration that the costs deterred them from bringing the claim, because the arbitration has already occurred.

The case-by-case approach presents additional problems. By only examining the effect of cost-spitting clauses on the individual, the *Bradford* test "is inadequate to protect the deterrent functions of the federal anti-discrimination statutes at issue."[90] Thus, to address these deficiencies, the Sixth Circuit, in *Morrison v. Circuit City Stores, Inc.*,

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84 Bradford v. Rockwell Semiconductor Sys., Inc., 238 F.3d 549, 556 (4th Cir. 2001).
85 *Id.*
86 *See id.* at 559 n.5.
87 Morrison v. Circuit City Stores, Inc., 317 F.3d 646, 660 (6th Cir. 2003).
88 *See id.* at 660-61.
89 *Id.* at 662-63.
90 *Id.* at 661.

developed a revised approach focused on the deterrent effect on classes of complainants.[91] The Sixth Circuit determined that "a cost-splitting provision should be held unenforceable whenever it would have the 'chilling effect' of deterring a substantial number of potential litigants from seeking to vindicate their statutory rights."[92] The Sixth Circuit's revised test includes the following steps:

> 1. Identify the class of employees who are similarly situated in terms of job description and socio-economic status;
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> 2. Review the individual plaintiff's income and other resources as representative of the members of the class and their ability to pay for arbitration;
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> 3. Consider the average cost of a typical arbitration and compare it to realistic litigation expenses;
>
> 4. Review whether the employee will take on the added expenses of the arbitration forum (such as arbitrator fees and room rental); and
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> 5. Analyze the total costs and expenses of arbitration compared to the total cost of litigation and consider whether, when taken together, potential litigants would be deterred from arbitrating their claims.[93]

The Sixth Circuit also provided that courts "should discount the possibilities that the plaintiff will not be required to pay costs or arbitral fees because of ultimate success on the merits, either because of cost-shifting provisions . . . or because the arbitrator decides that such costs or fees are contrary to federal law."[94] The court reasoned that employees will likely "err on the side of caution"[95] when deciding whether or not to pursue a claim, "especially when the worst-case scenario would mean not only losing on their substantive claims but also the imposition of the costs of the arbitration."[96]

Even though the Sixth Circuit's revised case-by-case analysis in *Morrison* considered the deterrent purpose of federal anti-discrimination

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91 *See id.* at 663.
92 *Id.* at 661
93 *See* Morrison v. Circuit City Stores, Inc., 317 F.3d 646, 663-65 (6th Cir. 2003).
94 *Id.* at 664.
95 *Id.* at 665
96 *Id*

statutes in addition to the remedial role covered in the *Bradford* approach, critics still oppose *any* cost-sharing provisions for various reasons including: (1) arbitration should not cost the claimant any more than bringing the claim in court, (2) if the employer is unilaterally mandating arbitration, then it should have to pay the costs, and (3) litigants are not forced to compensate judges out of pocket, and therefore, they should not be responsible for paying the arbitrator's fees and expenses.[97] Thus, some courts have developed rules that deem cost-sharing provisions *per se* denials of an employee's access to a forum.

B. Cost-Sharing as a per se Denial of an Employee's Access to a Forum

In *Cole v. Burns International Security Services*, the D.C. Circuit ruled that an employer could not require employees to pay all, or even part, of an arbitrator's fees.[98] The D.C. Circuit reasoned that "because public law confers both the substantive rights and a reasonable right of access to a neutral forum in which those rights can be vindicated . . . employees cannot be *required* to pay for the services of a 'judge' in order to pursue their statutory rights."[99] The court further ruled that the only way an employment arbitration agreement could be required as a condition of employment is if the employer is fully responsible for paying the arbitrator's fees.[100] If the employer wants the benefits of arbitration, then it should be prepared to pay for it, as the DC Circuit explained:

> Arbitration will occur in this case only because it has been mandated by the employer as a condition of employment. Absent this requirement, the employee would be free to pursue his claims in court without having to pay for the services of a judge. In such a circumstance—where arbitration has been imposed by the employer and occurs only at the option of the employer—arbitrators' fees should be borne solely by the employer.[101]

Thus, *per se* rules disallowing cost-sharing, such as this, are more employee-friendly than case-by-case approaches, not only because they place the financial burden solely on the employer who benefits from

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97 *See, e.g.*, Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465, 1465-69 (D.C. Cir. 1997).
98 *See id.* at 1485.
99 *Id.* at 1468.
100 *See id.*
101 *Id.* at 1484-85.

arbitration, but also because employees do not have to spend additional time and money seeking a judicial determination on the validity of such cost-sharing provisions before the actual arbitration of the claim ever begins.

IV. STATE LAW DECISIONS ON COST PROVISIONS UNDER CONTRACT LAW

Similar to the federal circuit court divide over cost-splitting provisions, the state courts vary significantly in their evaluation of arbitration fees as a barrier to vindicating statutory rights. Some states have *per se* rules, similar to the D.C. Circuit's approach, and others employ case-by-case methods with differing standards of analysis that range from providing the employee with very little burden to requiring detailed calculations that demonstrate the employees' inability to pay. This difference in state law analysis can be attributed, to some extent, to the states' use of contract law to determine the validity of arbitration agreements.

The Supreme Court has clearly stated in several opinions that the FAA pre-empts state law, and thus, governs arbitration agreements in both state and federal court.[102] Therefore, state courts have limited power in this area since they are bound by the FAA and any state laws that disfavor arbitration will be pre-empted through the Supremacy Clause.[103] However, even though the FAA creates a "liberal federal policy favoring arbitration,"[104] section 2 of the FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[105] In other words, "[s]ection 2 is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."[106] Therefore, an arbitration agreement is only valid if it meets the requirements of the applicable state's contract law, and the agreement must withstand general contract defenses, including fraud, duress, and unconscionability.[107]

Nevertheless, states must treat arbitration favorably. As the Supreme Court provided in *Moses H. Cone Mem'l Hospital v. Mercury Construction Corp.*: "Any doubts concerning the scope of arbitrable

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102 *See* Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp., 460 U.S. 1, 24 (1983); *see also* Perry v. Thomas, 482 U.S. 483, 489 (1987).
103 *See In re* Poly-Am. L.P., 262 S.W.3d 337, 349 (Tex. 2008).
104 *Moses H. Cone Mem'l Hosp.*, 460 U.S. at 24.
105 9 U.S.C. § 2 (2012).
106 *Moses H. Cone Mem'l Hosp.*, 460 U.S. at 24.
107 *See* Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 686 (1996).

issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability."[108] Furthermore, courts are not permitted to "invalidate arbitration agreements under state laws applicable *only* to arbitration provisions."[109] Thus, arbitration agreements must be evaluated like any other contract and not singled out for extra scrutiny or subjected to special rules.[110]

A state court must determine "through the neutral application of its own contract law"[111] whether there is an enforceable contract and whether there are any defenses that invalidate the contract while remaining in accord with the FAA's provisions. It follows that challenges to the validity of arbitration agreements under state law often include a claim that the agreement is unenforceable on the grounds of unconscionability.[112]

A. Unconscionability and Arbitration

Although state laws vary, contracts are largely analyzed with regard to both procedural and substantive unconscionability.[113] Unconscionability, in general, refers to "extreme unfairness" in an agreement, as evaluated by the weaker party's lack of meaningful choice and "contractual terms that unreasonably favor the other party."[114] Procedural unconscionability refers to unfairness in the formation of the contract, while substantive unconscionability refers to the specific terms of the contract that may be unduly harsh or one-sided.[115] Although some states, like California, require a finding of both procedural and substantive unconscionability in order to render the contract unenforceable, a greater showing of one will mean a lesser showing of the other is required.[116]

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108 *Moses H. Cone Mem'l Hosp.*, 460 U.S. at 24-25.
109 *Doctor's Assocs., Inc.*, 517 U.S. at 687 (emphasis in original).
110 *In re* Poly-Am., L.P., 262 S.W.3d 337, 347-48 (Tex. 2008).
111 *Id.* at 348 .
112 *See* CARBONNEAU, *supra* note 15, at 183.
113 *See Poly-Am.*, 262 S.W.3d at 355; *see also* Armendariz v. Found. Health Psychcare Servs. Inc., 6 P.3d 669, 682-83 (Cal. 2000).
114 BLACK'S LAW DICTIONARY 1560 (8th ed. 2008).
115 *See id.* at 1561; *see also* Zimmer v. CooperNeff Advisors, Inc., 523 F.3d 224, 228 (3d Cir. 2008); *see also* James v. Conceptus, Inc., 851 F. Supp. 2d 1020, 1030-32 (S.D. Tex. 2012).
116 *See Conceptus*, 851 F. Supp. 2d at 1030-32.

1. California

While most state courts agree that placing limits on statutorily prescribed remedies is unconscionable, states are divided on the use of cost-splitting provisions.[117] Using the D.C. Circuit's analysis in *Cole* as guidance, the California Supreme Court, in *Armendariz v. Foundation Health Psychcare Services, Inc.*, developed four requirements that arbitration agreements must meet in order to withstand an unconscionability claim:

> 1. The agreement may not limit statutory remedies;
>
> 2. The agreement must not deny the opportunity to engage in adequate discovery;
>
> 3. A written arbitration decision must be issued to allow for judicial review; and
>
> 4. The employee shall not be responsible for unreasonable costs and arbitration fees.[118]

Where these minimum requirements were followed, in addition to arbitrator neutrality, the California Supreme Court held that arbitration is a permissible forum for employees to vindicate state statutory rights.[119]

With regard to the cost of arbitration, the *Armendariz* court further elaborated that "when an employer imposes mandatory arbitration as a condition of employment, the arbitration agreement . . . cannot generally require the employee to bear any *type* of expense that the employee would not be required to bear if he or she were free to bring the action in court."[120] The court found this to be a fair rule, because "it places the cost of arbitration on the party that imposes it."[121] Furthermore, since this rule only applies to *mandatory*, *pre-dispute* agreements, the court reasoned that where arbitration genuinely is an efficient means of dispute resolution, the parties may negotiate a *post-dispute* agreement to arbitrate.[122]

In her concurring opinion in *Armendariz*, Justice Brown disagreed with the "bright-line" approach requiring employers to pay for all of the costs peculiar to arbitration.[123] Justice Brown found that the majority's

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117 *See Armendariz*, 6 P.3d at 682-83; *Poly-Am.*, 262 S.W.3d at 355.

118 *See Armendariz*, 6 P.3d at 685.

119 *See id.* at 674.

120 *Id.* at 687 (emphasis in original).

121 *Id.* at 688.

122 *See id.*

123 *See id.* at 699.

approach "ignore[d] the unique circumstances of each case" including the employee's ability to pay the expenses and the fact that some arbitration proceedings are less costly to employees than litigation.[124] Thus, Justice Brown's concurring opinion concluded:

> As long as the mandatory arbitration agreement does not *require* the employee to front the arbitration forum costs or to pay a certain share of these costs, apportionment should be left to the arbitrator. When apportioning costs, the arbitrator should consider the magnitude of the costs unique to arbitration, the ability of the employee to pay a share of these costs, and the overall expense of the arbitration as compared to a court proceeding. Ultimately, any apportionment should ensure that the costs imposed on the employee, if known at the onset of litigation, would *not* have deterred her from enforcing her statutory rights or stopped her from effectively vindicating these rights.[125]

This rule would eliminate any upfront costs that serve as an obstacle for employees to bring their claims, and it would delegate the responsibility of determining actual cost sharing to the arbitrator.[126] However, it also asks the arbitrator to retrospectively determine what dollar amount would have deterred the employee from bringing a claim and to appropriate the costs accordingly.[127] This cost allocation method may be confusing for some employees, and leaving it up to the arbitrator to allocate costs after the fact may still be viewed as too risky to employees who would face the imposition of potentially high fees.[128]

2. Texas

The Supreme Court of Texas follows a similar approach to Justice Brown's, as it held in *In re Poly-America, LP* that determinations on the reasonableness of cost-splitting provisions were best left to the arbitrator.[129]

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124 *See* Armendariz v. Found. Health Psychcare Servs., Inc., 6 P.3d 669, 699-700 (Cal. 2000).

125 *See id.* at 700.

126 *See id.*

127 *See id.* at 700 ("[A]ny apportionment should ensure that the costs imposed on the employee, if known at the onset of litigation, would *not* have deterred her from enforcing her statutory rights or stopped her from effectively vindicating these rights.").

128 *See id.*

129 *See In re* Poly-Am., L.P., 262 S.W.3d 337, 357 (Tex. 2008).

In *Poly-America*, an employee filed a claim for wrongful discharge and retaliation for filing a workers' compensation claim under the Texas Workers' Compensation Act, and in response, the employer filed a motion to compel arbitration.[130] The employee claimed, *inter alia*, that the cost-splitting provision in the arbitration agreement was substantively unconscionable, and therefore, unenforceable under Texas law.[131] The cost provision in *Poly-America* provided as follows:

> Fees associated with arbitration—including but not limited to mediation fees, the arbitrators' fees, court reporter fees, and fees to secure a place for a hearing—are to be split between the parties, with the employee's share capped at 'the gross compensation earned by the Employee in Employee's highest earning month in the twelve months prior to the time the arbitrator issues his award.'[132]

The agreement further provided that the arbitrator had the authority to modify unconscionable terms.[133] The recently discharged employee expressed concern that this provision, which would potentially require him to pay his highest month's gross income (around $3,300.00) in arbitration costs, was "way more money than [he] could afford."[134] He also stated that he unsuccessfully attempted to retain two attorneys on a contingency-fee basis, and both attorneys declined to represent him based on the arbitration agreement.[135] The employer did not dispute these facts, but maintained that the provision was not unconscionable under Texas law.[136]

The Texas Supreme Court declined to apply the *per se* unconscionability rule of the California courts, reasoning that employees should be required to provide "some evidence" that they "will likely incur arbitration costs in such an amount as to deter enforcement of statutory rights in the arbitral forum."[137] The court in *Poly-America* found the mere risk of unaffordable costs to be "too speculative to justify the invalidation of an arbitration agreement."[138]

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130 *See id.* at 355.
131 *See id*.
132 *Id.* at 344 (citation omitted).
133 *See id.* at 357.
134 *Id.* at 354.
135 *See In re* Poly-Am., L.P., 262 S.W.3d 337, 355 (Tex. 2008).
136 *See id.*
137 *Id.* at 356.
138 *Id.* (quoting Green Tree Fin. Corp.-Ala. v. Randolph, 531 U.S. 79, 91 (2000)).

The court also found in *Poly-America* that, depending on the situation, the employee may not have to pay any expenses at all, or could even benefit from the capped cost provision as compared to the potential cost of litigation.[139] Moreover, since the agreement in *Poly-America* allowed the arbitrator to modify unconscionable terms, the court reasoned that "if the cost provisions precluded [the employee's] enforcement of his non-waivable statutory rights, they would surely be unconscionable . . . and the arbitrator would be free to modify them."[140] The court held that the arbitrator was more suited to determine if the cost provision was prohibitive and upheld the lower court's decision declining to find the provision unconscionable.[141]

3. Other States

Comparable to Texas, Washington requires employees to show that the cost-splitting provision is prohibitive.[142] In *Mendez v. Palm Harbor Homes, Inc.*, the Court of Appeals of Washington found a cost-splitting provision to be prohibitively expensive where the employee would have been required to pay a $2,000.00 filing fee in order to bring a $1,500.00 claim.[143] In *Mendez*, "[t]he filing cost of $2,000 [was] relatively certain under the AAA schedules produced by [the employee]."[144] To the contrary, in *Zuver v. Airtouch Communications, Inc.*, where the employee could not offer any details about the actual fees she would incur in arbitration or her inability to pay them, the Supreme Court of Washington held the cost-splitting fee was not unconscionable (the issue, however, was also rendered moot because the employer offered to pay the arbitrator's fees).[145]

Further, in *Zuver*, even though the agreement provided that the prevailing party may be entitled to attorney's fees, when the state law only allowed for the prevailing plaintiff to recover fees, the court did not find the provision to be unconscionable. The court reasoned that because the agreement used "the permissive word 'may,'" it was "mere speculation to assume that the arbitrator would disregard case law holding that a prevailing defendant may receive attorney fees only if a plaintiff's discrimination claim was 'frivolous, unreasonable, or without foundation.'"[146] In contrast, where the agreement used the directive word

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139 *See id.* at 357.
140 *Id.*
141 *See In re* Poly-Am., L.P., 262 S.W.3d 337, 357 (Tex. 2008).
142 *See* Zuver v. Airtouch Communications, Inc., 103 P.3d 753, 762 (Wash. 2004).
143 *See* Mendez v. Palm Harbor Homes, Inc., 45 P.3d 594, 603 (Wash. Ct. App. 2002).
144 *Id.*
145 *See Zuver*, 103 P.3d at 762-63.
146 *Id.* at 764 (citation omitted).

"shall" in a similar provision in *Walters v. A.A.A. Waterproofing, Inc.*, the Court of Appeals of Washington found the provision to be "one-sided and harsh" and "an enormous deterrent to an employee contemplating a suit."[147]

Missouri courts also require a specific showing of more than "just a hypothetical inability to pay."[148] In *Moore v. Ferrellggas, Inc.*, the Western District of Michigan, applying Missouri contract law, found a cost-splitting provision enforceable where the plaintiff did not provide "the necessary evidence . . . to estimate the length of time necessary to complete arbitration or an estimate of arbitrators' fees."[149] Nonetheless, the court in *Moore* decided to "indulge [the employee's] argument and alternatively demonstrate why it fails."[150] Since the employee earned $50,000.00 annual income, which was approximately in the fiftieth percentile of income in the United States, the court was being asked "to conclude that arbitration provisions, such as the one [here], cannot be enforced against at least fifty percent of the population of the United States."[151] The court found this to be "quite telling as to the frivolousness of [the employee's] argument,"[152] although it made no mention of the fact that the employee in *Moore* had recently lost his job and his income.

The Supreme Court of California cautions that "[t]urning a motion to compel arbitration into a mini-trial on the comparative costs and benefits of arbitration and litigation for a particular employee would not only be burdensome on the trial court and the parties, but would likely yield speculative answers."[153] The court also maintains that unless there are "clearly articulated guidelines,"[154] post-arbitration apportionment of costs will create uncertainty to a degree that employees may consider it too risky to bring meritorious claims to arbitration. Furthermore, the employer is in the best position to perform a cost/benefit analysis when determining the most economical forum.[155] Thus, rather than a case-by-case analysis that burdens the courts and the parties, there should be a bright-line rule placing the unique cost of arbitration, specifically for mandatory, employer imposed, pre-dispute arbitration agreements, on the employer who imposed them.[156]

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[147] Walters v. AAA Waterproofing, Inc. 211 P.3d 454, 459 (Wash. Ct. App. 2009).

[148] Moore v. Ferrellgas, Inc., 533 F. Supp. 2d 740, 750 (W.D. Mich. 2008) (quoting Faber v. Menard, Inc., 367 F.3d 1048, 1053 (8th Cir. 2004)).

[149] *Id.* at 751.

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] Armendariz v. Found. Health Psychcare Servs., Inc., 6 P.3d 669, 688 (Cal. 2000).

[154] *See id.*

[155] *See id.*

[156] *See id.*

B. *Severability*

Even where clauses are held unenforceable, judges have the discretion, in accordance with an agreement's severability clause, to remove the invalid clause from the agreement and compel arbitration with the remaining, enforceable terms intact.[157] For example, in *Poly-America*, the Supreme Court of Texas held that where "provisions are not integral to the parties' overall intended purpose to arbitrate their disputes"[158] those terms "are severable from the remainder of the arbitration agreement."[159] However, "if the central purpose of the contract is tainted with illegality, then the contract as a whole cannot be enforced," as the Supreme Court of California ruled in *Armendariz*.[160] Thus, since unconscionable terms may be severed without invalidating the entire arbitration agreement, employers have little incentive to refrain from crafting one-sided terms that disfavor employees.

V. IS ARBITRATION A NEUTRAL FORUM WHEN THE EMPLOYER COVERS THE EXPENSES?

The *per se* rule that requires employers to pay for arbitration may eliminate cost as an obstacle for employees, however, it creates a potential, or at least perceived, arbitrator bias toward the financing company. In *Cole*, the D.C. Circuit briefly addressed the concerns of commentators regarding arbitrator biases based on employer funding and dismissed them as unlikely.[161] The *Cole* court felt that arbitrators were not concerned with the source of their paychecks, as long as each received one, and if an arbitrator was inclined to favor employers (which the court had no reason to believe was true) it was because the employer is a source of potential future business.[162] The D.C. Circuit further supports its position that employer-funded arbitration does not promote arbitrator bias by stating:

> [T]here are several protections against the possibility of arbitrators systematically favoring employers because employers are the source of future business. For one thing, it is unlikely that such corruption would escape the scrutiny of plaintiffs' lawyers or appointing agencies

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157 *See id.* at 695-96; *see also In re* Poly-Am., L.P., 262 S.W.3d 337, 344 (Tex. 2008).
158 *Poly-Am.*, 262 S.W.3d at 344.
159 *Id.*
160 *Armendariz*, 6 P.3d at 696.
161 *See* Cole v. Burns Int'l Sec. Servs., 105 F.3d 1465, 1485 (D.C. Cir. 1997).
162 *See id.*

> like AAA. Corrupt arbitrators will not survive long in the business. In addition, wise employers and their representatives should see no benefit in currying the favor of corrupt arbitrators, because this will simply invite increased judicial review of arbitral judgments. Finally, if the arbitrators who are assigned to hear and decide statutory claims adhere to the professional and ethical standards set by arbitrators in the context of collective bargaining, there is little reason for concern. In this sense, the rich tradition of arbitration in collective bargaining *does* serve as a valuable model.[163]

As a result, the D.C. Circuit held that the employee in *Cole* could not be compelled to arbitrate his claim as a condition of employment if he was required to pay any of the arbitrator's fees or expenses and rejected the notion that employer-financed arbitration creates a bias process in favor of the employer.[164]

Opponents of mandatory employment arbitration are not convinced by this reasoning. Judges in federal and state court alike are subject to disqualification if their ability to remain impartial may reasonably come into question.[165] This is an objective standard that applies even if there is no actual impartiality but only the appearance of it.[166] Courts regard this as a critical component in upholding the public's confidence in the judicial system.[167] Consequently, if arbitration is simply a change in forum, it should follow that arbitrators must also be disqualified if there is an appearance of bias.[168] Some scholars believe it is likely that where an employer pays for all the expenses and is also a "repeat player" in the arbitration setting, it will hire arbitrators again in the future, and at a minimum, the process will *appear* to be bias in the favor of the employer.[169]

VI. MINIMIZING EMPLOYER BIAS THROUGH A NEUTRAL ARBITRATOR SELECTION PROCESS

It may be impossible to remove all perceptions of bias when the employer is paying for the process, but even critics of employment

163 *Id.*
164 *See id.*
165 *See* Alleyne, *supra* note 26, at 35-36.
166 *See id.* at 36.
167 *See id.*
168 *See id.*
169 *See id.* at 38; *see also* Summers, *supra* note 31.

arbitration agree that the mutual selection of an arbitrator minimizes this potential perception.[170]

Biases may be further diminished by utilizing an arbitration service provider such as the AAA which is committed to neutrality in dispute resolution. The AAA has developed its own set of Employment Arbitration Rules and Mediation Procedures that outline the AAA's approved methods for selecting arbitrators, as well as the process for disqualifying partial arbitrators.[171] The AAA will honor contractually agreed upon arbitrator selection procedures between the parties; however, the arbitrators *must* be neutral and experienced in employment law matters.[172] Arbitrators must also act in good faith and "have no personal or financial interest in the results of the proceeding,"[173] nor may they have a relationship with the parties or their representatives "that may create an appearance of bias."[174] If an arbitrator appears to be partial, parties have the right to object to the continued use of the arbitrator's services, or the AAA may disqualify an arbitrator on its own accord.[175] Thus, since the employee may object to the arbitrator after the proceedings have begun, when a bias may be revealed, this provides an additional safeguard for the employee.

If the parties do not outline the arbitrator selection process in the agreement, the AAA shall send a list to both parties.[176] The parties are encouraged to agree upon an arbitrator on the list, but if they cannot reach a decision, they are permitted to strike the names of arbitrators they object to and rank the remaining names in order of preference.[177] The AAA will then select the name of a remaining arbitrator based on this elimination and ranking process.[178]

By utilizing the services of an arbitration association, such as the AAA, employees are provided with added protections from arbitration agreements designed to create employer biases. Further, the association's published rules and monitoring of procedures aid in institutionalizing fairness as part of the process.

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170 *See* Alleyne, *supra* note 26, at 38.

171 *See* AM. ARBITRATION ASS'N, EMPLOYMENT ARBITRATION RULES & MEDIATION PROCEDURES (Nov. 1, 2009).

172 *See id.*

173 *Id.* at 20.

174 *Id*.

175 *See id.*

176 *See id.* at 15.

177 *See id.*

178 *See id.*

VII. RECOMMENDATIONS FOR UNIFORMITY AND FAIRNESS

Due to the lack of uniformity among courts in determining standards of fairness to adequately protect employees, there have been legislative attempts to eliminate the use of mandatory arbitration agreements in employment. Additionally, arbitration service providers have imposed minimum standards of fairness to safeguard employee rights.

A. Proposed Legislation to Amend the Federal Arbitration Act

The most effective way to protect employees and create a uniform standard would be to pass legislation that clarifies the intent of Congress in the FAA. Several attempts have been made in Congress to pass legislation banning mandatory, pre-dispute arbitration agreements. An Arbitration Fairness Act was unsuccessfully introduced in the Senate in 2007, 2009, and 2011.[179] In May 2013, the Arbitration Fairness Act of 2013, S. 878 sponsored by Senator Alan "Al" Franken (D-MN), was introduced to the Senate and HR. 1844, sponsored by Rep. Henry "Hank" Johnson, Jr. (D-GA), was introduced to the House of Representatives. In the bill, Congressional findings included:

> (1) The Federal Arbitration Act . . . .was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.
>
> (2) A series of decisions by the Supreme Court of the United States have interpreted the Act so that it now extends to consumer disputes and employment disputes, contrary to the intent of Congress.
>
> (3) Most consumers and employees have little or no meaningful choice whether to submit their claims to arbitration. Often, consumers and employees are not even aware that they have given up their rights.
>
> (4) Mandatory arbitration undermines the development of public law because there is inadequate transparency and inadequate judicial review of arbitrators' decisions.

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179 Arbitration Fairness Act of 2007, S. 1782. 110th Cong.; Arbitration Fairness Act of 2009, S. 931 111th Cong.; Arbitration Fairness Act of 2011, S. 987 112th Cong.

> (5) Arbitration can be an acceptable alternative when consent to the arbitration is truly voluntary, and occurs after the dispute arises.[180]

The Arbitration Fairness Act would "restore the original intent of the FAA by clarifying the scope of its application."[181] A new chapter would be added to the FAA invalidating mandatory, pre-dispute arbitration agreements for employment, consumer, anti-trust, and civil rights matters.[182] The proposed Act would not ban arbitration or place limitations on parties' ability to enter into voluntary, post-dispute arbitration agreements, nor would it interfere with the rights of labor unions and companies to include arbitration provisions in CBAs.[183] The purpose of the Act is to "restore[] the rights of workers and consumers to seek justice in our courts" and to safeguard the rights afforded by statute.[184]

B. The Employment Due Process Protocol

Emphasizing the need for fairness in employment arbitration, A Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising out of the Employment Relationship ("Due Process Protocol") was developed in 1995 by individual members of the Labor & Employment Section of the American Bar Association, the National Academy of Arbitrators, the American Arbitration Association ("AAA"), the Federal Mediation and Conciliation Services, and the National Lawyers Association.[185] Although the committee of experts felt "impartiality is best assured by the parties sharing the fees and expenses of the mediator and arbitrator"[186] this belief may be attributable to the members' backgrounds in traditional labor arbitration where cost does

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180 Arbitration Fairness Act, H.R. 1844 § 2(1)-(5), 113th Cong. (2013).

181 Al Franken, *The Arbitration Fairness Act of 2013*, SENATE.GOV, http://www.franken.senate.gov/files/documents/130507ArbitrationFairness.pdf (last visited Sept. 27, 2014).

182 *See* H.R. 1844 § 3(a) (amending 9 U.S.C. by adding § 402(a): "Notwithstanding any other provision of this title, no predispute arbitration agreement shall be valid or enforceable if it requires arbitration of an employment dispute, consumer dispute, or civil rights dispute."); *see also* Al Franken, *The Arbitration Fairness Act of 2013*, SENATE.GOV, http://www.franken.senate.gov/files/documents/130507ArbitrationFairness.pdf (last visited Sept. 27, 2014).

183 Al Franken, *The Arbitration Fairness Act of 2013*, SENATE.GOV, http://www.franken.senate.gov/files/documents/130507ArbitrationFairness.pdf (last visited Sept. 27, 2014).

184 *Id.*

185 *See Policy Statement on Employment Arbitration,* NAT'L ACAD. OF ARBITRATORS (May 9, 2009), http://www.naarb.org/due_process/due_process.html.

186 *Id.*

not present the same dilemma as it does in the non-union workforce.[187] Nonetheless, the Due Process Protocol set forth the following provisions as essential to fair arbitration proceedings:

- Employee has the right to choose his or her own representative

- Employee and the representative may determine their own fee arrangement and the arbitrator may provide fee reimbursement

- Encouragement of "adequate but limited pre-trial discovery"

- Development of a roster of qualified mediators and arbitrators who have knowledge of the subject matter

- Training on statutory issues, as well as the mediation and arbitration process

- Duty of the arbitrator to disclose any relationships that present a conflict of interest – arbitrators should sign an oath stating that no conflict exists

- Arbitrator should be bound the applicable agreements, statutes, regulations and rules of procedure[188]

ADR service providers, such as the AAA, adopted the Due Process Protocol in their procedural rules and guidelines, although most providers have strengthened the employees' protection against prohibitive expenses by requiring employers to pay all but the initial filing fee.[189]

C. *Organizational Minimum Standards of Fairness*

ADR service provider, JAMS, The Resolution Experts (formerly Judicial Arbitration and Mediation Services, Inc.) has the following Policy on Employment Arbitration Minimum Standards of Procedural Fairness that must be included in mandatory arbitration agreements:

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187 *See* NOLAN, *supra* note 6, at 346-47.
188 *See id.*
189 *See id.*

> 1. All remedies that would be available to the employee in court, including attorneys' fees, exemplary damages, and statutes of limitations must also be available to the employee in arbitration.
>
> 2. The arbitrator(s) must be neutral and the employee must have the opportunity to participate in the selection process.
>
> 3. The employee must have the right to representation by counsel and the employer may not discourage the employee from obtaining counsel.
>
> 4. The arbitration agreement must allow for the exchange of essential information. This discovery should minimally include: relevant documents, identification of witnesses and one deposition for each side.
>
> 5. Each side has the right to present proof by way of testimony and documentary evidence, and each side also has the right to cross-examine witnesses.
>
> *6. The cost and location must not be prohibitive for the employee. The employee may only be required to pay the initial case management fee. The employer must pay all other costs, including additional case management fees, and all of the arbitrator's fees.*
>
> 7. There must be mutuality in the agreement, i.e., the requirements must be the same for the employer and the employee.
>
> 8. The award must include a signed statement by the arbitrator regarding each claim and award, the reasons for any award, and the essential findings and conclusions that merited the award.[190]

JAMS will only facilitate mandatory employment arbitrations if these minimum standards are met.[191] Further, JAMS encourages the use of voluntary mediation or other forms of dispute resolution in the early

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190 *See* JAMS, INC., POLICY ON EMPLOYMENT ARBITRATION MINIMUM STANDARD OF PROCEDURAL FAIRNESS 2-5 (Jul 15, 2009), *available at* http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_Employment_Min_Stds-2009.pdf (emphasis added).

191 *See id.* at 4.

stages of conflict.[192] It is important to note that the minimum standards listed above do not apply to individually negotiated agreements or to agreements that were entered into while the employee was represented or advised by counsel.[193] Thus, these standards are meant specifically to ensure fairness in pre-dispute, mandatory employment arbitration agreements that were signed as a condition of employment.[194]

Following these guidelines can help employers to create a fair and accessible dispute resolution process for employees and minimize potential litigation over the validity of the arbitration agreement.

VIII. CONCLUSION

There has been much debate, both in scholarly journals and in the courtrooms, over what constitutes a fair and neutral arbitration process for employees to effectively vindicate their statutory rights. Opinions range from proponents who believe that arbitration is a quick and cost effective dispute resolution forum that is sufficiently bargained for in the employment process, to critics who feel that arbitration can never be an acceptable forum in employment because it takes advantage of workers in a weaker bargaining position. In the middle of the spectrum are employees and employers who would like to avoid the slow and highly adversarial litigation process in way that minimizes obstacles for employees.

As demonstrated here, cost is a significant obstacle for employees and minimizes the other benefits of arbitration for those who cannot afford it. However, since legislative attempts to eliminate mandatory employment arbitration agreements have been unsuccessful, and the courts overwhelmingly favor arbitration, it is likely that employment disputes will be subjected to mandatory arbitration for the foreseeable future. Thus, to ensure that cost is not a barrier to employees seeking to vindicate statutory rights, it is essential for arbitration service providers and drafters of mandatory arbitration agreements to provide for employer paid arbitration expenses and a carefully designed arbitrator selection process that ensures neutrality.

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[192] *See id.* at 2.
[193] *See id.* at 5.
[194] *See generally id.* at 2-5.

Renewable Energy: Where We Are Now and How Renewable Energy Investment and Development Can Be Expanded

Kevin M. Walsh*

The renewable energy field is currently stifled because many renewable energy developments require tax equity investors to provide additional funds to get the projects off the ground and running. The Tax Code provides credits to incentivize investors to invest. Currently, the Investment Tax Credit ("ITC") is the only available credit remaining for renewable projects. Tax credits are a step in the right direction to encourage renewable investment; however, the credits are limited in application, mostly to large financial institutions. Moreover, investing into one specific renewable energy project can be risky because there is no assurance that the development will yield a cash flow or be placed in service on time to receive the expected credit amount. Additionally, investing directly on-site into a renewable energy project is mostly accomplished for the purpose of receiving a credit to offset taxes from passive taxable income. This purpose may not meet the needs of many investors. Instead of a tax credit, other investors may want some type of rate of return, either through dividends, stock appreciation or some other method.

To remedy these issues, the legislature and the IRS should focus on alternative methods to expand renewable energy investment. First, the government should continue to put pressure on large companies (finance and other) to invest in renewable energy projects and to make renewable energy investment commitments. Second, these companies may not have an objective to receive a

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tax credit for investing directly on-site to a renewable project. Therefore, there needs to be alternative methods for these companies to invest. Asset-backed securities, Real Estate Investment Trusts (REITs) and Master Limited Partnership's (MLPs) are alternative investment methods that would satisfy these companies' investment needs. Moreover, because on-site investment is mostly limited to large institutions, these alternative investment methods open the market for smaller investors to get a piece of the pie. The smaller investor pool is untested water: it could provide for a substantial amount of renewable energy investment.

These alternative methods should be used in conjunction with the ITC because companies have varying investment objectives. Large financial institutions will still want to invest on-site to receive the credits and deductions, whereas other companies that do not have enough taxes from passive taxable income (and otherwise would not be investing in the renewable project) can invest in the securities for a rate of return. This will have the effect of increasing renewable investment and development.

I. INTRODUCTION

Renewable energy has become an important economic sector in the United States over the past decade. Renewable energy has historically represented five to seven percent of power consumption in the United States.[1] In June 2013, the Energy Information Administration (EIA) issued a report that renewable energy sources provided 9.81 percent of U.S. energy consumption and 11.82 percent of U.S. energy production for the first half of year 2013.[2] Despite this progress, the United States remains far from its goal to have fifteen percent of electric energy consumption produced by renewable energy sources in 2016 and 2017, 17.5 percent in 2018 and 2019, and twenty percent in 2020 and each year thereafter.[3] To incentivize renewable energy growth, the United States government provides credits to tax equity investors. This Article will explore the available tax credits, identify the tax equity investors, describe those investors' roles in renewable energy development, explain why credits are limited to large financial institutions, and discuss four possible investment alternatives–(a) increased investment by large companies/institutions, (b) asset-backed securitization, (c) Real Estate Investment Trusts and (d) Master Limited Partnerships–that the government may use to incentivize renewable energy development and investment by broadening the investment pool to include large and small companies and smaller investors.

II. BACKGROUND

A. What is So Important About Renewable Energy?

There are two facets of renewable energy that are increasingly important. First, the United States heavily relies on coal, oil and natural

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1 Hobart King, *Trends in Renewable Energy Production & Consumption in the USA*, GEOLOGY.COM, http://geology.com/articles/renewable-energy-trends (last visited Sept. 27, 2014).

2 Kenneth Bossong, *Renewable Energy Mid-Year Report: 10% US Energy Consumption, 14% Net Electrical Generation*, RENEWABLEENERGYWORLD.COM (Sept. 30, 2013), http://www.renewableenergyworld.com/rea/news/article/2013/09/renewable-energy-mid-year-report-10-us-energy-consumption-14-net-electrical-generation.

3 Memorandum from President Barack Obama for the Heads of Executive Departments and Agencies about Federal Leadership on Energy Management (Dec. 5, 2013), *available at* http://www.whitehouse.gov/the-press-office/2013/12/05/presidential-memorandum-federal-leadership-energy-management [hereinafter Presidential Memorandum].

gas for energy consumption.[4] While the United States' net import share of total U.S. energy consumption was sixteen percent in 2012, the country imported forty percent of the petroleum it consumed that year.[5] The EIA predicts that the net import share of energy consumed will decrease to four percent by 2040.[6] This prediction demonstrates that the United States expects to domestically produce an increasing share of its energy consumption. This is a step in the right direction for our country.

There are currently about 950,000 people employed, directly or indirectly, through the renewable energy market.[7] At the very least, this Article contends that the United States needs to maintain the current level of production and utilization of renewable energy sources to keep these individuals employed. Fortunately, there is much room for growth here. For example, employment in the solar field has grown sixty percent since 2010, creating over 25,000 new jobs in that sector alone.[8] This Article also contends that if the renewable energy industry is to expand, the U.S. must rely less on exports from its foreign counterparts and boost domestic production, thereby augmenting GDP, by continuing to employ more workers. As renewable energy growth occurs, however, there is a likelihood that other, non-renewable energy sectors, such as coal mining, will lose market share and experience a possible compounding negative effect on employment therein.[9]

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4 Kevin M. Walsh, *Renewable Energy Financial Incentives: Focusing on Federal Tax Credits and the Section 1603 Cash Grant: Barriers to Development*, 36 ENVIRONS ENVTL. L. & POL'Y J. 207, 208-09 (2012) (citing Gary C. Bryner, *Challenges In Developing A Diverse Domestic Energy Portfolio: Integrating Energy And Climate Policy In The Western United States*, 15 N.Y.U. ENVTL. L.J. 73, 73-74, 83 (2007); *How Dependent Are We On Foreign Oil?*, U.S. ENERGY INFO. ADMIN., http://www.eia.gov/energy_in_brief/foreign_oil_dependence.cfm (last updated July 13, 2012)).

5 U.S. ENERGY INFO. ADMIN., DOE/EIA-0383ER(2014), ANNUAL ENERGY OUTLOOK 2014 EARLY RELEASE OVERVIEW 12 (Dec. 16, 2013).

6 *Id.* at 2.

7 Scott Sklar, *New Solar Job Statistics Released, But Other Renewables are Growing, Too*, RENEWABLEENERGYWORLD.COM (Jan. 28, 2014), http://www.renewableenergyworld.com/rea/news/article/2014/01/new-solar-job-statistics-released-but-other-renewables-are-growing-too; THE SOLAR FOUNDATION, THE ANNUAL REVIEW OF THE U.S. SOLAR WORKFORCE (2013), *available at* http://www.thesolarfoundation.org/sites/thesolarfoundation.org/files/TSF%20Solar%20Jobs%20Census%202013.pdf.

8 *Id.*

9 Christopher DeMorro, *The U.S. Has More Solar Workers Than Coal Miners*, CLEAN TECHNICA, http://cleantechnica.com/2014/07/22/u-s-solar-workers-coal-miners/ (last visited Oct. 28, 2014).

B. *Tax Credit Overview*[10]

Title 26 of the United States Code, section 45, governs the Production Tax Credit ("PTC"), a per-kilowatt-hour tax credit for electricity that is generated by "qualified energy resources" and sold to unrelated persons.[11] Section 45 provides that the taxpayer responsible for the renewable energy development will receive credits for ten years and that the annual credit is dependent on energy production.[12] The Section also provides that the credited project must have been placed in service by December 31, 2013, to be eligible to receive the credit.[13]

The inconsistency of the availability of tax credits is a major problem for investors as, for example, the tax credit expires and is not automatically renewed. Investors in renewable energy projects make their business decisions, in part, based on whether the tax credit will be available to use.[14] Tax equity investment is stifled without the kind of stability that is borne out of knowing whether the tax credit will be available.[15] A decrease in investment is seen especially when the credit expires because there is no assurance that the credits will be extended.[16] While understanding this issue is critical in context to grasp the issues in renewable energy investment, the focus of this Article discusses who can take advantage of these credits and how the current renewable investment sector can be expanded.

Title 26 of the U.S. Code, section 48, governs the Investment Tax Credit ("ITC"). Unlike the PTC, taxpayers utilize the ITC by taking a tax credit, equal to thirty percent or ten percent of their cost basis in the development—depending on the type of renewable energy development—in the year the development is placed in service.[17] The

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10 Tax credits are amounts that reduce a taxpayer's total tax liability. The following example will illustrate this point: A person or company generates income. This income, following certain deductions, is considered a taxpayer's taxable income ("TI"). The applicable tax rates are applied against the TI and the taxpayer's resulting tax liability is borne. Credits are the amounts that reduce tax liability, dollar for dollar. If the taxpayer owes $4,000 in taxes but has $3,000 in tax credits, now the taxpayer only owes $1,000 in taxes.

11 26 U.S.C. § 45 (2006); DEP'T OF ENERGY, *Renewable Electricity Production Tax Credit (PTC)*, http://energy.gov/savings/renewable-electricity-production-tax-credit-ptc (last visited Oct. 6, 2014).

12 26 U.S.C. § 45 (2006).

13 *Id.*

14 *See* Walsh, *supra* note 4, at 235 (citing *Energy Tax Policy and Tax Reform: Hearing Before H. Comm. on Ways and Means*, 112th Cong. 14 (2011) (statement of Neil Z. Auerbach, Managing Partner of Hudson Clean EnergyPartners), *available at* http://waysandmeans.house.gov/uploadedfiles/auerbachtestimony922.pdf).

15 *Id.*

16 *Id.*

17 26 U.S.C. § 48 (2006).

ITC is also available for properties that are placed in service before January 1, 2017.[18]

From a policy perspective, the PTC seems like the more efficient credit because it is entirely based on the production of electricity. The ITC, however, has nothing to do with production of electricity, as the ITC development could be useless and the taxpayer would still receive the credit.[19] From a business perspective, this Article contends that the ITC is preferable to the PTC as an incentive to encourage renewable energy investment.

Although the ITC theoretically achieves the goal of attracting more investors to renewable energy projects[20], the ITC for solar energy used to generate electricity, heat and cool a building or provide solar process heat is legislated to decrease from thirty percent to ten percent after December 31, 2016.[21] Moreover, the ITC for geothermal heat pumps, hybrid solar lighting, small wind, fuel cells and micro-turbines will expire.[22] This Article contends that the reduction and expiration of the ITC is a mistake.

This Article believes that these forthcoming changes are bad policy. For example, consider that in the United States over the last decade, the amount of wind energy consumed has exponentially increased as compared to total renewable energy consumed.[23] In year 2000, wind energy consumption comprised less than one percent of total renewable energy consumed.[24] However, in 2007, wind energy represented 5.2 percent of total renewable energy consumed, and, in 2013, wind energy represented 17.2 percent of total renewable energy consumed.[25] This Article contends that reducing the percentage of the ITC against certain renewable energy, such as wind, will reduce the amount of renewable energy developments put in place.

Although there is not direct evidence that the credits are the reason that renewable energy production and consumption has increased over the past six years, there is a strong correlation between the availability of

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18 *Id.*

19 *See* generally 26 U.S.C. § 48 (2006).

20 *See* Walsh, *supra* note 4, at 235 (citing *Energy Tax Policy and Tax Reform*, *supra* note 14 (statement of Neil Z. Auerbach, Managing Partner of Hudson Clean Energy Partners)).

21 Dep't of Energy, *Business Energy Investment Tax Credit (ITC)*, ENERGY.GOV, http://energy.gov/savings/business-energy-investment-tax-credit-itc (last visited Oct. 6, 2014); *see also* 26 U.S.C. § 48 (2006).

22 Dep't of Energy, *supra* note 21.

23 U.S. ENERGY INFO. ADMIN., DOE/EIA-0035(2014/09), MONTHLY ENERGY REVIEW SEPTEMBER 2014 137 (Sept. 25, 2014).

24 *Id.*

25 *Id.*

the credit and the upticks in domestic production and consumption. The ITC was created and applied in 2006, and was expanded by the American Recovery and Reinvestment Act of 2009.[26] Since its adoption, total renewable energy production and consumption has increased from 6,500 trillion btu (British Thermal Unit) in 2007, to 8,100 in 2010 and 9,300 in 2013.[27] Further, since 2007, there has been an influx of renewable energy growth that this Article attributes to the availability and expansion of tax credits. Rather than reduce or eliminate the existing tax credits, this Article calls for the credit percentage for wind energy to increase if the United States intends to achieve its goal to have twenty percent of electric energy consumed through renewable energy sources in 2020.[28]

It has been previously documented that renewable energy investment and development sharply decreases as a result of tax credits lapsing.[29] Although renewable energy investment and development will not likely decline drastically as a result of the forthcoming ITC percentage decrease, the outcome could be similar. As a result, this Article issues a call to expand the investor base for renewable projects. Before describing the methods of expanding investment, this Article will first explain what are tax equity investments, why the investment is deemed to be passive, and what effect the passive limitation has on investors and their investment abilities and decisions.

C. What is a Tax Equity Investment?

Tax equity financing occurs when an investor makes an investment into a renewable energy development specifically for the cash flow and tax benefits associated with that investment.[30] These tax credits can only be used by clean energy developers who generate enough profits with which to offset the credit.[31] However, because renewable energy developments are typically start-ups, the developer most likely has not reached the point of profitability yet and, thus, will not be able to use the tax credits.[32] As a result, developers seek investment from institutions

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[26] Dep't of Energy, *supra* note 21.
[27] U.S. ENERGY INFO. ADMIN., *supra* note 23.
[28] Presidential Memorandum, *supra* note 3.
[29] Walsh, *supra* note 4, at 235 (citing *Energy Tax Policy and Tax Reform*, *supra* note 14 (statement of Neil Z. Auerbach, Managing Partner of Hudson Clean Energy Partners)).
[30] U.S. PREF: U.S. P'SHIP FOR RENEWABLE ENERGY FIN., TAX CREDITS, TAX EQUITY AND ALTERNATIVES TO SPUR CLEAN ENERGY FINANCING 1 (Sept. 2011) [hereinafter U.S. PREF 1].
[31] *Id.* (the mechanics of using credits to offset income will be described below).
[32] *Id.*

that have enough taxes from passive taxable income with which to offset the tax credit.[33] These institutional investors are called tax equity investors, which are typically "large tax-paying financial entities such as banks, insurance companies and utility affiliates."[34] Fifteen to twenty of these financial institutions have dominated the renewable energy credit market.[35]

D. Why Are The Major Renewable Energy Credit Players Large Financial Entities?

Tax equity investors typically get involved in the management or development of the project when something goes wrong with the performance of the investment or project.[36] Such investments are commonly structured through limited liability companies ("LLC") or limited partnerships wherein the investor's activities are typically passive.[37] A passive activity means that the investor does not "materially participate" in the development and management of the renewable energy development.[38] The IRS designated what "material participation"[39] means in Publication 925.[40] Specifically, the IRS noted that "personal service activities" represent "material participation," stating that:

> The activity is a personal service activity in which you materially participated for any 3 (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts,

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33 *Id.*

34 U.S. PREF: U.S. P'SHIP FOR RENEWABLE ENERGY FIN., U.S. RENEWABLE ENERGY TAX EQUITY INVESTMENT AND THE TREASURY CASH GRANT PROGRAM 1 (Apr. 2011) [hereinafter U.S. PREF 2].

35 Michael Meyers et al., *Bridging the Tax Equity Funding Gap*, PROJECT FINANCE INTERNATIONAL: RENEWABLES REPORT, May 2012, at 6.

36 U.S. PREF 2, *supra* note 34, at 1.

37 John A. Eliason, *Investing in Alternative Energy? Consider the Passive Activity Loss Rule*, RENEWABLEENERGYWORLD.COM (Dec. 19, 2012), http://www.renewableenergyworld.com/rea/news/article/2012/12/investing-in-alternative-energy-consider-the-passive-activity-loss-rule.

38 INTERNAL REVENUE SERV., PUB. 925, CAT. NO. 64265X, PASSIVE ACTIVITY AND AT-RISK RULES 3 (Jan. 23, 2014) [hereinafter IRS PUB. 925].

39 Black's Law Dictionary Online ("the taxpayer will be identified as materially participating in the business if the taxpayer participates in business activities on a regular basis").

40 IRS PUB. 925, *supra* note 38, at 5-6.

> consulting, or any other trade or business in which capital is not a material income-producing factor.[41]

Renewable energy investors are, for the most part, logically limited to large financial institutions for two reasons. First, the IRS provides an exception for large financial institutions by excluding them as a "personal service activity" in test six of the "material participation tests."[42] By definition, a financial institution is not a "material participator" unless it meets one of the other tests noted in the publication.[43] If the investor materially participates, the investment is no longer considered a passive activity.[44] The IRS further explains the exception for financial institutions by specifically noting that "[y]ou do not treat the work you do in your capacity as an investor in an activity as [material] participation unless you are directly involved in the day-to-day management or operations of the activity."[45] Although tax equity investors may get involved if something goes wrong with the investment or development, IRS Publication 925 designates in several "material participation tests" that an investor may not participate for more than a certain quantity of hours in the project, depending on the circumstances, in order to remain passive.[46]

Second, the tax credit is limited to passive taxable income because the credit relates to the investment, which is itself considered to be a passive activity as a result of the tax-planning structure that is set in place.[47] For this reason, the ITC is mostly limited to financial institutions, which have a lot of passive taxable income and, therefore, the capability to use the tax credit to offset passive taxes.[48] This Article will briefly discuss three structures to give a high-level idea about what

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41 *Id.* at 5.

42 *Id.*

43 *Id.*

44 *Id.*

45 *Id.*

46 IRS PUB. 925, *supra* note 38, at 5. The tests to which this refers are one, two, three, four and seven. Depending on which test is used, the hourly limit may be 100 or 500 hours.

47 ED FEO & STEPHEN TRACY, COMMERCIAL FINANCE: THE DARK ARTS OF LEVERAGE, TAX EQUITY, LEASES AND MORE 22 (2009), *available at* http://www.novoco.com/energy/resource_files/reports/sbt_finalpreso_102609.pdf (discussing financing structures, federal tax law, and sources of financial incentives); *see also* Eliason, *supra* note 37.

48 *See* U.S. PREF 2, *supra* note 34, at 1; U.S. PREF 1, *supra* note 30, at 1; Meyers, *supra* note 35.

is going on and why the tax credit relates to passive income: (1) Partnership Flip; (2) Sale Leaseback; and (3) Inverted Lease.[49]

1. The Partnership Flip Structure

In a partnership flip, a developer and tax equity investor form a partnership.[50] The taxpayer, who can be the partnership or the tax equity investor, must be the owner of the assets.[51] A taxpayer is considered the "owner" if there is substantial economic effect in the partnership's profit or loss allocations.[52] To have substantial economic effect, the partner to whom the allocation is made must receive the economic benefit or economic burden that corresponds to the allocation.[53] As the "owner," the taxpayer can take advantage of the allocations that the partnership agreement sets forth.[54]

The tax equity investor is allocated ninety-nine percent of partnership net income and losses for a five-year period.[55] Then, usually about ninety-five percent of the net income and losses are flipped back to the developer.[56] Therefore, the tax equity investor will retain about a five percent interest in the project.[57] Ultimately, the tax equity investor hopes to receive income and tax credits as a return on the investment (ROI), and the developer hopes to receive the partnership interest five years later at a discounted cost.[58] The tax equity investor retains a passive relationship in the partnership and the renewable energy development.

A typical partnership flip transaction may be shown as follows. First, a tax equity investor will contribute funds to a partnership for a ninety-nine percent partnership interest. The tax equity partner, therefore, will be entitled to ninety-nine percent of the tax credit.[59] The tax equity investor will be entitled to the ITC in the first year and the depreciation

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49 Gary Hecimovich & Tom Stevens, *Introduction to Tax Equity Structures*, DELOITTE (2012), https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Energy_us_er/us_er_AESem2012_1_1_2_1IntTaxEquity_101012.pdf.

50 ANDREA S. KRAMER & PETER C. FUSARO, ENERGY AND ENVIRONMENTAL PROJECT FINANCE LAW AND TAXATION § 27.05 (2010).

51 Hecimovich & Stevens, *supra* note 49, at 7.

52 26 U.S.C. § 704(b) (2006); *see also* Hecimovich & Stevens, *supra* note 49, at 7.

53 Treas. Reg. § 1.704-1(b)(2)(ii)(a) (2013); *see* Treas. Reg. § 1.704-1(b)(2)(iii) (2013).

54 26 U.S.C. § 704(a)-(b) (2006).

55 KRAMER & FUSARO, *supra* note 50; Brandon Conard, *Solar Tax Equity Investments 101*, GREENZU http://greenzu.com/solar-tax-equity-investor-returns (last visited Oct. 7, 2015); *see also* Rev. Proc. 2007-65, 2007-2 C.B. 967 (providing additional rules governing the structure of a solar project).

56 KRAMER & FUSARO, *supra* note 50.

57 Thomas W. Giegerich, *The Monetization of Business Tax Credits*, 12 FLA. TAX. REV. 709, 770 (2012).

58 KRAMER & FUSARO, *supra* note 50.

59 Giegerich, *supra* note 57, at 769-70.

deductions thereafter.[60] For example, if the project's cost was $334,000 (and ITC is based on cost basis) and the tax equity investor gets ninety-nine percent of the ITC—because in this example the investor has a ninety-nine percent partnership interest—the ITC is $100,000, or 30% of $334,000, and the tax equity investor gets a $99,999 ITC.[61] Then, the investor will be entitled to the allocable share of depreciation deductions in the following years.[62]

Even if the tax equity investor receives about $100,000 in tax credits and $100,000 in depreciation deductions over the five-year period, the tax benefit in and of itself is not enough to fully incentivize an investor to invest because the tax benefits are only worth the taxpayers' tax rate per dollar.[63] That is to say, if the taxpayers' tax rate is thirty-five percent, the benefit the taxpayer receives is thirty-five cents on each dollar. Thus, to make the investment worthwhile in any tax equity investment, there has to be some prospect of positive cash flow for the tax equity investor to receive a ROI. This cash flow is achieved, in part, by a constant rate of return each year and, at the end of the five-year period, through a buyout price that the developer pays to acquire the majority of the tax equity investor's interest in the partnership.[64] Otherwise, the tax equity investor only receives profit or loss, according to his ninety-nine percent interest in the partnership.[65] This alternative would prove to be an investment deterrent because, in the early years, many start-ups, such as those being discussed herein, lose money, which renders the tax equity investor as more likely to realize losses.

2. The Sale-Leaseback Structure

In a sale-leaseback scenario, the developer sells the renewable energy development to the tax equity investor, who subsequently leases the project back to the developer in an integrated transaction.[66] This is similar to car leases from dealerships where the dealership remains the "owner" for tax purposes–the tax equity investor is still the owner, and therefore, is entitled to receive the ITC the first year and depreciation deductions thereafter–and the lessee has a right to use the car–as the

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60 Conard, *supra* note 55.
61 *Id.*
62 *Id.*
63 *Tax Exemptions, Deductions, and Credits*, CENTER ON BUDGET & POL'Y PRIORITIES 2 (Apr. 16, 2013), http://www.cbpp.org/files/policybasics-exempt.pdf.
64 *Id.*
65 Giegerich, *supra* note 57, at 769.
66 BRUCE K. BENESH & M. KEVIN BRYANT, DEPRECIATION HANDBOOK § 8.03 (Matthew Bender & Co. ed., 2014).

developer has the right to operate the renewable energy development.[67] An advantage of the sale-leaseback model is that the tax equity investor receives one hundred percent of the tax benefits, in addition to the lease payments.[68] One disadvantage to this model is that the tax equity investor has to put up more financing—one hundred percent of the project's cost.[69] Still, parties are incentivized to enter into this type of transaction because once the tax equity investor has received the ROI and tax credits, the project is sold back to the developer.[70] Again, the nature of this structure is passive, and therefore, the credits offset taxes from passive taxable income.

3. The Inverted-Lease Structure

In the inverted-lease transaction, there are two partnership entities. The first partnership entity, the "master tenant," is created through funding by the tax equity investor, who furnishes ninety-nine percent of necessary funding, and the developer, who supplements the total with the remaining one percent.[71] The "master tenant" functions both as a flow-through (meaning the entity is not taxed, but rather the partners are) and as the lessee of the renewable energy development.[72] The other partnership entity, designated as a "property owner," installs the renewable energy project.[73] The "property owner" partnership then leases the renewable energy project to the "master tenant" partnership and elects to pass the credits to the "master tenant."[74] Because the "master tenant" is also a partnership, the credits will flow through to the partners–ninety-nine percent accredited to the tax equity investor and one percent to the developer.[75] The "master tenant" can then sublease the renewable energy development to a third-party entity, whereby the

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67 *See* Hecimovich & Stevens, *supra* note 49, at 10.

68 Stephan L. Hodge, *Sale-Leasebacks: A Search for Economic Substance*, 61 IND. L.J. 721, 726-27, 729 (1986).

69 BENESH & BRYANT, *supra* note 66.

70 *See* Hecimovich & Stevens, *supra* note 49, at 20-21.

71 *See id.*; Gary Hecimovich & Mark Hindes, *Structuring Lease Transactions – Tax Perspective*, DELOITTE 14-15 (Sept. 20, 2013), http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Energy_us_er/us_er_2013AESeminar_StruLeasTrans_Sep2013.pdf.

72 *See* Hecimovich & Stevens, *supra* note 49, at 25-27; Hecimovich & Hindes, *supra* note 71.

73 *See* Hecimovich & Stevens, *supra* note 49, at 26; Hecimovich & Hindes, *supra* note 71, at 15.

74 *See* Hecimovich & Stevens, *supra* note 49, at 26; Hecimovich & Hindes, *supra* note 71, at 15.

75 *See* Hecimovich & Stevens, *supra* note 49, at 26-27; Hecimovich & Hindes, *supra* note 71, at 14-15.

resultant income will be distributed to the partners according to the allocations set forth in the partnership agreement. These allocations must continue to operate within the IRS' standards for "substantial economic effect" to be sustained.

Given that the aforementioned nature of these structures is passive and, therefore, the credits offset taxes from passive taxable income, the structures and ITC are mostly limited in application to large financial institutions. These major financial institutions have the resources to understand and work through the above scenarios, but the inherent complications and technicalities often prove to be a strong barrier to entry for smaller "new entrant" investors, who might otherwise had been a viable investment candidate.[76] To remedy this barrier to entry issue, some scholars have proposed the issuance of a standardization of transaction documents and contracts to provide a comprehensive and understandable guide for investors who seek to use these tax structures.[77] These documents "could be drafted and peer-reviewed by key industry participants, energy finance lawyers and financial institutions, and then reviewed by various trade associations, including the American Wind Energy Association, the Solar Energy Industries Association, and the American Council on Renewable Energy."[78]

However, this Article submits that standardization of transaction documents is not nearly enough to broaden the investor base. Standardization in and of itself would not accomplish much because the investment remains passive as a result of the structure and investment objectives. Therefore, regardless of whether there is standardization, a direct, on-site, passive investment is still mostly limited to large financial institutions that invest to obtain credits to offset taxes from passive taxable income. Yet, standardization could prove to be effective if used in conjunction with other methods that expand the investor base. These other methods are: increasing investment amongst large companies; asset-backed securitization; "Real Estate Investment Trusts" (REITs); and "Master Limited Partnerships" (MLPs). The descriptions and analyses of these investment methods is where the Article will next turn.

III. BROADENING THE INVESTOR POOL

There are two major ways to broaden the investor pool: (a) generally encouraging investment from large companies in all industries, both (i)

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76 *See* Meyers et al., *supra* note 35, at 6.

77 Andrew C. Fink, *Securitize Me: Stimulating Renewable Energy Financing by Embracing the Capital Markets*, 12 U. N.H. L. REV. 109, 123-24 (2014).

78 Meyers et al., *supra* note 35, at 9.

domestic and (ii) foreign,[79] and (b) expanding investment opportunities to companies and smaller investors through (i) asset-backed securitization, (ii) Real Estate Investment Trusts ("REITs") and (iii) Master Limited Partnerships ("MLPs").

A. Encouraging Investment from Large Companies

1. Domestic and Foreign Corporate Investment

In 2012, the Obama administration courted seventy-nine U.S. technological, industrial and retail companies, including Exxon Mobil and Walt Disney, to invest in renewable energy projects.[80] These companies have significant capacity to make renewable investments and take advantage of the ITC because, in 2011 alone, the 500 largest American companies paid over $137 Billion in taxes.[81] In fact, Ceres, a leading non-profit organization in the renewable field, has called for one trillion dollars of *global* renewable energy investment per year for thirty-six years.[82] In 2012, the total global renewable energy new investment was $250 billion.[83] In 2013, however, such new investment decreased to $214 billion.[84] Ceres notes that, to realistically attain the trillion-dollar goal, renewable energy investment needs to reach around $500 Billion per year by 2020.[85] This goal can be attained through increased investment from companies across all industries.

Applying political pressure to spur increased renewable investment by large corporations has had some success. Some Fortune 100 and Global 100 corporations, such as AT&T, Google, GM, HSBC and Wal-Mart, have set voluntary renewable energy investment commitments.[86] Currently, fourteen percent of the Fortune 100 and sixteen percent of the Global 100 have set renewable energy commitments.[87] These investment commitments are categorized as near-term (will invest through 2015), mid-term (investing through 2020) and long-term (investing through

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79 *Id.*
80 *Id.* at 8.
81 *Id.*
82 *Clean Trillion*, CERES, http://www.ceres.org/issues/clean-trillion (last visited Oct. 8, 2014).
83 FRANKFURT SCHOOL – UNEP COLLABORATING CENTRE FOR CLIMATE & SUSTAINABLE ENERGY FINANCE, GLOBAL TRENDS IN RENEWABLE ENERGY INVESTMENT 2014 KEY FINDINGS 15 (Angus McCrone et al. eds., 2014).
84 *Id.*
85 *Clean Trillion*, *supra* note 82.
86 DAVID GARDINER & ASSOCS., POWER FORWARD: WHY THE WORLD'S LARGEST COMPANIES ARE INVESTING IN RENEWABLE ENERGY 4 (Dec. 10, 2012).
87 *Id.* at 12-13.

2050).[88] Other companies, like Costco, buy into renewable energy without establishing commitment targets, but rather with a goal of offsetting their own electricity costs.[89] On the whole, however, companies with specific commitment targets have invested more into renewable projects.[90]

This Article advocates that the pressure for new companies to invest continue, but that the pressure also extends to existing corporate investors to harden their renewable energy investments by establishing investment commitments. Moreover, the political pressure might be most effective if concentrated on specific industries. For example, in 2012, the health care and industrial sectors had only one company that set renewable energy investment commitments.[91] These various pressures would hopefully help to achieve the United States' goal of having twenty percent of energy consumed by renewable energy sources in 2020 and each year thereafter.[92]

These renewable energy investment commitments are made domestically and globally. However, before foreign corporations invest in renewable energy projects in new markets (i.e., different countries), such as that of the United States, these corporations first identify favorable opportunities, such as the availability of renewable energy credits, before making any investment decisions. These opportunities should also include renewable-based asset-backed securities, REITs and MLPs.[93]

2. Foreign Corporation Issues with Global Renewable Investment

Companies will most likely invest in direct, on-site renewable projects only if the ITC will be available,[94] about which market uncertainty yields a couple of issues for foreign corporations. For one, foreign companies may be reticent to invest in U.S. renewable projects because foreign corporations need enough U.S.-source passive taxable income for the ITC to offset passive taxes, assuming that the investment is passive.[95] Without U.S.-source passive taxable income, the ITC cannot be applied.

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88 *Id.* at 13.
89 *Id.* at 14.
90 *Id.*
91 DAVID GARDINER & ASSOCS., *supra* note 86, at 16.
92 Presidential Memorandum, *supra* note 3.
93 *See infra* Parts III (c)-(e).
94 Walsh, *supra* note 4, at 235.
95 26 U.S.C. §§ 881-882 (2006).

Foreign entities operate under different rules than their domestic counterparts in determining U.S. active and passive income. A foreign entity has U.S.-source active income if the income is "effectively connected" to a U.S. trade or business ("ECI")[96]; a foreign entity has U.S.-source passive income if the income is interest, dividends, rents, salaries, wages and other fixed or determinable annual periodic income ("FDAP" income).[97]

For the purpose of foreign entities, passive income may be transformed into income that is effectively connected to a U.S. trade or business,[98] thereby triggering a reclassification of such passive income to active income and affecting the applicability of the ITC. In such situations, while the investment in the renewable project may be passive, the foreign corporation may not have passive taxable income where the FDAP is transformed into ECI, thereby rendering the ECI useless for the year at issue, if no other passive income exists for the ITC to offset.[99]

There are two tests that are used to determine whether FDAP income is reclassified as ECI: the asset-use test and the business-activities test.[100] The asset-use test examines "whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States."[101] The business-activities test evaluates "whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss."[102]

This Article is skeptical that foreign companies would invest in renewable projects without ITC utilization and no other investment alternatives. This could occur if FDAP income were transformed into ECI due to the asset-use or business-activities test. This scenario assumes, however, that the multinational has no other U.S.-source passive taxable income to be offset by the ITC. If the multinational were to invest under this scenario, it would need to engage in foreign tax planning and generate passive income in the future to use the ITC, which can be carried forward twenty years thereafter.[103] It appears more probable that, without current use of the ITC, foreign multinationals will not invest. However, those foreign companies that are capable of investing in renewable projects are likely to be large, multinational

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96 26 U.S.C. § 882 (2006).
97 26 U.S.C. § 881 (2006).
98 Treas. Reg. § 1.864-4(c) (2005).
99 *Id.*
100 *Id.*
101 *Id.*
102 *Id.*
103 26 U.S.C. §§ 39, 48 (2006).

companies. As such, it is probable that these companies have sufficient U.S.-source passive income so as to render this a superfluous issue.

As a final wrinkle, recall that renewable energy credits are mostly limited to offset taxes from passive taxable income because the investment is considered to be a passive activity. Although large financial institutions satisfy Publication 925's "material participation" tests, foreign entities must also satisfy these tests as well.[104]

B. Encouraging Investment from Smaller Entities

The second major way to broaden the investor pool is to expand investment opportunities to smaller foreign and domestic corporations and investors by using renewable-based asset-backed securitization, REITs and MLPs.

1. Asset-Backed Securitization

Asset-backed securitization "refers to a process whereby receivables, loans or other predictable forms of cash flows are pooled and sold to investors through one or more special purpose vehicles ("SPV") in the form of debt instruments called asset-backed securities or . . . commercial paper."[105] This means that assets are pooled or bundled together into a SPV.[106] The SPV can be a trust, corporation or limited liability company (LLC), with the most efficient vehicles being the trust or LLC.[107] Then, the SPV markets securities, backed by the SPV assets, to investors.[108] The pooled assets produce a stream of income to investors through the securitized asset[109] to achieve a two-fold purpose: (1) reducing investor risk by pooling together multiple assets, as in a mutual fund; and (2) transforming illiquid assets into a liquidated security that can be sold to investors.[110]

As applied to renewable energy, a pool of renewable energy developments would back the offered security.[111] This means that asset-backed securities are less risky than direct on-site investments because the security pools various renewable developments into one security. Essentially, the security "hedges" the investor's risk because, instead of investing into one project that may fail, the security pools multiple—so

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104 *See* IRS PUB. 925, *supra* note 38, at 5-6.
105 JEROME F. FESTA, SECURITIZATIONS: LEGAL & REGULATORY ISSUES § 1 (2013).
106 *Id.* § 5.01.
107 *Id.* § 28.03.
108 *Id.* § 5.01.
109 *Id*.
110 Fink, *supra* note 77, at 120.
111 *Id.* at 124-25.

that one renewable project failure does not destroy the investment. Even still, companies will choose direct on-site investment for the ITC, asset-backed securitization, or both, depending on the company's financial needs. A company that needs deductions and tax credits would directly invest into the renewable energy project.[112] In contrast, companies that desire a steady, securitized rate of return, opt instead for the asset-backed security.[113] Thus, this Article contends that asset-backed securities would not replace the ITC, but rather would supplement the credit as such investments in asset-backed securities do not yield a tax credit.[114]

Moreover, this Article contends that renewable-based, asset-backed securities may provide an increase in investment to renewable energy projects because the securitization process allows companies to invest without having to carry the risk of direct on-site investment.[115] Direct on-site investment has been a historic deterrent to renewable energy developments for smaller corporations given the inherent risk of investing in only one particular project without a guarantee of success or income.[116] An additional risk of direct on-site investment is the lack of certainty that the project will be placed in service in time for the investor to take advantage of the ITC.[117] Finally, and again, the investor risks not having sufficient passive taxable income with which to offset the ITC.[118] By contrast, the asset-backed security absolves much of this risk because a pool of assets backs the security; the investor does not need to worry about offsetting taxes from passive taxable income.[119] Instead, the investor would receive a rate of return on the security and contribute to global investment goals for renewable energy projects.

The demographic of asset-backed security investors are typically institutional in nature.[120] Therefore, this Article contends that asset-backed securities accomplish the objective of increasing investment by foreign and domestic corporations. Moreover, foreign corporations do

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112 DAVID GARDINER & ASSOCS., *supra* note 86, at 24.

113 FESTA, *supra* note 105, at § 5.01; Fink, *supra* note 77, at 120.

114 FESTA, *supra* note 105, at § 5.01; Fink, *supra* note 77, at 120.

115 FESTA, *supra* note 105, at § 5.01; Fink, *supra* note 77, at 120.

116 *See* Fink, *supra* note 77, at 121.

117 *See* Walsh, *supra* note 4, at 235 (citing *Energy Tax Policy and Tax Reform*, *supra* note 14 (statement of Neil Z. Auerbach, Managing Partner of Hudson Clean Energy Partners)).

118 FEO & TRACY, *supra* note 47, at 22; *see also* Eliason, *supra* note 37.

119 FESTA, *supra* note 105, at § 5.01; Fink, *supra* note 77, at 120.

120 Travis Lowder, *New Report Navigates Solar Securitization*, RENEWABLEENERGYWORLD.COM (Feb. 13, 2014), http://www.renewableenergyworld.com/rea/news/article/2014/02/new-report-navigates-solar-securitization; *Introduction to Asset-Backed and Mortgage-Backed Securities,* FORBES.COM (Jan. 18, 2013, 1:08 PM), http://www.forbes.com/sites/investopedia/2013/01/18/introduction-to-asset-backed-and-mortgage-backed-securities/

not need to worry about FDAP and ECI distinctions because the investment is made purely for a rate of return, i.e., a passive investment.[121] These institutional investors use the securities to diversify their portfolio and receive a higher yield than on government bonds.[122] Additionally, the securities are available to smaller investors.[123] The asset-backed security, therefore, increases investment in renewable energy developments by: (1) allowing institutional investors and large corporations that want to avoid the risk of direct on-site renewable investment to get involved in the renewable energy field; and 2) providing smaller investors a chance to invest where they would be otherwise cut out from the field.

2. REITs

The U.S. Securities and Exchange Commission ("SEC") defines a REIT as a "company that owns – and typically operates – income-producing real estate or real estate-related assets . . . .REITs provide a way for individual investors to earn a share of the income produced through commercial real estate ownership – without actually having to go out and buy commercial real estate."[124] The SEC notes that to qualify as a REIT:

> [A] company must have the bulk of its assets and income connected to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. In addition to paying out at least 90 percent of its taxable income annually in the form of shareholder dividends, a REIT must: 1) Be an entity that would be taxable as a corporation but for its REIT status; 2) Be managed by a board of directors or trustees; 3) Have shares that are fully transferable; 4) Have a minimum of 100 shareholders after its first year as a REIT; 5) Have no more than 50 percent of its shares held by five or fewer individuals during the last half of the taxable year; 6) Invest at least 75 percent of its total assets in real estate assets and cash; 7) Derive at least 75 percent of its gross income from real estate related sources, including rents from real property and interest

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121 FESTA, *supra* note 105, at § 5.01; Fink, *supra* note 77, at 120.

122 *Introduction to Asset-Backed and Mortgage-Backed Securities*, *supra* note 120.

123 Fink, *supra* note 77, at 123.

124 *Real Estate Investment Trusts (REITs)*, SEC, http://www.sec.gov/answers/reits.htm (last visited Oct. 8, 2014); *see also* Treas. Reg. § 1.856-1 (2013).

> on mortgages financing real property; 8) Derive at least 95 percent of its gross income from such real estate sources and dividends or interest from any source; and 9) Have no more than 25 percent of its assets consist of non-qualifying securities or stock in taxable REIT subsidiaries.[125]

A REIT may be publicly or privately held.[126] Public REITs offer investors liquidity,[127] while private REITs may be difficult to exit because "new money has to come in before cash is available for a payout."[128] Public REITs, therefore, are a better option for large companies to balance a portfolio.[129] The REIT utilizes securitization because assets, such as real estate holdings, are pooled together in a trust, and dividend-yielding shares are issued to investors.[130] Securitization reduces the risk of the investment in a manner similar to that accomplished by a mutual fund.[131]

"An individual may invest in a publicly-traded REIT, which is listed on a major stock exchange, by purchasing shares through a securities dealer."[132] REIT investors may purchase common stock, preferred stock or debt securities,[133] and diversify their investment portfolio by buying shares in a REIT mutual fund or exchange-traded fund.[134] Institutional and small investors have an equal opportunity to buy securities because REIT shares average from $10 to $60 a share.[135] "This means the little guy can get a piece of the action."[136] Similar to the asset-backed security, a REIT comprised of renewable energy developments would allow domestic and foreign companies an option to invest in packages of renewable projects, without investing directly on-site for an ITC that may not be accessible to that specific company. In the absence of

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125 Treas. Reg. § 1.856-1 (2013).

126 Glenn R. Mueller, *Securitization of Real Estate and Global Growth*, GLOBAL EXECUTIVE FORUM REPORTS, Winter 2005-2006, at 4, *available at* http://www.ucdenver.edu/academics/InternationalPrograms/CIBER/GlobalForumReports/Documents/Global_Forum_Report_Winter_2005.pdf.

127 *Id.*

128 *Id.*

129 *Id.*

130 Fink, *supra* note 77, at 131.

131 Mueller, *supra* note 126.

132 Nat'l Ass'n of Real Estate Inv. Trusts, *Investing in REITs*, REIT.COM, http://www.reit.com/investing/reit-basics/reit-faqs/investing-reits (last visited Oct. 8, 2014).

133 *Id.*

134 *Id.*

135 Mueller, *supra* note 126.

136 *Id.*

alternative investment mechanisms, such as a REIT, an entity may not invest if the ITC, the only other investment incentive, is not obtainable given that entity's particular financial circumstances.

REITs invest in different property types–including those zoned for residential, industrial and health care uses–but there is a limit to the extent that the REIT can be comprised of a renewable energy project.[137] The IRS does not currently consider renewable energy projects "real estate"[138]; therefore, a REIT cannot consist of more than twenty-five percent of renewable energy projects.[139] Moreover, because ninety-five percent of income must be derived from "real estate," only five percent of income can be derived from the renewable energy project.[140]

In all, only twenty-five percent of the REIT can be comprised of renewable energy projects, only five percent of income can be derived from the renewable energy project and small and large investors alike can purchase publically traded REIT shares.[141] Like the asset-backed securities, this Article contends that REITs are not a replacement of, but rather a supplement to the ITC in terms of incentives for renewable energy investment. As aforementioned, the REIT and ITC perform different functions–and therefore, each attracts investors for different investment objectives.[142]

It is unclear what effect it would have if the IRS were to interpret renewable energy projects as "real estate" for REIT purposes. Some believe that the IRS will not take this type of "rifle-shot approach."[143] If the IRS did make such an interpretation, the REIT structure would become a very attractive method for small investors to get involved in the renewable energy investment world because the REIT shares are priced at reasonable levels and the investors receive most of the income in the form of a dividend.[144]

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137 *Id.*; Brad Thomas, *REITs Boom as More Industries Discover This Tax-Friendly Structure*, FORBES.COM (Nov. 26, 2012, 8:00 AM), http://www.forbes.com/sites /bradthomas/2012/11/26/reits-boom-as-more-industries-discover-this-tax-friendly-structure.

138 26 U.S.C. § 856(c)(5) (2006).

139 *Real Estate Investment Trusts (REITs), supra* note 124; Fink, *supra* note 77, at 130.

140 *Real Estate Investment Trusts (REITs), supra* note 124; Fink, *supra* note 77, at 130.

141 Mueller, *supra* note 126; Fink, *supra* note 77, at 130; *Real Estate Investment Trusts (REITs)*, *supra* note 124; Thomas, *supra* note 137.

142 Fink, *supra* note 77, at 131; 26 U.S.C. § 48 (2006).

143 Eric Kroh, *IRS Not Expected to Allow REITs To Invest in Renewable Energy*, TAX ANALYSTS 707 (2014).

144 Mueller, *supra* note 126.

3. MLPs

"A master limited partnership (MLP) is a type of business structure that is taxed as a partnership, but whose ownership interests are traded on financial markets like corporate stock."[145] Because the MLP is structured as a partnership there is only one level of tax—at the partner level.[146] The ownership interest in an MLP is not stock, but is called an "MLP unit."[147] Like corporate stock, the units are publically traded and pay dividends.[148] The MLP investors, i.e., partners, also receive their share of the "partnership's income, deductions, and credits, and pay tax on the net income according to ordinary income tax rate."[149] MLP units are attractive to investors because unlike the corporate double-level tax there is only one level of tax in a partnership–attached to the partners–and therefore, investors yield higher after-tax returns.[150]

In general, MLPs structurally own and operate business assets through a subsidiary or operating company.[151] The MLP is formed as a limited partnership, meaning there is a general partner and many limited partners.[152] The limited partners (LPs) provide most of the capital to the MLP in exchange for the MLP units.[153] This Article will briefly delve into partnership tax law so as to highlight the inter-workings of being a partner and distinguish limited partners from general partners.

The first step in forming an MLP is that a partner contributes property to a partnership (here, cash) and receives an interest in the partnership, the MLP unit. The partner and the partnership each receive a transfer basis in the partnership interest and asset, respectively.[154] The partner's capital contribution is placed as an asset on the partnership's balance sheet and also as the partner's equity amount (called the partner's capital account).[155] This capital contribution amount also constitutes a portion of the partner's outside basis in the partnership, and

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145 MOLLY F. SHERLOCK & MARK P. KEIGHTLEY, CONG. RESEARCH SERV., *Master Limited Partnerships: A Policy Option for the Renewable Energy Industry* 1 (2011) *available at* http://www.ieeeusa.org/policy/eyeonwashington/2011/documents/masterlmtdpartnerships.pdf.
146 *Id.*
147 *Id.* at 2.
148 *Id*.
149 *Id.* at 4.
150 *Id.* at 2.
151 Fink, *supra* note 77, at 132.
152 SHERLOCK & KEIGHTLEY, *supra* note 145, at 2.
153 *Id*.
154 26 U.S.C. §§ 722-723 (2006). As on any partnership balance sheet, *Assets = Liabilities + Equity*.
155 Wales Mack & John Marciano, *Modeling Investments in Tax Equity Partnerships: Solving the Puzzle in a Post-Treasury Grant World*, DAILY TAX REPORT 2-3 (2012).

will constitute the full amount of that outside basis if the partnership does not assume any liabilities or if there is not any debt relief.[156]

The advantage of being a LP is that the liability assumed by the LP is limited to either the LP's capital contribution or the capital contribution plus an additional amount, called the deficit restoration obligation ("DRO").[157] In the latter situation, if the LP's capital account is reduced below zero as a result of losses and deductions–that is, the partner "owes" the partnership money–and the allocations are sustained because they have substantial economic effect, then the LP does not owe any money beyond the DRO if the partnership terminates or is sold because the LP is only liable to the capital contribution amount plus the DRO.[158]

The general partner (GP), which can be a single person, parent company or group of individuals, manages the MLP in exchange for a percentage of the MLP's income–typically two percent[159]–called the "incentive distribution right"[160] to compensate the GP for taking on risks and to maximize return to investors.[161] The GP's risk is borne out of the possibility that the partnership could terminate or be sold, leaving no value in the partnership, while the partnership has a positive capital account balance. While, in such a case, the GP should conceivably receive at least nominal compensation, the GP may not get anything if the LPs do not have a DRO.[162]

The income, losses, deductions and credits generated from an MLP unit are deemed to be passive.[163] Given the partnership structure, the income, losses, etc. flow through to the partners, such as investors who own the MLP units in accordance with their distributive shares. Therefore, the investor can only use the credit to offset taxes from passive taxable income, which is similar to direct on-site investment that generates an ITC.[164] The MLP is unique in that the cash distributions are only taxed once, when the MLP unit is sold, typically at capital gain rates.[165]

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156 26 U.S.C. §§ 722, 752(a)-(b) (2006).
157 Treas. Reg. § 1.704-1(b)(2) (2013).
158 Treas. Reg. § 1.704-1(b)(2)(ii)(a) (Economic Effect); § 1.704-1(b)(3)(iii)(c) (PIP Orich Test); § 1.704-1(b)(2)(iii)(d) (2013) (Alternative Economic Effect Test).
159 SHERLOCK & KEIGHTLEY, *supra* note 145, at 2.
160 *Id.*
161 *Id.*
162 Treas. Reg. § 1.704-1(b)(2)(ii)(a); § 1.704-1(b)(2)(iii)(d); § 1.704-1(b)(3)(iii)(c) (2013).
163 SHERLOCK & KEIGHTLEY, *supra* note 145, at 4.
164 *Id.*
165 *Id.*

For renewable energy investments to enter the MLP field, income from renewable energy projects must be deemed "qualifying income."[166] Currently, the MLP structure requires

> at least 90% of a business's gross income must be considered 'qualifying income.' Qualifying income generally includes dividends, interest, rents, capital gains, and mining and natural resource income. Income related to the exploration, development, mining or production, processing, refining, transportation, storage, and marketing of any mineral or natural resource falls under the latter income category. Recently, the definition of qualifying income was expanded. The expanded definition includes income from the transportation and storage of certain renewable and alternative fuels, including ethanol and biodiesel, and activities involving industrial source carbon dioxide.[167]

On April 24, 2013, Senator Christopher A. Coons, Democrat-Delaware, proposed legislation, the Master Limited Partnerships Parity Act (S. 795), that would permit renewable energy investors to form MLPs.[168] This Article contends that expanding the definition of "qualified income" to include renewable energy would spur investment in renewable projects because MLP units, taxed only once because it is a partnership structure, yield a higher rate of return than corporate shares, which are subject to double taxation.[169] Both large institutions and small investors would be able to invest in the MLP, thus further expanding the renewable energy investor base.[170] This Article also contends that, similar to asset-backed securities and REITs, the MLP would not replace the ITC, but rather work in conjunction with the credit to target a different set of investors and investment purposes.

However, the MLP appears more limited in application than asset-backed securities or REITs. Although the MLP offers a security in the form of an MLP unit, the MLP features look very much like direct on-site investment as the investor receives an allocable share of income, loss, deductions and credits.[171] Moreover, because the investment in the

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166 *Id.* at 2.

167 SHERLOCK & KEIGHTLEY, *supra* note 145, at 2-3.

168 S. 795 "*Master Limited Partnerships Parity Act*", 113th Congress (2013-2014); *see also* Kroh, *supra* note 143, at 707.

169 SHERLOCK & KEIGHTLEY, *supra* note 145, at 1-2.

170 *Id.* at 9.

171 *Id.* at 2.

MLP unit is passive, like direct on-site investment to get an ITC, the allocable share of losses and credits are limited by passive rules.[172]

However, the MLP remains different than direct on-site investment in that: (1) the investor can buy "unit" shares instead of providing a substantial amount of capital directly into the project; and (2) the risk is reduced because the MLP unit is securitized through multiple renewable assets, as opposed to investing in merely one particular project. While the investor base for MLP units may be smaller than asset-based securities or REITs, the investment purpose is largely to receive losses, deductions and credits on a smaller scale than direct on-site investment.[173] The MLP unit does offer an allocable share of income, prospect for "unit" appreciation and reduces risk through securitization.[174]

IV. CONCLUSION

The ITC currently allows for a thirty percent or ten percent tax credit, the amount of which is dependent on what kind of renewable energy project is being placed in service, through 2017. At that time, the percentages will be reduced or eliminated for certain types of renewable projects. While this Article posits that this reduction is a mistake, there are other means by which the United States can facilitate renewable energy investment from foreign and domestic corporations and smaller investors. These alternative methods include encouraging investment from large corporations and pressuring them to make long-term investment commitments, and legislatively approving renewable-based asset-backed securities, REITs and MLPs. The asset-backed securities, REITs and MLPs could provide less risky investment alternatives to investors other than investing directly on-site.

Although these alternatives would not replace the ITC, they may compensate for the ITC in 2017, when the credit percentages are reduced or eliminated. The potential effect of these replacement possibilities is unknown. It is possible that the amount of investment by financial institutions will decline. More plausible, however, is the notion that financial institutions will instead invest in, for example, an MLP, if it were to be legislated into existence, instead of investing substantial funds into one isolated project, so as to give the investor an allocable share of income, losses, deductions and credits, along with diversified holdings.

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172 *Id.* at 4.
173 *Id.* at 2.
174 *Id.* at 2.

In the near future, the majority of renewable energy investments may come through securities, as opposed to direct on-site investments. The effect that this will have on the renewable energy field is a question for legislators to consider. If the effect is negative, legislators may want to reconsider extending the credits to work in conjunction with the alternative investment methods. This Article submits that a compilation of these investment strategies would satisfy all investor needs–institutional and individual, domestic and foreign–and offer the greatest potential for renewable investment growth.

Molly and the Crack House Statute: Vulnerabilities of a Recuperating Music Industry

Jacob A. Epstein*

The normalcy of "club drug" use in today's live music culture makes concert promoters and venue managers particularly vulnerable to prosecution under the "crack-house statute," 21 U.S.C. § 856. Section 856(a)(2) makes it illegal for a promoter or venue manager to "manage any place . . . and knowingly and intentionally . . . profit from, or make available for use . . . the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance." In United States v. Tebeau, *the Eighth Circuit Court of Appeals held that third parties could satisfy the statute's "intent" requirement. This Note examines the Eighth Circuit's interpretation and the uncertainty that it has created, which may lead to a situation where any promoter involved in any event where illegal drugs are consumed can be held liable under Section 856. This Note calls for an amendment to the statute, better designed (1) to curb dangerous club drug use, (2) to provide health and safety measures for patrons, and (3) to punish, specifically, rogue concert promoters who facilitate such dangerous situations, so that the many positive economic effects of the live music sector may continue to flourish.*

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I. INTRODUCTION

Calvin Harris made an astounding $46 million in 2012, and the estimated $300,000 he made for one night's performance in August of 2013 was well worth the expense to his Las Vegas-based promoter.[1] Today, numbers like these are increasingly common as the music

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1 Ryan Mac and Zack O'Malley Greenburg, *Sin City's Latest Savior*, FORBES, Sept. 2, 2013, at 44.

industry continues to derive profits from festivals and concerts.[2] Music festivals like Ultra,[3] Bonnaroo,[4] Coachella,[5] and Austin City Limits[6] have become household names, as music fans young and old flock to cities all over the country each year to see their favorite musicians perform.

While those in the industry are excited by the rising prevalence of this source of revenue, the dangers associated with large crowds of people congregating in one, high-energy atmosphere are palpable.[7] Drug use at music festivals and concerts is rampant.[8] "Club drug" use, combined with high temperatures and the inevitable dehydration resulting from such situations, led to at least seven deaths between March and September of 2013.[9] Should concert promoters and venue managers be held responsible for the drug use at their events? If so, how can they be expected to prevent these drugs, some of which are no smaller than your average Tylenol pill, from entering a venue? The pervasiveness of these drugs at music festivals today, and the lack of any comprehensive legal guidance as to how concert promoters and venue managers should handle the situation, has created a grey area where their liability for such activities is unclear.

Concert promoters and venue managers are especially vulnerable to prosecution under the "crack house statute," 21 U.S.C. § 856, due to the statute's over-inclusiveness and unclear language. The statute's shortcomings are vividly illustrated in *United States v. Tebeau*, where the Eighth Circuit Court of Appeals found an organizer of an outdoor music festival criminally liable under Section 856(a)(2).[10] Tebeau, the defendant, filed a petition for certiorari (the "Petition") in July 2013, arguing that the Eighth Circuit's finding that he "knowingly and intentionally" made his premises available for drug use was an invalid

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2 *See* Chris Parker, *The Economics of Music Festivals: Who's Getting Rich, Who's Going Broke?*, LA WEEKLY (Apr. 17, 2013, 4:00 AM), http://blogs.laweekly.com/westcoastsound/2013/04/economics_of_music_festivals.php.

3 ULTRA MUSIC FESTIVAL, http://www.ultramusicfestival.com (last visited Sept. 19, 2014).

4 BONNAROO MUSIC AND ARTS FESTIVAL, http://www.bonnaroo.com (last visited Sept. 20, 2014).

5 COACHELLA VALLEY MUSIC AND ARTS FESTIVAL, http://www.coachella.com/ (last visited Sept. 20, 2014).

6 AUSTIN CITY LIMITS MUSIC FESTIVAL, http://www.aclfestival.com (last visited Sept. 20, 2014).

7 *See* Ben Sisario & James C. McKinley, Jr., *Drug Deaths Threaten Rising Business of Electronic Music Fests*, N.Y. TIMES, Sept. 10, 2013, at A1.

8 *Id.*

9 *Id.*

10 *See, e.g.*, United States v. Tebeau, 713 F.3d 955 (8th Cir. 2013).

and overly zealous conclusion.[11] The Supreme Court's hasty denial[12] of the Petition will likely have enormous implications for the music industry, creating a dangerous zone of liability for many concert promoters and venue managers who will be left with little guidance on how to prevent a situation analogous to Tebeau's. Moreover, corporate sponsors and promoters may be less inclined to participate in certain types of music festivals, especially those that are associated with heavy drug use, for fear of the inevitable liability that will eventually become associated with those festivals.

This Note will analyze the strengths and weaknesses of Tebeau's arguments and supplement his points with the business and drug-culture realities of the music industry today. Section II will specifically illustrate the current state of the live music industry, addressing both its positive and negative aspects. Section III will present the crack house statute, the purposes for its enactment, and the 2003 amendment to the statute that is at issue in the Petition. Section IV will explain the facts of the *Tebeau* case, the arguments put forth, and the Eighth Circuit's reasoning. Section V will argue that, as it stands, the statute is a hindrance to the music industry. Section V will subsequently propose another amendment to the crack house statute, one that would address the concerns outlined in this Note, suggesting additional requirements that venue managers and concert promoters take "reasonable precautions" to prevent illicit activities at their events and to ensure that medical attention for patrons is readily available. Section V will then clarify the reasoning behind the proposed amendment, the main goals of which are to allow a positive trend in the music industry to thrive and to protect the health and safety of live music fans.

II. SETTING THE STAGE

A. The Trend Toward More Music Festivals Is Significant.

The global recorded music industry in 2012 saw its first rise in revenue since 1999 largely due to the increase in digital music sales.[13] Global digital revenues climbed nine percent, according to the

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11 *See* Petition for Writ of Certiorari, Tebeau v. United States, 134 S. Ct. 314 (No. 13-146) (2013).

12 *See* Tebeau v. United States, 134 S. Ct. 314 (2013).

13 Richard Smirke, *IFPI Digital Music Report 2013: Global Recorded Music Revenues Climb for First Time Since 1999*, BILLBOARD (Feb. 26, 2013, 8:52 AM), http://www.billboard.com/biz/articles/news/digital-and-mobile/1549915/ifpi-digital-music-report-2013-global-recorded-music.

International Federation of the Phonographic Industry's[14] 2013 Digital Music Report,[15] helping to raise global digital music revenues to $5.6 billion, up from $5.1 billion in 2011.[16] While the media tends to focus on digital music's role in saving the recorded music industry,[17] the lack of attention to live music's contribution to the industry as a whole is remarkable.

In 2010, corporate concert promoter Live Nation merged with ticket vendor Ticketmaster to create Live Nation Entertainment.[18] Live Nation Entertainment, now a giant in the industry, had a record summer in 2013, bringing in $2.3 billion of revenue.[19] According to Billboard,[20] worldwide concert ticket sales increased approximately thirty percent between 2012 and 2013.[21] Because hundreds of thousands of people are often willing to spend between three and four hundred dollars on one festival pass, corporate sponsors are inevitably attracted to such events. Live Nation Entertainment's Sponsorship & Advertising segment had a fifteen percent increase in revenue between the third quarter of 2012 and the third quarter of 2013.[22] Although still a very new festival series, the Made In America Festival landed Budweiser as its corporate sponsor.[23] The 2014 Bonnaroo Music and Arts Festival had a list of major corporate sponsors that included, but was certainly not limited to, Miller Lite, Ford, Gap, and Ben & Jerry's.[24] Coachella's sponsors in 2014 included

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14 The International Federation of the Phonographic Industry (the "IFPI") represents "the interests of 1,300 record companies from across the globe." *See* IFPI, http://www.ifpi.org/about.php (last visited Oct. 5, 2014).

15 *IFPI Digital Music Report 2013* http://www.ifpi.org/content/library/dmr2013.pdf at 6.

16 *Id*.

17 *See* Eric Pfanner, *Music Industry Sales Rise, and Digital Revenue Gets the Credit*, N.Y. TIMES, Feb. 27, 2013, at B3.

18 TICKETMASTER, http://www.ticketmaster.com/about/about-us.html (last visited Sept. 20, 2014).

19 Live Nation, Quarterly Report (Form 10-Q) 3 (November 5, 2013) [hereinafter Live Nation Third Quarter Report].

20 Known as "the world's premier music publication," Billboard's "popular music charts have evolved into the primary source of information on trends and innovation in music, serving music fans, artists, top executives, tour promoters, publishers, radio programmers, lawyers, retailers, digital entrepreneurs and many others." *See* BILLBOARD, http://www.billboard.com/articles/news/467859/about-us (last visited Oct. 5, 2014).

21 Ray Waddell, *Live and On Fire*, BILLBOARD, Dec. 21, 2013, at 44.

22 *See* Live Nation Third Quarter Report, *supra* note 19, at 34.

23 BUDWEISER MADE IN AMERICA FESTIVAL, http://budweisermadeinamericafestival .tumblr.com (last visited Sept. 21, 2014).

24 BONNAROO PARTNERS, http://www.bonnaroo.com//get-involved/partners/ (last visited Sept. 21, 2014).

Heineken, H&M, Samsung, and Red Bull.[25] The prevalence of live music as a source of revenue, corporate sponsorship, and consumer involvement is now undeniable.

B. This Trend is Beneficial and Should Be Encouraged.

Music festivals transform their host cities or towns into music-fan destinations, a transformation that not only helps the industry at large, but also pours millions of dollars into these cities' revenue streams. In 2012, the Washington Economics Group estimated that the Ultra Music Festival contributes approximately $79 million into the Miami-Dade County economy each year.[26] The local economic benefits of music festivals are not limited to major tourist cities like Miami; indeed, dozens of other cities see their economies skyrocket in the weeks surrounding their major festivals. Every spring, some of the best jazz and rock musicians in the world travel to New Orleans, Louisiana, for The New Orleans Jazz & Heritage Festival.[27] It is estimated that "Jazz Fest,"[28] which began in 1970, now attracts approximately 400,000 attendees and generates approximately $300 million each year.[29] These economic benefits are conspicuous and not just to the residents of a city like New Orleans, which is known for its vibrant live music scene.

Concerts and music festivals provide a stream of income to local food, alcohol, and merchandise vendors, hotels and restaurants, and taxi services. While the album cover and record store advertisements clearly do their parts, an artist's best publicity arguably comes from a great live performance. In addition to increasing their fan bases at music festivals by being exposed to attendees who had never before seen particular artists, most concert and festival promoters allow artists to sell their own merchandise at events.

While the economic benefits of concerts and festivals are plentiful, this sector of the industry has an unfortunate dark side. When thousands of young, dance-hungry patrons congregate in one confined space, health and safety problems are bound to surface. Dangerous drug use at these

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25 COACHELLA SPONSORS, http://www.coachella.com/festival-info/sponsors (last visited Sept. 21, 2014).

26 Hannah Sampson, *Ultra Music Festival Pours Millions into Economy, Study Says*, MIAMI HERALD (Oct. 10, 2012), http://www.miamiherald.com/2012/10/10/3042176/ultra-music-festival-pours-millions.html.

27 NEW ORLEANS JAZZ & HERITAGE FESTIVAL, http://www.nojazzfest.com (last visited Sept. 21, 2014).

28 The New Orleans Jazz & Heritage Festival is more commonly known as "Jazz Fest."

29 Adriana Lopez, *New Orleans Jazz Fest Comes Full Circle with Its Mission*, FORBES (May 6, 2013, 4:33 PM), http://www.forbes.com/sites/adrianalopez/2013/05/06/new-orleans-jazz-fest-comes-full-circle-with-its-mission/.

events has become a stark reality in recent years; as the public becomes aware of this reality, a looming threat to the live-music industry will continue to grow.

C. The Pervasiveness of Drug Use at Music Festivals Is Substantial.

It was 107 degrees on Governor's Island when twenty-year-old Matthew Rybarczyk collapsed at the 2013 Electric Zoo Festival in New York.[30] Fourteen hours after his grandmother visited him in the hospital, the young man was dead.[31] A significant amount of the party drug, "Molly," was found in his system.[32]

Deaths from drug use at music festivals are not uncommon; between March and September of 2013, at least seven people attending electronic dance music ("EDM") festivals died after exhibiting symptoms consistent with "party drug" overdoses.[33] When the death toll reached two at the 2013 Electric Zoo Festival, the entire event was cut short, as the dangers quickly began to outweigh any benefit of following through with the planned set list.[34] These tragic losses of life may have drastic effects on the music industry as "[e]xecutives say that deaths like these have the potential to scare off investors and the corporate sponsors that are eager to reach the genre's young, affluent and technologically connected fans."[35]

Ecstasy, or MDMA, became prevalent in the late 1990s and early 2000s.[36] "Molly," which is slang for a pure, powder or crystal form of MDMA,[37] has become popular at music festivals in recent years.[38] While the media initially associated MDMA with a "deviant youth subculture,"[39] often tied to the "rave scene,"[40] modern EDM has arguably adopted many of the rave scene's problematic aspects, as

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30 Sisario & McKinley, Jr., *supra* note 7, at A1.

31 *Id.*

32 *Id.*

33 *Id.*

34 *See* Jon Pareles, *Dancing in the Eternal Present, Before Harsh Reality Intervened*, N.Y. TIMES, Sep. 2, 2013, at C1.

35 Sisario & McKinley, Jr., *supra* note 7, at A1.

36 Deborah Ahrens, *Drug Panics in the Twenty-First Century: Ecstasy, Prescription Drugs, and the Reframing of the War on Drugs*, 6 ALB. GOV'T L. REV. 397, 404 (2013).

37 *See* DrugFacts: MDMA (Ecstasy or Molly), NATIONAL INSTITUTE ON DRUG ABUSE, http://www.drugabuse.gov/publications/drugfacts/mdma-ecstasy-or-molly (last visited Sep. 26, 2014).

38 *See* Sisario & McKinley, Jr., *supra* note 7, at A1.

39 Ahrens, *supra* note 36, at 412.

40 Shadi Kardan, Comment, *The Government's New War on Drugs: Threatening the Right to Dance!*, 29 NEW ENG. J. ON CRIM. & CIV. CONFINEMENT 99, 100-03 (2003).

evidenced by the aforementioned MDMA-related deaths. Although raves were distinctive in the late 1990s and early 2000s, largely because of the electronic music and "underground" nature of such events,[41] today such music has migrated from the fringes of society to the mainstream music culture.

There is a subtle, yet clearly problematic, endorsement of the rave culture in modern-day EDM. Madonna, known more for her pop music than her recent endeavor into EDM, titled her twelfth studio album "MDNA."[42] The pop star's not-so-subtle play on words demonstrates how the mainstream music culture has come to embrace, albeit not directly, the club drug culture. Madonna, as a major pop star and representative of the mainstream music culture, has perpetuated the normalization of club drug use through her actions. During her 2012 performance at Ultra, Madonna allegedly screamed to the crowd, "How many people in this crowd have seen 'Molly'?"[43]

The EDM fan base is growing: as of September 2013, the EDM industry was estimated to be worth $4.5 billion.[44] It is no secret that the artists and promoters in the business are aware of the rampant drug use at their festivals, so for the sake of continued growth of the live music industry, these problems must be addressed. And as long as this culture remains the status quo, there is at least one federal law[45] that poses a significant danger to the music industry.[46]

III. THE CRACK HOUSE STATUTE

A. The Substance and Purpose of the Original Crack House Statute

Section (a)(1) of the Anti-Drug Abuse Act of 1986, also known as the "crack house statute," made it illegal to "knowingly open or maintain any place, for the purpose of manufacturing, distributing, or using any controlled substance."[47] Section (a)(2) of the statute made it illegal to

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41 *Id.* at 101.

42 MADONNA, MDNA (Interscope Records 2012).

43 Pareles, *supra* note 34, at C1. Madonna is not the only major pop star to make such a reference. "Today, stars like Miley Cyrus and Kanye West allude to molly in songs, and the term turns up repeatedly at festivals, on T-shirts, banners or body paint." Sisario & McKinley, Jr., *supra* note 7, at A1.

44 Sisario & McKinley, Jr., *supra* note 7, at A1.

45 *See infra* Part III.

46 *See infra* Part IV-V.

47 21 U.S.C. § 856(a)(1) (1986).

> manage or control any building, room, or enclosure, either as an owner, lessee, agent, employee, or mortgagee, and knowingly and intentionally rent, lease, or make available for use, with or without compensation, the building, room, or enclosure for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance.[48]

The original crack house statute was designed to punish those who used their property to run drug businesses.[49] Congress explained that one of the 1986 Act's functions was to "outla[w] [the] operation of houses or buildings, so-called 'crack houses,' where 'crack,' cocaine and other drugs are manufactured and used."[50] The 1986 Act, as the name suggests, addressed a very specific problem during the height of the 1980's crack epidemic.[51] The statute's nickname, the "crack house statute," was wholly appropriate as the original wording of the statute made it very clear whom the statute was targeting.[52]

B. The 2003 Amendment to the Crack House Statute

In 2003, the statute was amended to its present language.[53] Although the "knowingly" and "for the purpose" clauses from the original 1986 version remain in Section (a)(1), the 2003 amendment broadened the statute to also include those who "lease, rent, or use . . . any place, whether permanently or temporarily."[54] Section (a)(2) of the statute now makes it illegal to

> manage or control ***any place***, ***whether permanently or temporarily***, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of

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48 § 856(a)(2).

49 *See* U.S. v. Verners, 53 F.3d 291, 296 (10th Cir. 1995).

50 132 CONG. REC. 26,474 (1986).

51 *See* 132 CONG. REC. 14,097-99 (1986) (statement of Sen. Chiles); H.R.J. Res. 678, 99th Cong. (1986).

52 § 856(a)(2). The original crack house statute targeted specifically those who controlled any building, room, or enclosure who made that property available for the use, distribution, manufacture or storage of illegal drugs.

53 *See* Illicit Drug Anti-Proliferation Act of 2003, S. 226, 108th Cong. (2003).

54 21 U.S.C. § 856(a)(1) (2012).

> unlawfully manufacturing, storing, distributing, or using a controlled substance.[55]

A person convicted under this statute may be sentenced to a prison term of up to twenty years or "a fine of not more than $500,000, or both, or a fine of $2,000,000 for a person other than an individual."[56] Moreover, one who violates this statute may be liable for civil penalties.[57]

The 2003 amendment expanded the range of people who may be affected by the statute, thereby increasing the possibility that Section 856(a)(1) could be deemed unconstitutionally vague if construed expansively.[58] The specificity of the 1986 crack house statute was diminished, as the 2003 amendment enabled the crack house statute to be applied to "single-event" activities, not just to ongoing drug distribution operations.[59] The amendment clarified that a "one-time event . . . where the promoter knowingly distributes [drugs] over the course of an evening . . . violates the statute the same as a crack house which is in operation over a period of time."[60] Moreover, the amendment made the statute apply to outdoor as well as indoor venues in order to reach rogue promoters that used fields to distribute controlled substances.[61]

Drafted at a time when ecstasy usage was considered a grave problem, the 2003 amendment was originally referred to as the RAVE Act, which stood for "Reducing Americans' Vulnerability to Ecstasy Act."[62] The RAVE Act, however, was highly criticized due to the findings section of the bill, which accused property owners and rave promoters of being intentional profiteers of illicit drug use.[63] As a result, the RAVE Act died at the end of 2002, until former Senator, and current Vice President, Joe Biden reintroduced a slightly modified version in February of 2003, which took out the controversial findings section.[64]

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55 21 U.S.C. § 856(a)(2) (2012) (emphasis added).

56 21 U.S.C. § 856(b) (2012).

57 21 U.S.C. § 856(d) (2012).

58 *See* Shetler, F.3d at 1164.

59 149 CONG. REC. 1847 (2003) (statement of Sen. Biden).

60 *Id*.

61 *Id*.

62 *See* Reducing Americans' Vulnerability to Ecstasy (RAVE) Act, H.R. 718, 108th Cong. (2003).

63 *See* 148 CONG. REC. 10,671 (2002).

64 *See* Illicit Drug Anti-Proliferation Act of 2003, S. 226, 108th Cong. (2003); 149 CONG. REC. 1846, 1847 (2003) (statement of Sen. Biden).

The bill was re-named the "Illicit Drug Anti-Proliferation Act," and it was attached as a rider to the Amber Alert Bill, which Congress passed.[65]

C. The Purpose of the 2003 Amendment to the Crack House Statute

Senator Grassley, a co-sponsor of the 2003 bill, explained why the crack house statute needed to be updated: "[I]t is important that we update the laws that have been effectively used to shut down crack houses so they can go after temporary events used as a cover to sell drugs."[66] He further explained, "as drug dealers discover new drugs and new methods of pushing their poison, we must make sure our legal system is adequately structured to react appropriately. I believe this legislation does that."[67] Senator Biden emphasized that the 2003 version of the statute was specifically intended to prohibit ecstasy use and to simultaneously target the problematic "Rave Scene" at the time:

> This legislation arises out of a hearing Senator Grassley and I held in the Senate Caucus on International Narcotics Control in December 2001 on the proliferation of Ecstasy and other club drugs generally, and the role of some promoters of all-night dance parties, known as ''raves'', in distributing Ecstasy to young people. Our bill provides Federal prosecutors the tools needed to combat the manufacture, distribution or use of any controlled substance at any venue whose purpose is to engage in illegal narcotics activity.[68]

Senator Grassley noted the dangers of ecstasy and detailed how certain promoters take advantage of the drug's use at their shows:

> Ecstasy raises the heart rate to dangerous levels, and in some cases the heart will stop. It also causes severe dehydration, a condition that is exacerbated by the high levels of physical exertion that happens at raves. Users must constantly drink water in an attempt to cool off—a fact that some unscrupulous event promoters take advantage of by charging exorbitant fees for bottles of

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65 S*ee* Prosecutorial Remedies and Other Tools to End the Exploitation of Children Today (PROTECT) Act, Pub. L. No. 108-21, 117 Stat. 650 (2003); 149 CONG. REC. 1847 (2003) (statement of Sen. Biden).
66 149 CONG. REC. 1849 (statement of Sen. Grassley).
67 *Id.* at 1848.
68 149 CONG. REC. 1846 (2003) (statement of Sen. Biden).

> water, after cutting off water to drinking fountains and rest room sinks. Too often, Ecstasy users collapse and die because their bodies overheat.[69]

Senator Biden addressed, even at this introductory juncture, his critics' concerns with the bill, yet he explicitly denied that the amendment would be used to target concert promoters:

> We know that there will always be certain people who will bring drugs into musical or other events and use them without the knowledge or permission of the promoter or club owner. This is not the type of activity that my bill would address. ***The purpose of my legislation is not to prosecute legitimate law-abiding managers of stadiums, arenas, performing arts centers, licensed beverage facilities and other venues because of incidental drug use at their events***. In fact, when crafting this legislation, I took steps to ensure that it did not capture such cases. ***My bill would help in the prosecution of rogue promoters who not only know that there is drug use at their event but also hold the event for the purpose of illegal drug use or distribution***.[70]

Senator Biden continuously stressed that the statute would not target responsible promoters,[71] noting, "neither current law nor my bill seeks to punish a promoter for the behavior of their patrons."[72] He even described the type of promoters he was targeting:

> [T]here are a few promoters out there who are taking steps to profit from drug activity at their events. Some of these folks actually distribute drugs themselves or have their staff distribute drugs, get kickbacks from drug sales at their events, have thinly veiled drug messages on their promotional flyers, tell their security to ignore drug use or sales, or send patients who need medical attention because of a drug overdose to a hospital across town so that people won't link emergency room visits with their club.[73]

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69 *Id*. at 1848 (statement of Sen. Grassley).
70 *Id*. at 1847 (2003) (statement of Sen. Biden) (emphasis added).
71 *Id.*
72 *Id.*
73 *Id.*

Biden explained that he did not intend to provide "a disincentive for promoters to take steps to protect the public health of their patrons including providing water or air conditioned rooms, making sure that there is an ambulance on the premises, etc."[74] He explicitly noted, "there are legitimate reasons for selling water, having a room where people can cool down after dancing, or having an ambulance on hand. Clearly, the presence of any of these things is not enough to signify that an event is 'for the purpose of' drug use."[75] His statements indicate that the statute was not designed to discourage promoters from taking safety precautions nor was it designed to prevent these types of concerts from taking place. Biden clarified, "If rave promoters and sponsors operate such events as they are so often advertised as places for people to come dance in a safe, drug-free environment then they have nothing to fear from this law. In no way is this bill aimed at stifling any type of music or expression[;] it is only trying to deter illicit drug use and protect kids."[76] The legislative record and the wording of the statute itself suggest that its goal was to curb drug use on a larger scale, however, the statute's ambiguous nature has allowed it to be used for other purposes.

IV. UNITED STATES V. TEBEAU

A. Introduction

What happens when the crack house statute is used to go after a concert promoter?[77] When the court allows the intent requirement of the statute to be satisfied by third parties, it potentially creates a zone of liability where any concert promoter can be convicted under the statute due to the rampant drug use that occurs at many music festivals and concerts. In *United States v. Tebeau*, the Eighth Circuit Court of Appeals affirmed the validity of the crack house statute and effectively deemed an organizer of an outdoor music festival as criminally liable under the crack house statute.[78] Tebeau's conviction and the Supreme Court's denial of his Petition should raise awareness as to the problematic aspects of the statute's current form.

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74 *Id*.

75 *Id.* at 1847-48.

76 *Id.* at 1848.

77 *See* United States v. Tebeau, 713 F.3d 955 (8th Cir. 2013).

78 *Id.*

B. Facts and Procedural History of United States v. Tebeau

James Tebeau owned approximately three hundred acres of land in Shannon County, Missouri, which he frequently utilized to promote a series of weekend music festivals.[79] Festival attendees would pay sixty dollars to enter Tebeau's property for three-day festivals, and the number in attendance at each festival ranged from 3,600 to nearly 8,000.[80] After several drug-related arrests near the property, undercover law enforcement officers conducted an operation at his festivals, making over 150 controlled purchases of illegal drugs.[81] "The officers observed 100 to 200 drug dealers at each festival and estimated that approximately $500,000 worth of illegal drugs was sold at each event."[82] The officers witnessed open drug use and open drug sales among festival attendees, as many dealers refrained from using any sort of discretion.[83]

Tebeau was present at each of these festivals.[84] Aware that the drug use and drug sales were going on, Tebeau took the precaution to set up a medical facility on the premises known as "Safestock," where attendees who had overdosed on dangerous drugs could be treated.[85] He instructed his employees that certain types of drugs, including marijuana, LSD, and mushrooms, were permissible at the events.[86] "According to employees, Tebeau instructed security guards in the camp to move sellers away from the front gates to avoid detection by law enforcement officers."[87] After officers executed a search warrant in November 2010, Tebeau was later indicted for managing drug-involved premises in violation of 21 U.S.C. § 856 (a)(2).[88]

Tebeau moved to dismiss the charge, arguing that the government did not allege sufficient facts to demonstrate that "he had the specific intent to sell drugs on his property."[89] After the district court denied the motion, Tebeau entered a conditional guilty plea reserving his right to appeal the motion.[90] In the plea agreement, the government stipulated that Tebeau had not personally participated in any drug sales, but Tebeau admitted that he had "intended [his property to] be made available" for

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79 *Id.* at 957.
80 *Id.* at 958.
81 *Id.*
82 *Id.*
83 *Id.*
84 *Id.*
85 *Id.*
86 *Id.*
87 *Id.*
88 *Id.*
89 *Id.*
90 *Id.*

people "who had the intent to sell and use controlled substances."[91] Although undercover officers alleged that they made some drug purchases in the presence of festival security, Tebeau did not stipulate to that fact in his plea.[92] However, he did agree that 700 kilograms of marijuana had likely been distributed on his premises.[93]

The district court sentenced Tebeau to thirty months imprisonment, two years of supervised release, and a $50,000 fine, and he was required to forfeit his property to the government.[94] Tebeau appealed the district court's denial of his motion to dismiss to the Eighth Circuit Court of Appeals, which affirmed the district court's finding.[95] Most notably, the Eighth Circuit concluded that Tebeau did not need to have the illegal purpose proscribed by the statute[96]; rather, the various people who attended the festivals on his property could fulfill the statute's required illegal purpose.[97] Tebeau filed a petition for certiorari to the Supreme Court of the United States on July 29, 2013, challenging the Eighth Circuit's decision.[98] However, the Supreme Court denied the Petition on October 7, 2013.[99]

C. Tebeau's Textual Argument

Tebeau argued that the district court's reading of Section 856(a)(2) conflicted with the statute's textual and legislative history and that the statute should be interpreted to require proof that he specifically intended illegal drugs to be manufactured, stored, distributed, or used on his property.[100] The district court found that no such proof was required; instead, the court found that the statute only required the government to show that Tebeau intended to make his property available for others who had that purpose.[101]

The Eighth Circuit, without any binding precedent in the context of music festivals, relied on other circuit courts of appeal to determine how

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91 *Id.*

92 Transcript of Change of Plea Hearing at 18-20, United States v. Tebeau, No. 1:11-cr-00083-SNLJ (E.D. Mo. 2012) (No. 113).

93 *Id*. at 19.

94 Transcript of Sentencing Hearing at 18-25, United States v. Tebeau, No. 1:11-cr-00083-SNLJ (E.D. Mo. 2012) (No. 101).

95 *Tebeau*, 713 F.3d at 963.

96 21 U.S.C. § 856(a)(2) prohibits one to "manage or control any place . . . and knowingly and intentionally . . . make available for use . . . the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance."

97 *Tebeau*, 713 F.3d at 961.

98 *See generally* Petition for Writ of Certiorari, *supra* note 11.

99 Tebeau v. United States, 134 S.Ct. 314 (2013).

100 *Tebeau*, 713 F.3d at 958-59.

101 *Id.* at 959.

to interpret the statute.[102] More specifically, the Eighth Circuit examined the decision in *United States v. Chen*, where the Fifth Circuit Court of Appeals concluded that the government did not need to show that a property owner had the purpose of storing, distributing, using, or manufacturing a controlled substance in order to convict her under Section 856(a)(2).[103] In *Chen*, the Fifth Circuit concluded, "the phrase *for the purpose of* applies to the person who opens or maintains the place for the illegal activity."[104] However, the Fifth Circuit also concluded that under Section 856(a)(2), "the person who manages or controls the [property] . . . need not have the express purpose . . . that drug related activity is taking place," as long as others on the property have that purpose.[105] The Fifth Circuit reasoned, "[i]t is well established that a statute should be construed so that each of its provisions is given its full effect; interpretations which render parts of a statute inoperative or superfluous are to be avoided."[106] Accordingly, the Fifth Circuit found that Section 856 (a)(2) would be redundant if it required the same actor-specific intent already necessitated by Section 856 (a)(1).[107]

Moreover, the Eighth Circuit analyzed *United States v. Tamez*, where the Ninth Circuit Court of Appeals concluded that the "'plain meaning and interrelation of the two [Section] 856 provisions suggest that Section 856(a)(2) does not require proof that the defendant intended to use a property for a prohibited purpose."[108] The Eighth Circuit also referenced *United States v. Wilson*, where the Second Circuit Court of Appeals found that any other reading of Section 856(a)(1) and Section 856 (a)(2) would "conflate [the] two subsections, rendering one superfluous."[109] Based on the reasoning of the Second, Fifth, and Ninth Circuit Courts, the Eighth Circuit found that Section 856 (a)(2) did not require proof that Tebeau had the illegal purpose to use, manufacture, sell, or distribute controlled substances.[110] Rather, it was sufficient that Tebeau intended to make his property available to others who had that purpose.[111]

In the Petition, Tebeau argued that, because Section 856 (a)(2) adds "storing" to the list of prohibitions in the statute, that particular provision

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102 *Id.*
103 *Id.* (citing United States v. Chen, 913 F.2d 183, 190 (5th Cir. 1990)).
104 *See Chen*, 913 F.2d at 190.
105 *Id.*
106 *Id.*
107 *Id.*; *see* 21 U.S.C. §§ 856(a)(1)-(2) (2012).
108 *Tebeau*, 713 F.3d at 960 (quoting United States v. Tamez, 941 F.2d 770, 774 (9th Cir. 1991)).
109 *Id.* (quoting United States v. Wilson, 503 F.3d 195, 198 (2d Cir. 2007)) (internal quotation marks omitted).
110 *Id.* at 961.
111 *Id.*

is not wholly superfluous with Section (a)(1) if read on its own.[112] His argument contrasted with the Eighth Circuit's reasoning, which maintained that, because Section 856(a)(1) contained an intent requirement for the actor, an identical requirement in Section 856(a)(2) would be "superfluous" or unnecessary.[113] According to Tebeau, if the actor had as part of his illegal purpose renting the place to another for the purpose of *storing* a controlled substance, that person could be prosecuted only under Section 856 (a)(2) but not under Section 856 (a)(1).[114] Tebeau argued that the Eighth Circuit violated a well-established statutory rule: that "identical words used in different parts of the same act are intended to have the same meaning."[115] If the prohibited purpose in Section 856 (a)(1) unambiguously applied to the actor in the statute, then Section 856 (a)(2) had to be interpreted in the same manner because it shared the same grammatical structure with Section 856 (a)(1).[116] "Although there is some overlap between the two provisions, each section captured [prohibited] conduct that the other did not."[117]

Finally, Tebeau argued that his interpretation of the statute was consistent with congressional intent[118] and was mandated by the rule of lenity.[119] Tebeau pointed to former senator, and co-sponsor of the 2003 Amendment to the statute, Joe Biden's comments,[120] which purportedly underscored his point that the actor in the statute must possess the illegal purpose prohibited by Section 856 (a)(2) to be convicted under the statute.[121]

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112 *See* Petition for Writ of Certiorari, *supra* note 11, at 20.

113 *Tebeau*, 713 F.3d at 960; *see also Wilson*, 503 F.3d at 198; *Chen*, 913 F.2d at 190.

114 Petition for Writ of Certiorari, *supra* note 11, at 8.

115 *Id.* at 20 (quoting Gustafson v. Alloyd Co., 513 U.S. 561, 570 (1995)).

116 Petition for Writ of Certiorari, *supra* note 11, at 21. Tebeau argued that the Eighth Circuit essentially read Section 856 (a)(2) as follows: "it shall be unlawful to manage or control . . . and knowingly and intentionally rent, lease, profit from, or make available for use . . . the place [*to others who have*] the purpose . . . " *Id.*

117 *Id.* at 8; *see* 21 U.S.C. § 856 (2012). The "storing" prohibition is found in section (a)(2), but not in section (a)(1).

118 *See* Petition for Writ of Certiorari, *supra* note 11, at 23.

119 *See id*. at 24. "The purposes underlying the rule of lenity [are] to promote fair notice to those subject to the criminal laws, to minimize the risk of selective or arbitrary enforcement, and to maintain the proper balance between Congress, prosecutors, and courts." *See* United States v. Kozminski, 487 U.S. 931, 952 (1988).

120 Petition for Writ of Certiorari, *supra* note 11, at 23; *see* 149 Cong. Rec. 1847 (2003) (statement of Sen. Biden); *see also infra* Part III-C.

121 Petition for Writ of Certiorari, *supra* note 11, at 24.

D. Tebeau's Procedural Argument

Tebeau also argued that his indictment was deficient pursuant to Rule 7(c)(1) of the Federal Rules of Criminal Procedure[122] because there was no allegation that Tebeau was personally involved in any illicit drug transaction.[123] Therefore, he could not possess the illegal purpose proscribed by the statute.[124] The government conceded that there were no such allegations but argued that this was irrelevant because the indictment tracked the language of the statute, and the main purpose of many of the campers who attended the festival was to sell and use drugs.[125] The Eighth Circuit rejected Tebeau's procedural argument, concluding "[t]he indictment sufficiently described Tebeau's offense conduct in making his property available for illegal use."[126]

E. Tebeau's Due Process Argument

Tebeau further argued that the court's interpretation of the statute as lacking a specific intent requirement rendered the statute unconstitutionally vague in violation of the Fifth Amendment.[127] Specifically, Tebeau contended that by allowing the statute's intent requirement to be satisfied by third parties, the defendant does not receive the necessary "notice" required by due process.[128] Such an interpretation would enable the government to enforce the statute selectively, thus giving festival promoters no guidance as to what level of precautions they could lawfully make available to treat attendees who use drugs at music festivals.[129]

The Eighth Circuit, however, found that the statute provided sufficient notice.[130] The court utilized the Sixth Circuit Court of Appeals' decision in *United States v. Rosa*, which found that Section 856(a)(2) "furnishes fair notice that it is illegal for a homeowner to knowingly and intentionally allow her house to be used in the distribution of drugs."[131]

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122 Fed. R. Crim. P. 7(c)(1). "The indictment or information must be a plain, concise, and definite written statement of the essential facts constituting the offense charged . . . .A count may allege that the means by which the defendant committed the offense are unknown or that the defendant committed it by one or more specified means." *Id.*

123 Petition for Writ of Certiorari, *supra* note 11, at 6.

124 *Id.*

125 *Id.*

126 *Tebeau*, 713 F.3d at 963.

127 *Id.* at 961; *see* U.S. CONST. amend. V.

128 *Tebeau*, 713 F.3d at 961.

129 *Id.*

130 *Id.*

131 *Id.* (quoting United States v. Rosa, 50 F. App'x 226, 227 (6th Cir. 2008)).

Based on the *Rosa* reasoning, the Eighth Circuit found that "the inclusion of a specific *mens rea* element[132] provided[ed] fair notice to Tebeau and others that certain conduct [addressed in the statute] is prohibited."[133] The court found no evidence to support the proposition that Section 856 (a)(2) itself led to any arbitrary enforcement.[134] The Eighth Circuit concluded that the open and obvious drug-use taking place on Tebeau's property was "precisely the conduct prohibited by [Section] 856(a)(2)'s plain language, and the statute therefore was not unconstitutionally vague as applied to Tebeau."[135]

The court failed to address what precautions a property owner could take to avoid liability under the crack house statute.[136] Tebeau asserted that the court mistakenly dismissed his arbitrary enforcement claim, when it summarily concluded that he had provided no evidentiary support for his argument.[137] Notably, the court failed to address his claim that the prosecution did not comport with existing DEA guidelines[138] and that it did not address the many instances of music festivals in Missouri and surrounding states with similar drug-related problems but no prosecutions.[139]

Tebeau relied on Supreme Court reasoning that "[a] statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates this first essential of due process of law."[140] He distinguished *Rosa* on the basis that the defendant in that case allowed people to use and sell drugs in her house.[141] Such a distinction was critical because controlling activities that occur in one's house is substantially different than controlling activities of thousands of people spread over a 350-acre property.[142]

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132 BLACK'S LAW DICTIONARY 1134 (10th ed. 2014) (defining "*mens rea*" as "[t]he state of mind that the prosecution, to secure a conviction, must prove that a defendant had when committing a crime.").

133 *Tebeau*, 713 F.3d at 961.

134 *Id.*

135 *Id.* at 961-62.

136 *See* Petition for Writ of Certiorari, *supra* note 11, at 14.

137 *See id.*

138 "Tebeau noted that his prosecution did not appear to follow the guidelines published by the Drug Enforcement Administration . . . on its own website." *Id.* at 9-10.

139 *Id.* at 14. "Tebeau noted that no other concert promoter and/or outdoor music festival organizer had been prosecuted in this district or surrounding district . . . .Tebeau introduced evidence of a number of music festivals in Missouri and surrounding states where significant illicit drug activity was taking place, including drug-related injuries and deaths." *Id.* at 10.

140 *Id.* at 25 (citing Connolly v. Gen. Const. Co., 269 U.S. 385, 391 (1926)).

141 *Id.* at 26; *Rosa*, 50 F. App'x at 227-28.

142 *Id.*

Tebeau supplemented his vagueness argument by contending that the precautions he took to ensure the safety of festival attendees were used against him to establish his liability, just as they were used against the owners of the State Palace Theatre in the case of *McClure v. Ashcroft*.[143] In *McClure*, an analogous situation existed where owners of a theatre were prosecuted in violation of Section 856 (a)(2) after an investigation showed that approximately seventy patrons had been transported from their theatre to the hospital for drug overdoses.[144] Because of the statutory interpretation advanced in *Chen*, the government was able to prosecute the theatre's owners even though they were not personally involved in the sale or distribution of drugs.[145]

> Despite precautions taken by the owners, it was not enough to avoid liability; rather, such precautions were used against the owners to establish liability. For example, the theater had medical personnel and an ambulance service on hand to assist or transport anyone in need. Yet, the Government argued that this very fact showed that the owners and promoters knew that patrons were likely to suffer the effects of drugs and alcohol.[146]

By allowing the purpose element to be satisfied by the acts of others, a property owner is placed in a "Catch 22."[147] If venue managers and concert promoters do not provide safety precautions for the inevitable drug users at their events, they may be prosecuted or sued for their failure to do so; but, if they take those precautions, Tebeau argued, it could be used against them for Section 856 (a)(2) purposes.[148] "Absent such a safe harbor, the only guaranteed way for a music promoter . . . to avoid liability under the [crack house] statute is to not hold the event at all."[149]

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143 *Id.* at 28; *see generally* McClure v. Ashcroft 335 F.3d 404 (5th Cir. 2003).

144 *McClure*, 335 F.3d at 406. The Fifth Circuit dismissed *McClure*, finding it non-justiciable because "in a civil proceeding, at least under circumstances similar to those presented in this action, a third-party collateral attack on a final criminal judgment is nonjusticiable." *Id*. at 414.

145 Petition for Writ of Certiorari, *supra* note 11, at 28.

146 *Id.* (citing McClure v. Ashcroft, No. CIV A 01-2573, 2002 WL 188410 (E.D. La. Feb. 1, 2002)).

147 *Id.* at 29.

148 *Id.*

149 *Id.*

F. Tebeau's First Amendment Argument

Because the statute leaves a promoter or venue manager with little guidance how to avoid liability, Tebeau contended, the Eighth Circuit's interpretation of Section 856(a)(2) violates his First Amendment rights by effectively preventing him, as well as other promoters, from organizing music festivals.[150] The cumulative effect of the court's statutory interpretation would be the "chilling" of free speech, particularly the freedom of expression associated with music festivals.[151] In analyzing his argument, the Eighth Circuit utilized the standard set forth in *United States v. O'Brien*:

> Where "'speech' and 'nonspeech' elements are combined in the same course of conduct," the government regulation is justified if (1) "it is within the constitutional power of the Government," (2) "it furthers an important or substantial governmental interest," (3) "the governmental interest is unrelated to the suppression of free expression," and (4) "the incidental restriction on alleged First Amendment freedoms is no greater than is essential to the furtherance of that interest."[152]

In Tebeau's case, only the third and fourth *O'Brien* elements are at issue.[153] With respect to the third element, Tebeau argued that Section 856(a)(2) fails "because it was originally aimed at eliminating music festivals with high drug use," and music festivals are a form of protected speech.[154] He further contended that "Section 856(a)(2) . . . fails to satisfy the fourth element because it too broadly punishes organizers and promoters of music festivals."[155] The Eighth Circuit, however, concluded the statute satisfied the *O'Brien* test and was therefore consistent with the First Amendment.[156] The court reasoned that "the government interest in regulating drug use is unrelated to any incidental impact the law has on music festivals"[157] and that "a prohibition on knowingly making premises available for drug use imposes only an incidental restriction on

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150 *Tebeau*, 713 F.3d at 962.
151 *Id.*; Petition for Writ of Certiorari, *supra* note 11, at 10.
152 *Tebeau*, 713 F.3d at 962 (quoting United States v. O'Brien, 391 U.S. 367, 376–77 (1968)).
153 *Id.*
154 *Id.*
155 *Id.*
156 *Id.*
157 *Id.*

music festival hosts which does not 'significantly compromise' their First Amendment rights."[158] The Eighth Circuit also found that Tebeau's concern about the statute's "chilling effect" was overstated because he did not cite to any "case in which the government has charged another music festival organizer under the statute, and [because his] own involvement in the drug activities . . . was extensive."[159]

"Because a property owner is left guessing how to avoid liability," owners might simply take the "prudent approach and not hold a musical event at all," which would lead to the "chilling" effect of first amendment free speech.[160] Tebeau argued that "the Eighth Circuit conducted a superficial analysis" of the two *O'Brien* prongs at issue[161] and that the Eighth Circuit failed to apply the court's interpretation of the *O'Brien* test as modified in *Clark v. Community for Creative Non-Violence*.[162] Tebeau claimed that the government could not pass the standard set forth in *Clark*, namely, that "in analyzing content neutral regulations the balancing must also take into account whether such regulations leave open ample alternative channels for communication of the information."[163]

In *United States v. Alvarez*, the Supreme Court of the United States explained, "the threat of criminal prosecution for making a false statement can inhibit the speaker from making true statements, thereby 'chilling' a kind of speech that lies at the First Amendment's heart."[164] Tebeau argued that by adhering to the plain language of the crack house statute and by applying the *mens rea* requirement of the illegal purpose to the actor in the statute, the appropriate "breathing room" would be given to important First Amendment rights—playing and listening to music.[165] With an additional *mens rea* requirement in tow, promoters could continue holding festivals without the cloud of uncertainty concerning liability under the crack house statute.[166]

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158 *Id.* (citing Bd. of Airport Comm'rs v. Jews for Jesus, Inc., 482 U.S. 569, 574 (1987)).

159 *Id.*

160 Petition for Writ of Certiorari, *supra* note 11, at 10; *see generally* N.Y. Times v. Sullivan, 376 U.S. 254, 300-01 (1964) (The court noted its concern that an Alabama libel law would "chill" free speech. The court found the law unconstitutional).

161 Petition for Writ of Certiorari, *supra* note 11, at 30.

162 *Id.*; *see* Clark v. Cmty. for Creative Non-Violence, 468 U.S. 288, 298-99 (1984)).

163 Petition for Writ of Certiorari, *supra* note 11, at 30; *see Clark*, 468 U.S. at 293.

164 *See* Petition for Writ of Certiorari, *supra* note 11, at 31-32 (quoting United States v. Alvarez, 132 S. Ct. 2537 (2012)). In *Alvarez*, the court held that the Stolen Valor Act was a content-based restriction on free speech in violation of the First Amendment.

165 *Id.* at 32.

166 *Id.*

V. ARGUMENT

A. The Supreme Court Should Have Granted Tebeau's Petition for Certiorari.

Because some of Tebeau's arguments have substantial merit and because of the potential implications of the decision on the music industry, there was significant reason for the Supreme Court to have granted his Petition and reviewed the Eighth Circuit's decision. In the Petition, Tebeau argued:

> The Court should grant certiorari because the Eighth Circuit's decision threatens important public speech rights and creates uncertainty amongst musical festival promoters over what, if any, precautions can be taken to avoid liability under the crack house statute. Moreover, the Eighth Circuit's decision is inconsistent with this Court's prior decisions regarding statutory construction and the proper analysis to be conducted for vagueness and First Amendment challenges.[167]

There is a three-part inquiry that must be satisfied in order for the Supreme Court to grant certiorari:

> [T]here must be a reasonable probability that four [m]embers of the Court would consider the underlying issue sufficiently meritorious for the grant of certiorari or the notation of probable jurisdiction; there must be a significant possibility of reversal of the lower court's decision; and there must be a likelihood that irreparable harm will result if that decision is not stayed.[168]

Tebeau's prosecution will likely set a dangerous precedent for other concert promoters.[169] Under the Eighth Circuit's opinion, a concert "promoter [could] be held liable under the statute if he makes his land available for others to use [illegal drugs], even though his primary purpose is to host a musical event."[170] Tebeau's argument that, "the Court should address this issue now and not wait for such an issue to

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[167] *Id.* at 15.
[168] *See* Beaver v. Netherland, 101 F.3d 977, 978-79 (5th Cir. 1996) (citing Barefoot v. Estelle, 463 U.S. 880, 895-96 (1983)).
[169] *See* Petition for Writ of Certiorari, *supra* note 11, at 17.
[170] *Id.*

percolate in the other circuits,"[171] was quite tangible due to the realities of the live music industry today and the uncertainties created by the current version of the crack house statute.

As discussed previously,[172] drug use at music festivals is prevalent and the music industry is deriving more of its profits than ever from its live music sector. Concert promoters and venue managers are not naïve; they are aware that drug use and drug sales are transpiring, despite any efforts to thwart such activities. Tebeau's conviction and the Eighth Circuit's affirmance of the conviction appear to be focused on Tebeau's awareness that drug sales were going on at his festivals. While curtailing the distribution of drugs appears to be at the heart of the crack house statute,[173] what the Eighth Circuit and what Tebeau's petition fail to address substantially is that the statute also makes it illegal to "make available . . . the place for the purpose of . . . ***using*** a controlled substance."[174]

Although most concert promoters are not as lax as Tebeau regarding drug *distribution* at festivals, drug *use* is inevitably happening. The primary purpose of these legitimate promoters is to promote and to present live music, but, because the Eighth Circuit's reasoning was not overruled and because authorities are able to attack promoters for "knowingly" making their property available for drug use, these promoters may be subject to prosecution under the crack house statute based on the same reasoning by which Tebeau was convicted. The legal difference between the two potential situations–where promoters are facilitating the distribution or the use of drugs at their venues–is simply that one focuses on the "distribution" provision of Section (a)(2), while the other focuses on the "using a controlled substance" provision of Section (a)(2). Without a controlling decision as to how this statute ought to be interpreted and enforced in all federal Circuit Courts of Appeal, Tebeau is justified in contending that concert promoters are left with little guidance on avoiding prosecution under the crack house statute.

Although it is fairly clear that Tebeau made his property available for drug use and drug distribution, the Supreme Court should have granted certiorari in order to address these fundamental inconsistencies in the current version of the crack house statute, which may very well lead to its arbitrary enforcement. Under the Eighth Circuit's decision, the crack house statute could potentially be used to prosecute any concert promoter or venue owner presiding over an event where drug use is occurring.

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171 *Id.* at 18.

172 *See infra* Part II-A, C.

173 *See* 21 U.S.C. § 856(a)(2) (2012); 149 CONG. REC. 1846-48 (2003) (statement of Sen. Biden).

174 149 CONG. REC. 1846 (2003) (statement of Sen. Biden) (emphasis added).

Such a result will likely affect the entire live music industry, which will in turn hurt the entertainment industry and the many local economies benefitting from the substantial revenue live music produces.

B. The Potential Implications of the Tebeau Decision Are Worrisome.

In an age of a growing live music economy and an even faster growing EDM market, copious "club drug" use is an inevitable problem. Due to the significant health risks associated with such drug use and the substantial number of drug-related deaths at EDM festivals,[175] the government may have good reason to eventually pursue and prosecute concert promoters and venue owners under the authority of the crack house statute. The constituents of various congressional districts may reasonably call on their representatives to rectify this problem, especially as drug overdoses at festivals continue to be reported in the news. Concert promoters and venue managers may very well become unwarranted targets in the fight against dangerous "club drug" use.

The *Tebeau* decision may yield a limitless number of concert promoter and venue manager arrests, even in situations where the facts are not as compelling as they were in Tebeau's case. As long as a third-party can satisfy the "intent" requirement, concert promoters will be susceptible to prosecution under Section 856(a)(2). This is unfortunate for many reasons. In Tebeau's case, he actually took several, arguably positive, safety precautions. He explicitly prohibited what he deemed to be more "dangerous" drugs like crack-cocaine, methamphetamine, and nitrous oxide at his events.[176] Cognizant of the on-going drug use, he set up medical aid facilities to treat patrons who had overdosed after ingesting illegal drugs.[177] He instructed security to remove people who were out of control.[178] He tried, in his own, however misguided, way to create a safe environment for his patrons to enjoy music, which he claimed to be the primary purpose of his festivals.[179]

While the evidence shows that Tebeau intended to make his property available for drug use, an affirmance of his conviction, without further guidelines for concert promoters, may have dire consequences for the industry. The fact that it is not possible to completely eliminate drug use at music festivals was acknowledged by the applicable statute's co-

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175 Sisario & McKinley, Jr., *supra* note 7, at A1.
176 *Tebeau*, 713 F.3d at 958.
177 *Id.*
178 *Id.*
179 Tebeau's Petition repeatedly alleged that his primary purpose was to produce a music festival, not to provide a venue for people to use drugs.

sponsors.[180] For the same reason, it is nearly impossible to eliminate drug sales at music festivals. Because the statute prohibits making a property available for drug use and because the *Tebeau* case allows for a promoter's conviction even where such an activity is not the primary purpose of an event, the promoters of certain musical genres should prepare for a series of future prosecutions as long as the *Tebeau* decision stands and the text of Section 856 remains unchanged.

Further, given that the statute's broader purpose is to curb drug use and drug sales[181] and that the 2003 amendment expanded the statute to apply to outdoor festivals,[182] it is reasonable to expect the government to pursue concert promoters and venue managers who may be associated with genres of music known for substantial drug use. Just as ecstasy use at raves was the public policy concern in 2003,[183] the increasing number of deaths at EDM festivals today will likely catch the government's attention and may turn into someone's political agenda.

The government may plausibly rely on the rampant drug use and deaths at EDM concerns as ammunition to prosecute promoters of other genres of music. Consider the promoters of Phish concerts.[184] It is fairly common knowledge in the live music community that illegal drug use is common at Phish shows. As VICE writer Dick Corvette jested, "One does not simply walk into a Phish concert . . . not on drugs."[185] Corvette's VICE article highlights his experience attending his first Phish show and the market of illegal drugs available there:

> As with the Grateful Dead, there's a weird little economy that operates within the context of Phish. People follow the band around, and then other people follow those people around selling stuff to the people following Phish around. It's magical in its own way, and more than a little exploitative. One of these streets, and by far the most interesting one is called Shakedown Street, which if you've ever been to a Phish show (or Bonnaroo) before, is the "street" (read: row of cars) that you can buy drugs and other stuff on.[186]

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180 149 CONG. REC. 1847 (2003) (statement of Sen. Biden).
181 *See infra* Part III-C.
182 149 CONG. REC. 1847.
183 *Id.* at 1847-48.
184 *See* Dick Corvette, *I Survived A Phish Show*, VICE (Jul. 11, 2012), http://www.vice.com/read/i-survived-a-phish-show.
185 *Id.*
186 *Id.*

Due to the common knowledge that drug use occurs among the fans of many varieties of musical genres, it is foreseeable under a *Tebeau* regime that the promoters of these concerts, who are certainly aware of the inherent drug use, will be prosecuted under the crack house statute. During the first three nights of Phish's 2013 Madison Square Garden residency, at least 228 fans were arrested on drug charges.[187] This Note is not advocating for the legalization of drugs[188] but rather for a realistic assessment of the pervasiveness of drug use at many concerts and music festivals. Phish is merely a paradigmatic example of drug use being associated with a band's fan base.[189] This example emphasizes the facts that drug use and drug sales are occurring, concert promoters are aware of their occurrence, and such a reality breeds potential abuse of the crack house statute by authorities beyond the envisioned legislative purpose.

While the potential for increased prosecution against promoters becomes a distinct possibility in the aftermath of the *Tebeau* decision, the precise goals of the statute's co-sponsors[190] remain overlooked. Senators Biden and Grassley emphasized that the statute was crafted to go after (1) promoters who seek to "profit" from drugs being used and sold at their events and (2) those individuals whose main purpose is to provide a venue for such activities.[191] Rather than accomplish these goals, in upholding Tebeau's conviction and rejecting his Petition, the Supreme Court implicitly authorizes the punishment of a promoter (1) who shared in none of the profits from the drug sales at his event and (2) whose main purpose was to merely facilitate a music festival. The affirmance of Tebeau's conviction, therefore, has the effect of punishing the sort of promoter whom the statute was *not* designed to pursue.

C. The Crack House Statute Threatens the Profitability of the Live Music Industry.

The *Tebeau* case primarily addresses the criminal repercussions for a concert promoter for violating Section 856, but early critics of the 2003 version of the statute recognized the dangers of the civil penalties for

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187 Eli Rosenberg & Michael Schwirtz, *Phish Fans Encounter Crackdown at Garden*, N.Y. TIMES, Jan. 1, 2014, at A14.

188 *But see, e.g.*, David Elkins, *Drug Legalization: Cost Effective and Morally Permissible*, 32 B.C. L. REV. 575 (1991); James Ostrowski, *The Moral and Practical Case for Drug Legalization*, 18 HOFSTRA L. REV. 607 (1990); Doug Bandow, *War on Drugs or War on America?*, 3 STAN. L. & POL'Y REV. 242 (1991).

189 It must be noted that I personally have several friends who are life-long Phish fans, and they do *not* use illegal drugs.

190 149 CONG. REC. 1846-49 (2003) (statements of Sen. Biden and Sen. Grassley).

191 *Id.*

which the statute provides.[192] What will happen once a few more concert promoters are criminally prosecuted under the crack house statute and the families of drug overdose victims realize that those promoters are also liable for civil penalties? In addition to possible wrongful death suits and criminal prosecutions, promoters of all kinds could potentially face a series of lawsuits under the crack house statute.

Rather than attracting additional corporate sponsors, the existing sponsors previously mentioned in this Note[193] may shy away from such involvement once they realize that the promoters with whom they are doing business are civilly and criminally liable under the statute. Under Section 856 (d)(2), "[i]f a civil penalty is calculated . . . and there is more than [one] defendant, the court may apportion the penalty between multiple violators, but each violator shall be jointly and severally liable for the civil penalty under this subsection."[194] If sponsors are determined liable as co-defendants, their wallets, in addition to their reputations, will likely suffer.

While there is no guarantee that such arrests or lawsuits will continue to occur, recent deaths at EDM festivals[195] and the rising popularity of the genre[196] will likely prompt awareness of the crack house statute under which festival promoters may be prosecuted. Although Tebeau is not a "major" concert promoter like Live Nation Entertainment,[197] his conviction should sound the alarm bells for corporate concert promotion companies and their sponsors. If the government can make a case, with analogous facts to the *Tebeau* precedent, against promoters who are aware of the drug use present at their festivals, it is only a matter of time before the major promoters and venue managers are attacked.

The dangers of "club drugs," like ecstasy, have been a federal public policy concern since the crack house statute was amended in 2003.[198] As the popularity of EDM continues to evolve, there is good reason to believe that the government's next target for prosecution could be EDM concerts,[199] in the same manner "raves" were targeted back in 2003.[200] As the profitability of concerts and music festivals continues to grow and these event revenues continue to support the music industry, the threat of

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192 149 CONG. REC. 9378 (2003) (statement of Sen. Leahy).
193 *See infra* Part II-A.
194 21 U.S.C. § 856(d)(2) (2012).
195 Sisario & McKinley, Jr., *supra* note 7 at, A1.
196 *See infra* Part II-C.
197 *See infra* Part II-A.
198 *See* 149 CONG. REC. 1846-49 (2003) (statements of Sen. Biden and Sen. Grassley).
199 Other musical genres, known for substantial drug use, may also be targeted. *See infra* Part V-B.
200 *See* 149 CONG. REC. at 1847-48; *see also infra* Part III-C.

major promoters and venue managers being arrested and sued, combined with the possibility of major sponsors abandoning their interest in live music, may have extremely damaging effects on the industry and reverse the positive industry trends of the last several years.

D. *The Music Industry Should Lobby on Tebeau's Behalf.*

As demonstrated, Tebeau's case is representative of the dangerous path that lies ahead for the live music industry.[201] It is in the interest of the industry, and of the many sectors of the economy that profit from live music, to lobby in support of Tebeau's contentions and to raise awareness of the issues at hand. To be successful in their efforts, these potential Tebeau supporters should be aware that although Tebeau put forth several respectable statutory arguments that can greatly help their cause, his conviction was likely justified.

Because Tebeau allegedly gave his security staff clear permission to allow certain types of drug sales at his events,[202] it would have been very difficult to overturn the conviction under the current version of Section 856(a)(2). Although Tebeau did not profit from the drug sales directly,[203] he arguably profited indirectly because certain drug dealers, who would have likely known about the festival security's laissez faire attitude toward drugs like marijuana, mushrooms, and LSD, likely paid for admission to the festival for the specific purpose of selling illegal drugs. Tebeau's best chance to overturn his conviction would have been to focus on his arguments that the statute is unconstitutionally vague and that its effects are contrary to the statute's purpose.

Because a festival promoter or venue manager can be held liable for the acts of others who use his property, there is little guidance as to what precautions ought to be taken to avoid liability under the statute. While the major concert promoters take significantly more safety precautions than Tebeau did with regard to drug sales at their events, Tebeau's proponents can argue that, under the statute, the commonplace nature of drug use at such events remains problematic. As long as the current iteration of the statute remains and the *Tebeau* precedent stands, the shadow of his conviction will loom over concert promoters nationwide who surely cannot prevent all drug distribution and use at their events.

Although Tebeau's First Amendment argument may appear overstated,[204] the inevitability of pervasive drug use at many music festivals may lead certain promoters and venue managers to abandon

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201 *See infra* Part V-C.
202 *Tebeau*, 713 F.3d at 958.
203 *Id.*
204 *See id.* at 962.

specific endeavors for fear of prosecution, with the resultant effect being the "chilling" of free speech.[205] In the Petition, Tebeau should have dedicated more time to this argument and should have provided the Supreme Court with the factual background highlighting the substantial scope of the statute's reach. The cumulative effects of a *Tebeau* precedent may very well curb the number of music festivals and concerts in certain genres of music for as long as promoters and venue managers lack the guidelines necessary to take sufficient precautions to immunize themselves against prosecution under the statute.

Moreover, Tebeau's proponents should dissect both the 1986 version and the 2003 version of the statute and emphasize the reasons and purpose for each version's enactment.[206] They should argue, in detail, that the goals of the 2003 version are not being realized by the *Tebeau* decision. Just as the 1986 version was meant to address a specific problem dealing with crack houses,[207] the 2003 version was meant to address a specific problem dealing with high instances of ecstasy use among young people in the rave scene.[208] Congressional intent for both of these bills focused on cutting down the instances of drug use, the specific drug depending on the time period.[209] If legitimate promoters and venue managers are attacked under Section 856 and legitimate venues are shut down, it is reasonable to surmise that young people will seek alternative, illegitimate venues to enjoy their music and to potentially use drugs. The more guidance and support the government can give to legitimate promoters and venue managers, the more the congressional intent of the statute can be realized.

Lobbyists on Tebeau's behalf should not underestimate the potentially devastating impact on certain local economies that may result from the Supreme Court's decision to let the Eighth Circuit's holding stand. While Tebeau's festivals took place in rural Missouri,[210] host cities of major festivals around the nation, which have grown accustomed to the jobs and economic boost that such festivals yield,[211] may be significantly affected if the festivals were substantially scaled back or fully shut down. The impact on the national economy could be substantial, as the live music industry has come to generate billions of dollars per year.[212]

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205 *See infra* Part IV-F.
206 *See infra* Part III-A, C.
207 *See infra* Part III-A.
208 *See infra* Part III-C.
209 *See infra* Part III-A, C.
210 *Tebeau*, 713 F.3d at 957.
211 *See infra* Part II-B.
212 *See infra* Part II-A-B.

Moreover, as long as the statute is not applied universally,[213] and only certain promoters are prosecuted under its current form, it leaves open the potential judicial discretion that allows a court to twist the content of the statute to reach a variety of conclusions in different situations. Music industry lobbyists must stress that if Section 856 were actually applied universally under the *Tebeau* rationale, **all promoters aware of drug use at their festivals could theoretically be prosecuted**. Based on the realities of the live music culture today and the fact that most promoters and venue managers are aware of what is going on, such a class of potential convicts would be enormous.

E. Popular Culture's Acceptance of Drug Use Is Problematic.

Clearly, music festivals and concerts need to be made safer, and attacking the drug use and drug sales at these events seems to be a rational method of achieving such a goal. The 2003 amendment to the crack house statute, while primarily aimed at rogue concert promoters,[214] was also an attempt to attack the "club drug" epidemic on a larger scale.[215] When addressing some of the critics of his bill, Senator Biden explained,

> the answer to the problem of drug use at raves is not simply to prosecute irresponsible rave promoters and those who distribute drugs. There is also a responsibility to raise awareness among parents, teachers, students, coaches, religious leaders, etc. about the dangers of the drugs used and sold at raves.[216]

Senator Grassley noted the problematic acceptance of such drug use among young people claiming, "[m]any young people perceive Ecstasy as harmless."[217] The social and cultural acceptance of Ecstasy has arguably increased since the EDM scene emerged from the underground to the mainstream. Now, young people are ingesting MDMA at major music festivals[218] rather than at "underground raves."[219] While the statute's co-founders sought to raise awareness of the dangers of club

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213 An underlying theme of this Note is that the government chose, selectively, to prosecute Tebeau under the statute predominantly because he was aware of the drug sales going on at his festivals and did little to prevent it.

214 *See infra* Part III-C.

215 149 CONG. REC. 1847 (2003) (statement of Sen. Biden).

216 *Id.* at 1848.

217 *Id.* at 1849 (statement of Sen. Grassley).

218 *See* Sisario & McKinley, Jr., *supra* note 7, at A1; *see also infra* Part II-C.

219 *See* 149 CONG. REC. 1846 (2003) (statement of Sen. Biden).

drugs among "parents, teachers, [and] students,"[220] a more concerted effort must be made to address the actual festival attendees. It would be in the best interest of all involved if the amount of drug use in the live music scene were curtailed. In order to do this successfully, upgrading standard security measures at concerts and music festivals will likely be insufficient. The culture itself needs to change.

Madonna's 2012 antics and her decision to title her album "MDNA"[221] exemplify the popular culture's acceptance of "club drug" use.[222] She provides an excellent example of precise behavior that musicians should avoid in front of impressionable, young music fans. Musicians like Madonna and EDM DJs like Calvin Harris have the power and influence to help diminish the acceptance of ecstasy in the EDM culture. These artists have the opportunity to highlight the dangers of "club drugs" and to encourage their fans to enjoy their music without the "aid" of those drugs. The music industry should give serious consideration to a marketing campaign demonizing the use of these drugs in a similar fashion to anti-cigarette and drunk driving campaigns that have become so prevalent in our society.

In the same way many famous rappers have been vocal proponents in anti-violence campaigns, often expressing such sentiments in their songs,[223] EDM artists have a real opportunity to make a difference. Although such an idealistic and likely all-too-hopeful plan to help shape the culture may be unlikely to succeed without the backing of serious players in the industry, it just may suffice for a new beginning. However, until a plan with similar goals gets moving and has time to yield results, drug use will remain rampant, and concert promoters and venue managers will consequently remain vulnerable to prosecution.

F. There is an Inherent Problem With the Current Wording of the Statute.

Tebeau presents a valid argument regarding the unambiguous nature of the statute because the statute's language is clear on its face.[224] Although promoters and venue managers are undoubtedly aware that

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[220] *Id.* at 1848.

[221] MADONNA, MDNA (Interscope Records) (2012).

[222] *See infra* Part II-C.

[223] *See, e.g.*, NAS, *I Gave You Power*, on IT WAS WRITTEN (Columbia Records 1996) (rapping about the horrors of gun violence growing up in New York); JAY-Z AND KANYE WEST, *Murder to Excellence*, on WATCH THE THRONE (Def Jam Records 2011) (decrying the rampant gun violence in Chicago, IL and its effects); SNOOP LION, *No Guns Allowed*, on REINCARNATED (RCA Records 2013) (calling for no more gun violence).

[224] *See* 21 U.S.C. § 856 (a)(2); *See* Petition for Writ of Certiorari, *supra* note 11, at 9-10.

illegal activities are occurring at certain events, this awareness does not mean that they are *intentionally* making the venue available for that *purpose* as the statute prohibits.[225] This begs the question of whether the Eighth Circuit's reading of the statute can be deemed an example of excessive judicial discretion. By allowing the "intention" requirement of the statute to be substituted by third parties, the precise wording of the statute appears to be ultimately ignored.

If the goal of the statute is to curb drug use and drug sales,[226] then the repercussions for violating the statute should be designed to achieve that purpose. Punishing promoters and venue managers for activities that will inevitably occur at such events hardly accomplishes that goal. As the recent deaths at music festivals have shown, the current version of the statute is doing little, if anything, to keep festival patrons from using dangerous drugs. The focus of the concert promoters and venue managers should be on curtailing the drug use and drug sales at these festivals, and the statute needs to help facilitate such efforts. Searches by security, removal of overly intoxicated patrons, and medical aid stations are all necessities that the current version of the statute fails to address.

Rather than being used merely to prosecute concert promoters and venue managers, the statute should provide guidelines for these actors to appropriately curb the drug use and drug sales at their events. As written, the statute provides a blanket provision that gives no such specifications. Until the current version is amended, the state interest of curbing drug use is not being achieved, and promoters are exposed to arbitrary prosecution. If courts are attributing the statutory "intention" requirement to third parties, an additional legislative provision to the statute is necessary to prevent inequitable application.

G. The Best Solution Is to Amend the Statute, Again.

In order to address all of these issues in a permanent and substantial fashion, a simple reversal of the *Tebeau* decision by the Supreme Court may not have sufficed. If the Court had taken the case and issued an opinion, concert promoters would likely still have little guidance about how to avoid liability while simultaneously providing the safest possible environment for their patrons. To avoid such a situation, Congress should consider another amendment to the crack house statute.[227] In the same fashion that the 2003 amendment sought to address a pressing issue at

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225 *See* 21 U.S.C. § 856 (a)(2).
226 *See infra* Part III-C.
227 *See, c.f.*, Lindsay M. Korey Lefteroff, E*xcessive Heckling and Violent Behavior at Sporting Events: A Legal Solution?*, 14 U. MIAMI BUS. L. REV. 119, 137 (2005).

the time,[228] a 2014 amendment to the statute could address the dilemma that has presented itself today. My proposed amendment to Section 856 (a)(2) would make it illegal to:

> [M]anage or control any place . . . and knowingly and intentionally . . . make available for use . . . the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance[229] **[if the actor does not take reasonable precautions (1) to prevent these activities and (2) to provide necessary health and safety measures for patrons]**.

Such a "reasonableness" test allows for different levels of precautions to be taken at different types of events. For example, EDM concerts with teenage and young adult fans will likely require more health and safety precautions than a jazz concert with an older patronage. A balancing test would encourage courts to issue judgments based on the necessities demanded by a particular genre of music, the location city, the particular venue, those in attendance, and the time of year. Outdoor festivals like Electric Zoo, in the heat of a New York summer, will inevitably require more precautions than an indoor, air-conditioned venue. Although this suggestion appears initially vague in and of itself, and may be susceptible to the same analogous possibility of judicial discretion that this Note has previously critiqued,[230] such an amendment would, at the least, give concert promoters some sort of standard by which they can conduct their affairs. A fact-specific inquiry is justified due to the virtually unlimited number of scenarios that can occur.

Courts will be able to consider several factors under the new test. Were there enough law enforcement personnel on site or nearby? What instructions were given to venue security? Were security personnel targeting all types of drug use and drug sales, or were they being selective? Could security reasonably eliminate all drug use, or did they do the best they could under the circumstances? Were enough medical precautions taken to ensure the safety of patrons? Were overtly intoxicated individuals removed and given adequate medical attention? Were there enough water stations?

All of these factors need to be addressed in order to achieve the state interests of curbing drug use and drug sales at these events and protecting the wellbeing and the safety of concert patrons.[231] While such an

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228 *See infra* Part III-C.
229 21 U.S.C. § 856(a)(2) (2012).
230 *See infra* Part V-F.
231 *See infra* Part III-C.

amendment would help to protect festival promoters and venue managers from arbitrary prosecution, it would not diminish the central purpose of Section 856, which is to combat the problematic drug use of the day and the related dangers.[232]

VI. CONCLUSION

The current version of Section 856 (a)(2) reaches an unreasonably large class of people, namely concert promoters and venue managers, who are left with little guidance about how to avoid liability when hosting a music event. A second amendment to the statute, adding a reasonableness test, would address Tebeau's textual, due process, and First Amendment concerns, while maintaining the statute's core purpose. Just as the 2003 amendment was passed to address a public policy concern of the day, this second amendment is needed to address a modern substantial policy concern.[233] As the statute currently stands, Tebeau's conviction was likely justified. However, as long as the intention element in Section 856 (a)(2) can be transferred from third parties to the defendant in crack house statute cases, concert promoters and venue managers around the country are in danger of being prosecuted for merely being passively aware of the drug use at their events.

To protect promoters and venue owners, to save the industry, and to protect the health and safety of music festival patrons, Congress needs to fix these statutory problems. Although the Supreme Court would have been wise to take the *Tebeau* case in order to address these concerns, Congress would save significant time and unnecessary litigation costs for the government, and for countless future defendants, by passing a new bill as soon as possible. Such a change is necessary for the future of the music industry and the national economy as a whole, as billions of dollars are at stake. For live music's sake and for the sake of the music industry at large, the crack house statute needs to be amended, again.

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232 *See id*.
233 *See infra* Part II.

“Dope” Dilemmas in a Budding Future Industry: An Examination of the Current Status of Marijuana Legalization in the United States

Steven A. Vitale*

This Comment provides an in-depth analysis of the current status regarding legalization of marijuana in the United States. It begins by tracing a brief history of the legalization movement in this country. The next section addresses the federal-state law conflict issue, coupled with a thorough analysis of two recent and relatively unexamined developments—the Department of Justice’s August 29, 2013 memorandum issued as a guide to federal prosecutors concerning marijuana law enforcement, and the September 10, 2013 judicial committee hearing on the conflict between federal and state marijuana laws. So long as the federal-state law conflict exists, it seems that the current climate, filled with uncertainty and ambiguity, allows for possible arbitrary abuse of power and selective prosecution by the federal government. A particularized focus on the current activities of Colorado and Washington places many of these issues into context, and enables us to study the progression of legalization in action. One section is dedicated to addressing the detrimental effects of current federal drug policy, and serves to highlight federal, state, and local reform efforts around the country. This newly emerging “cannabusiness” also creates some ethical dilemmas for lawyers seeking to aid clients in their business endeavors; thus, part of this Comment seeks to unpack these ethical quandaries and provide some clarity and guidance to attorneys. The role of the Fifth Amendment privilege against self-incrimination and its potential effect on this budding and

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lucrative industry is also closely examined. The final section discusses what the future of federally legalized marijuana might look like— how marijuana might be dealt with as a controlled and regulated substance in the business sector, how the law would handle such a shift, and what overarching effects this shift might have on the criminal justice system.

I. INTRODUCTION

Marijuana legalization has been a historically controversial topic sparking significant public discourse in the United States. Indeed, recent developments have catapulted the issue to the forefront of political debates, legal quandaries, and business opportunities. Despite the proliferation of this issue, and even with a mild familiarity regarding some of the discussions, it can be exceedingly difficult to locate and understand the latest research-based information on marijuana and its progression on the path to legalization. Health effects, conflicts of law, business ethics, and legal status are all compelling tangential issues shrouded in uncertainty. This confusion is fueled by self-serving messages presented by popular culture, the media, and political agendas.

The purpose of this Comment is to provide some level of clarity by first tracing a brief history of legalization in this country, with a particularized focus on the current activities of Colorado and Washington. The federal-state law conflict issue will also be addressed, coupled with a thorough analysis of two recent and relatively unexamined developments—the Department of Justice's August 29, 2013 memorandum issued as a guide to federal prosecutors concerning marijuana law enforcement, and the September 10, 2013 judicial committee hearing on the conflict between federal and state marijuana laws. The next major section will seek to unpack the ethical dilemma lawyers might face in aiding clients in the newly emerging marijuana business, with a specialized focus on the role of the Fifth Amendment privilege against self-incrimination, and its potential effect on this budding and lucrative industry. So long as the federal-state law conflict exists, it seems that the current uncertain and ambiguous climate allows for possible arbitrary abuse of power and selective prosecution by the federal government. The final section will briefly address what the future of federally legalized marijuana might look like— how marijuana might be dealt with as a controlled and regulated substance in the business sector, how the law would handle such a shift, and what overarching effects this shift might have on the criminal justice system.

II. A BRIEF HISTORY OF MARIJUANA AND ITS INTRODUCTION TO THE UNITED STATES

Marijuana is the most commonly used illicit drug in the world.[1] It is derived from the flowering hemp plant, bearing the scientific name *Cannabis sativa*.[2] Cannabis can be found in a variety of forms, but the most common and familiar form is marijuana.[3] Its primary psychoactive ingredient is delta-9-tetrahydrocannabinol, better known as THC, and it is just one of the many cannabinoids found in marijuana.[4] "Different parts of the plant, plants of different genetic strains, and plants grown under different conditions contain different mixes of these chemicals,"[5] and these factors contribute to the varying potency of a particular specimen.[6] Potency is measured by the concentration of cannabinoids—THC specifically—and, due to technological improvements, better growing methods, and selective breeding, marijuana has become increasingly potent over the past few decades.[7] With so many varying

1 *See* JONATHAN P. CAULKINS ET AL., MARIJUANA LEGALIZATION: WHAT EVERYONE NEEDS TO KNOW 3 (2012).

2 *See* JERROLD S. MEYER & LINDA F. QUENZER, PSYCHOPHARMACOLOGY: DRUGS, THE BRAIN, AND BEHAVIOR 328 (1st ed. 2005).

3 *Id.*

4 *See* CAULKINS ET AL., *supra* note 1, at 7.

5 *Id.* at 7.

6 *Id.* at 8.

7 *Id.* at 9.

cannabis strains continually discovered and grown, and due to the variety of preparation methods available, the potency of marijuana is constantly changing, influencing both its popularity and price.

The increase in potency over the years has been a topic of debate, but there has been an even greater dispute over whether or not this increased potency even matters. To the average consumer looking for a fix, more potent marijuana is preferred because a user requires less to attain the desired high. Smoking less pot could be additionally beneficial to the user in the sense that less pot equals less throat irritation, less exposure reduces the possibility of lung damage, and, since it takes less time to get high, less probability of getting caught.[8] Yet, some research suggests that more potent pot can lead to a greater likelihood of negative effects, such as panic attacks and anxiety fits, unfamiliar and intense intoxicating sensations, a higher probability of dependency, and other health risks.[9]

Marijuana has been used since ancient times as both a means for achieving a euphoric effect, as well as for medicinal purposes, such as treating pain, nausea, lack of appetite, and many other conditions. The oldest known written record of cannabis use comes from a Chinese medical compendium dating back to circa 2727 BCE.[10] Apart from its biological, religious, and therapeutic utility, the hemp plant has many industrial uses. In fact, there is archeological evidence of hemp rope dating back between 8,000–10,000 years ago, before farming was even invented.[11] Use of marijuana spread west to India, North Africa, and to the Arab world, where consumption became commonplace.[12] Western interest in marijuana came much later, around the early to mid-nineteenth century, when Napoleon's soldiers returned from Egypt with not only the Rosetta stone, but also the practice of smoking marijuana for recreational use.[13] The history of cannabis in the United States dates back to the colonial era, when the Virginia Company commissioned domestic production of hemp for industrial purposes.[14] The plant was an agricultural commodity with great economic importance to England. It was used to make rope, cloth, and paper. Medical use of cannabis began in the 1850s, when it became available in American pharmacies.[15] As its

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8 *See id.* at 11.

9 *See id.* at 11.

10 *See Cannabis, Coca, & Poppy: Nature's Addictive Plants*, DEA MUSEUM, http://www.deamuseum.org/ccp/cannabis/history.html [hereinafter DEA MUSEUM].

11 *See* CAULKINS ET AL., *supra* note 1, at 18.

12 *See* DEA MUSEUM, *supra* note 10.

13 *See* Michael Berkey, Note, *Mary Jane's New Dance: The Medical Marijuana Legal Tango*, 9 CARDOZO PUB. L. POL'Y & ETHICS J. 417, 420 (2011).

14 *See* ROBERT DEITCH, HEMP—AMERICAN HISTORY REVISITED: THE PLANT WITH A DIVIDED HISTORY 16 (2003).

15 *See* Berkley, *supra* note 13, at 420.

medicinal usefulness grew, efforts were made to regulate its sale, and pharmaceutical laws were created on a state-by-state basis.

Use of marijuana as an intoxicant in America did not emerge until the early 1900s.[16]

> [H]istorians believe that the social practice of consuming cannabis (mainly marijuana smoking) was brought into the United States . . . by Mexican immigrants crossing the Mexican–American border, and by Caribbean seamen and West Indian immigrants entering the country by way of New Orleans and other ports on the Gulf of Mexico.[17]

The history of marijuana regulation in the United States is a sad one.[18] "Marijuana in the early twentieth century was negatively associated in the popular consciousness with African–Americans and Mexican–Americans, a fact directly tied to the initial movement to criminalize it."[19] The word "marijuana" itself is derived from the Mexican word *maraguanquo* (meaning "an intoxicating plant").[20] Hostility towards Mexican immigrants eventually morphed into hostility toward "what was thought of as a Mexican drug."[21] According to some scholars, marijuana's growing popularity and use took off in the 1920s as a cheap and effective alternative to alcohol, which was prohibited throughout the county at the time.[22] From 1914 to 1930, state and local governments began enacting anti-marijuana laws to initially regulate pharmaceutical products, but were later aimed at restricting and prohibiting importation, distribution, sale, and possession.[23]

In the 1930s, the federal government initiated an anti-marijuana campaign, grossly exaggerating the drug's negative effects to instill fear and deter use. Harry Anslinger was appointed in 1930 as the first Commissioner of Narcotics in the Bureau of Narcotics of the United States Treasury Department.[24] "He spear-headed a public relations

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16 CAULKINS ET AL., *supra* note 1, at 19.

17 MEYER & QUENZER, *supra* note 2, at 329.

18 Sam Kamin & Eli Wald, *Marijuana Lawyers: Outlaws or Crusaders?*, 91 OR. L. REV. 869, 872 (2013).

19 *Id.*

20 MEYER & QUENZER, *supra* note 2, at 328.

21 CAULKINS ET AL., *supra* note 1, at 19.

22 LYNN ZIMMER, CHAPTER ONE: THE HISTORY OF CANNABIS PROHIBITION 2, *available at* http://www.bisdro.uni-bremen.de/boellinger/cannabis/03-zimme.pdf (last visited Oct. 5, 2014).

23 *See id.*

24 MEYER & QUENZER, *supra* note 2, at 327.

campaign to portray marijuana as a social menace capable of destroying the youth of America."[25] During this period, the government was feeding misinformation to the media, resulting in a stream of propaganda warning about the evils of marijuana use. Magazine and news articles with titles like "Marihuana: Assassin of Youth" and "Sex Crazing Drug Menace" permeated society.[26] Anti-marijuana movies such as *Reefer Madness*, which seems to artistically portray the conflicting duality of progress and degeneration, acted rather as a cautionary tale to the children of the country and to any other would-be users. The government's anti-marijuana campaign culminated in the passage of the Marihuana Tax Act of 1937, which effectively made possession and transfer of the drug as an intoxicant illegal throughout the United States under federal law.[27] "In congressional hearings that preceded passage of [the Act], Anslinger testified [that] 'those who are habitually accustomed to use of the drug are said to develop a delirious rage after its administration, during which they are temporarily, at least, irresponsible and liable to commit violent crimes.'"[28]

Although Anslinger's zealous advocacy was a strong impetus for federal anti-marijuana legislation, he should not be given full credit for creating the "anti-marijuana consensus."[29] Its origin can be traced back to before the introduction of marijuana into American culture. The sentiment is deeply rooted in the country, exemplified by the founding of the American temperance movement, whose members "were particularly concerned with the detrimental effects of alcohol and drugs on their own families and communities"[30] and sought to restrict and abolish the use of intoxicating substances. By 1942, cannabis was removed from the Pharmacopoeia, the nation's official list of approved pharmaceutical substances.[31] In 1951, the Boggs Act was passed by Congress, labeling cannabis as a "narcotic" and establishing minimum sentencing guidelines for marijuana-related offenses.[32] Despite continued regulation and harsh penalties, marijuana remained widely used and was embraced by the counterculture movement of the 1960s.[33]

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25 *Id.* at 327.
26 *Id.* at 328.
27 CAULKINS ET AL., *supra* note 1, at 19.
28 MEYER & QUENZER, *supra* note 2, at 327.
29 ZIMMER, *supra* note 22, at 3.
30 *Id.* at 3.
31 REP. EARL BLUMENAUR & REP. JARED POLIS, THE PATH FORWARD: RETHINKING FEDERAL MARIJUANA POLICY 4 (2013), available at http://polis.house.gov/uploadedfiles/the_path_forward.pdf [hereinafter THE PATH FORWARD].
32 Boggs Act of 1951, Pub. L. No. 82-235, 65 Stat. 767 (repealed 1970).
33 CAULKINS ET AL., *supra* note 1, at 19.

In the landmark case of *Leary v. United States*, the Supreme Court determined that the Marihuana Tax Act of 1937 was unconstitutional because it violated the Fifth Amendment privilege against self-incrimination.[34] The Court held that the statute compelled the petitioner to expose himself to the risk of self-incrimination by requiring him to identify himself in the course of obtaining an order form as an unregistered transferee who had paid the occupational tax.[35] The Marihuana Tax Act of 1937 was repealed, but President Nixon urged Congress to "get tough" on drugs,[36] in response to what "many saw as the self-indulgent excesses of the 1960s."[37]

As a result, the Comprehensive Drug Abuse Prevention and Control Act was passed in 1970, which included the Controlled Substances Act, the prevailing federal regulatory scheme to this day. The Act created a scheduling system and classified marijuana as a Schedule I drug along with heroin and LSD.[38] Schedule I drugs are classified as such due to their potential for abuse and lack of approved medical uses[39] The Act also authorized the creation of a National Commission on Marijuana and Drug Abuse.[40] Raymond Shafer was appointed as chairman and formed what would later become known as the "Shafer Commission."[41] The commission issued a report in 1972 entitled *Marijuana: A Signal of Misunderstanding*, which concluded that "neither the marijuana user nor the drug itself can be said to constitute a danger to public safety"[42] and recommended the "decriminalization of possession of marijuana for personal use on both the state and federal level."[43] Naturally, the report drew immediate and fierce opposition from the Nixon administration and was strongly criticized.[44] Its publication, however, indicated the continuing shift of "elite opinion,"[45] and sparked a movement among the states to decriminalize possession of marijuana and reduce associated penalties.

The decriminalization movement began in Oregon in 1973, when the state passed legislation that reduced the penalty for possession of small

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34 Leary v. United States, 395 U.S. 6 (1970).
35 *Id.* at 20.
36 Kamin & Wald, *supra* note 18, at 873.
37 *Id.* at 873.
38 *See* Controlled Substances Act, 21 U.S.C. § 812 (2012).
39 *Id.*
40 CAULKINS ET AL., *supra* note 1, at 20.
41 *Id.* at 20.
42 Patrick K. Nightingale, *A Brief History of Marijuana in the United States and a Case for Legalization in Pennsylvania*, PITTSBURGH NORML.
43 *Id.*
44 CAULKINS ET AL., *supra* note 1, at 21.
45 *Id.* at 21.

amounts of marijuana to a simple fine.[46] In the next few years, several more states including Colorado, Alaska, Ohio, and California had similarly passed laws decriminalizing possession of small amounts of cannabis, reducing the offense from a felony to a misdemeanor and lowering the accompanying penalties.[47] "With the advent of the Reagan administration [however], the 1980s saw increasing levels of anti-marijuana rhetoric."[48] During this resurgence of prohibitionist fervor, many states reinstated imprisonment for possession, and arrests for marijuana-related offenses were on the rise.[49]

Despite such opposition, marijuana usage nearly doubled in the early to mid-1990s.[50] The next major transition occurred in 1996, when California legalized the sale and use of medical marijuana with the passage of Proposition 215 (the Compassionate Use Act).[51] Since that time, the medical marijuana movement has gained momentum; currently twenty-three states and the District of Colombia have adopted programs and enacted laws removing criminal sanctions for the medical use of marijuana in order to treat a myriad of illnesses and conditions.[52] These states, however, approach the permissible use of medical marijuana in significantly diverse ways, creating a kaleidoscope of regulatory schemes. This makes it well-nigh impossible for the emerging business model to navigate, especially taking into account the conflict of state and federal approaches to the drug.

The federal government's adamant refusal to either reschedule marijuana under the Controlled Substances Act, or craft legislation to better manage this acute state-federal conflict, leaves an intolerable tension wherein law enforcement resources are not efficiently allocated, and the opportunity for individual states to garner much-needed tax revenue is squandered. With complete legalization fully implemented in Colorado and Washington, the current political climate allows for possible arbitrary abuse of power and selective prosecution by the federal

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[46] *See* OR. REV. STAT. § 475.864(3)(c) (which incorporates the decriminalizing language of the 1973 legislation).

[47] For an example of such state legislation, see CAL. STATE OFFICE OF NARCOTICS AND DRUG ABUSE, A FIRST REPORT OF THE IMPACT OF CALIFORNIA'S NEW MARIJUANA LAW, SB 95, Appendix I (1977), *available at* https://www.ncjrs.gov/pdffiles1/Digitization/45532NCJRS.pdf.

[48] CAULKINS ET AL., *supra* note 1, at 22.

[49] Zimmer, *supra* note 22, at 8.

[50] CAULKINS ET AL., *supra* note 1, at 22.

[51] *See* Compassionate Use Act of 1996, CAL. HEALTH & SAFETY CODE § 11362.5 (West 1996).

[52] *23 Legal Medical Marijuana States and DC*, PROCON.ORG, http://medicalmarijuana.procon.org/view.resource.php?resourceID=000881 (last updated July 31, 2014).

government. What remains is an unfair and unequal application of justice. Perhaps it is time for the government to recognize when the existing mechanisms no longer work and the status quo must be changed.

II. THE FEDERALISM ISSUE

State laws occasionally conflicting with federal laws have been a continuing and inevitable feature of the American federalist system. The aforementioned Controlled Substances Act is the current regulatory regime in place today regarding federal enforcement of marijuana laws. However, twenty three states and the District of Colombia have enacted laws decriminalizing possession and the use of medical marijuana despite the fact that the Drug Enforcement Agency ("DEA") still classifies marijuana as a Schedule I drug. These states and their residents are in direct conflict with federal regulations, and the marijuana issue continues to engender both confusion and outright conflict. In recent years, various efforts were made by states to legalize marijuana for recreational use. California's Proposition 19 (2010) and Oregon's Measure 80 (2012) came close to being passed by voters.[53] Then in the fall of 2012, Colorado and Washington became the first states to pass voter initiatives legalizing the sale and possession of marijuana for recreational use.[54]

"[The] interplay between state and federal law has prompted a unique legal result,"[55] where federal prohibition and state exemption coexist with one another. Pursuant to the statutory framework of the Controlled Substances Act, cultivation, distribution, or possession of marijuana is a federal crime.[56] The Supreme Court has determined that

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[53] *See* California Secretary of State, *Proposition 19: Legalize Marijuana in CA, Regulate and Tax*, (Jan. 5, 2011, 12:58 PM), http://www.sos.ca.gov/elections/sov/2010-general/maps/prop-19.htm (California's Proposition 19 was defeated 53.5% to 46.5%.); *see also Oregon 2012 Election Results*, OREGONLIVE (Nov. 9, 2012, 10:14 AM), http://gov.oregonlive.com/election/2012/Map/Measure-80/ (Oregon's Measure 80 was defeated 54% to 46%.).

[54] *See Amendment 64: Legalize Marijuana Election Results*, DENVER POST (Nov. 8, 2012), http://data.denverpost.com/election/results/amendment/2012/64-legalize-marijuana/ (Colorado's Amendment 64 passed with 54.8% of the vote.); *see also* Washington Secretary of State, *Initiative Measure No. 502 Concerns Marijuana*, (Nov. 27, 2012, 4:55 PM), http://vote.wa.gov/results/20121106/Initiative-Measure-No-502-Concerns-marijuana.html (Washington's Initiative 502 passed with 55.7% of the vote.).

[55] TODD GARVEY, CONG. RESEARCH SERV., R42398, MEDICAL MARIJUANA: THE SUPREMACY CLAUSE, FEDERALISM, AND THE INTERPLAY BETWEEN STATE AND FEDERAL LAW 16 (2012).

[56] Controlled Substances Act, 21 U.S.C. §§ 801-971 (2012).

Congress has the power to enact federal prohibitions on marijuana.[57] However, "even if the federal government sought to preempt state marijuana laws, its power to do so is inherently limited."[58] Principles of federalism, such as the limitations of the Tenth Amendment and state sovereignty, prevent the federal government from compelling states to participate in enforcing a federal regulatory scheme, and prohibit it from commandeering state legislatures and executive officers to act as a conduit for implementation and enforcement of federal law.[59] However, under the Supremacy Clause, state laws conflicting with federal law are generally preempted and therefore invalid because "the Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land."[60] Despite this, in *Rice v. Santa Fe Elevator Corp.*, the Court makes clear that there is a presumption against federal preemption, noting that "we start with the assumption that the historic police powers of the States [are] not to be superseded."[61] The courts have generally accorded this presumption to states' medical marijuana laws, and have viewed the relationship between federal and state marijuana laws in a different manner.

Preemption is divided into three general classes: *express* preemption, *conflict* preemption, and *field* preemption.[62] Determining the issue of preemption requires an analysis of congressional intent. Express preemption is self-explanatory: the statutory language will explicitly state the degree of preemption in some cases, but preemption can also be implied in two circumstances. "[U]nder conflict preemption, a state law is preempted 'where compliance with both federal law and state regulation is a physical impossibility . . . or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[63] Field preemption is the second implied situation, and occurs when a federal regulatory scheme is so

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[57] Gonzales v. Raich, 545 U.S. 1 (2005).

[58] Kamin & Wald, *supra* note 18, at 880.

[59] *See* South Dakota v. Dole, 483 U.S. 203 (1987); New York v. United States, 505 U.S. 144, 188 (1992) ("The Federal Government may not compel the States to enact or administer a federal regulatory program."); Printz v. United States, 521 U.S. 898, 925 (1997) ("[T]he Federal Government may not compel the States to implement, by legislation or executive action, federal regulatory programs.").

[60] U.S. CONST. art. VI, cl. 2.

[61] Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).

[62] *See generally* Lorillard Tobacco Co. v. Reilly, 533 U.S. 525 (2001); Florida Lime and Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963); *see also* Hines v. Davidowitz, 312 U.S. 52, 67 (1941) ("But none of these expressions provides an infallible constitutional test or an exclusive constitutional yardstick.").

[63] Garvey, *supra* note 55, at 8 (citing Gade v. Nat'l Solid Waste Mgmt Ass'n., 505 U.S. 88, 98 (1992) (internal citations omitted)).

comprehensive that a reasonable inference could be drawn that Congress "left no room for the States to supplement it."[64] Looking to the language of the Controlled Substances Act reveals Congress' preemptive intent in regard to the relationship between federal and state marijuana laws. Section 903 of the Act states:

> No provision of this subchapter shall be construed as indicating an intent on the part of the Congress to occupy the field in which that provision operates, including criminal penalties, to the exclusion of any State law on the same subject matter which would otherwise be within the authority of the State, *unless there is a positive conflict between that provision of this subchapter and that State law so that the two cannot consistently stand together*.[65]

On its face, Section 903 rejects the idea that the Controlled Substances Act creates any congressional intent to freeze states out of legislating in this area, except in the instance of a "positive conflict," which renders federal and state law incompatible with one another. Furthermore, the emphasized portion of Section 903 acts as a reserve clause for the federal government to retain effective enforcement power. Yet, the evolution of state regulations has made determining what constitutes such a conflict exceedingly difficult, and courts have reached starkly different results.

The bulk of preemption challenges have fallen short when it comes to state medical marijuana exemptions, and some states have taken such successes and attempted to push the boundaries of the preemption doctrine. Moving beyond "merely exempting qualified individuals from prosecution under state drug laws,"[66] some states have attempted to explicitly allow and regulate medical marijuana use. California, for instance, passed the Medical Marijuana Program Act, seeking to increase state control over the use of marijuana within its jurisdiction.[67] The Act required proof of registration in the form of I.D. cards issued to patients and caregivers who were legally qualified.[68] The registration and identification card provisions were sustained by a California appellate court, which found that the specific provisions at issue did not rise to a

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[64] Garvey, *supra* note 55, at 9 (citing Santa Fe Elevator Corp., 331 U.S. at 230).

[65] Controlled Substances Act, 21 U.S.C. § 903 (2012) (emphasis added).

[66] Garvey, *supra* note 55, at 11.

[67] *See* Medical Marijuana Program Act of 2003, CAL. HEALTH & SAFETY CODE §§ 11362.7 – 11362.9 (West 2003).

[68] *See* CAL. HEALTH & SAFETY CODE §§ 11362.71(a)(1), (b)(5).

positive conflict and thus were not preempted by Section 903 of the Controlled Substances Act.[69]

In direct contrast, a court in Oregon held that similar registration and identification card provisions of the Oregon Medical Marijuana Act rose to the level of a "positive conflict," and was therefore preempted by the Controlled Substances Act.[70] The takeaway from these two examples reveals a distorted landscape, in which different state courts employ diverging legal interpretations. These types of nuanced distinctions exemplify the larger context of marijuana legalization. Such a confusing legal climate creates an atmosphere of uncertainty and raises several constitutional queries and countless complications.

Notwithstanding the numerous unresolved issues surrounding preemption, other questions inevitably emerge. To what degree will the federal government enforce federal law in states that have legalized marijuana under state regulatory schemes? With so much confusion and uncertainty as regulations continue to change and conflict, how will the federal government identify and deal with the black market for marijuana, which poses a serious challenge to law enforcement as it seeks to apply existing drug policies?[71]

Despite their operation in the medical market, dispensaries in California, Washington, and Montana have been the recent victims of federal raids. In 2011, twenty-six Montana dispensaries that were "seemingly compliant with state law"[72] were raided. The raids seemed to send a clear message—the federal government intends to enforce the Controlled Substances Act and prohibit marijuana distribution.[73] Then in July 2013, the DEA raided four dispensaries in Washington, the first major raid on marijuana retailers in the state since voters passed Initiative 502, which legalized small amounts of marijuana for recreational use.[74] This string of seemingly arbitrary enforcement by the federal government stifles legitimate business, impairs access for medical usage, and results in a conflict that creates a constitutional conundrum, pitting the right of state voters to choose how they live

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69 *See* Cnty. of San Diego v. San Diego NORML, 81 Cal. Rptr. 3d 461, 481-83 (Cal. Ct. App. 2008).

70 *See generally* Emerald Steel Fabricators, Inc. v. Bureau of Labor and Indus., 230 P.3d 518 (Or. 2010).

71 *See* THE PATH FORWARD, *supra* note 31, at 11.

72 Nicole Flatow & Joseph Diebold, *Feds Raid Washington Medical Marijuana Dispensaries*, (July 25, 2013, 1:30 PM), http://thinkprogress.org/justice/2013/07/25/2353361/dea-raids-washington-marijuana/.

73 *See id.*

74 *See id.*

according to local community standards against the federal government's power to preempt state law under the Supremacy Clause.[75]

The doctrine of *prosecutorial discretion* enables the federal government to exercise broad discretionary power "as to when, whom, and whether to prosecute for violations of federal law."[76] Courts have recognized this power of the executive branch, and have deemed it "particularly ill-suited to judicial review,"[77] for it includes factors "not readily susceptible to the kind of analysis the courts are competent to undertake."[78] Prosecutorial discretion, although broad, is still subject to a few limitations such as the Equal Protection Clause.[79] The decision to prosecute must not be based on "an unjustifiable standard such as race, religion, or other arbitrary classification."[80] So long as the prosecutor's decision to move forward on a case does not have an underlying discriminatory purpose, he is free to prosecute any individual or organization that violates federal law, including the Controlled Substances Act. Utilizing its own investigative and prosecutorial resources, the federal government can bring charges against anyone who produces, possesses, or distributes marijuana, regardless of their compliance with state law. To clarify its position and power, the Department of Justice crafted memoranda in 2009 and 2011 to guide federal prosecutors with the enforcement of federal marijuana laws.[81] However, recent developments on the marijuana frontier, particularly the legalization of marijuana for recreational use by Colorado and Washington, have obligated the Department of Justice to act once again.

"In light of state ballot initiatives that legalize under state law the possession of small amounts of marijuana and provide for the regulation of marijuana production, processing, and sale,"[82] the Department of

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75 *See* THE PATH FORWARD, *supra* note 31, at 11-12.

76 Garvey, *supra* note 55, at 16 (citing United States v. Goodwin, 457 U.S. 368, 380 (1982)).

77 Wayte v. United States, 470 U.S. 598, 607 (1985).

78 *Id*.

79 *See* United States v. Batchelder, 442 U.S. 114, 125 (1979).

80 Oyler v. Boles, 368 U.S. 448, 456 (1962).

81 *See* Memorandum from David W. Ogden, Deputy Attorney Gen., DOJ, on Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009), *available at* http://www.justice.gov/opa/documents/medical-marijuana.pdf; *see also* Memorandum from James A. Cole, Deputy Attorney Gen., DOJ, on Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011), *available at* http://www.justice.gov/sites/default/files/oip/legacy/2014/07/23/dag-guidance-2011-for-medical-marijuana-use.pdf.

82 Memorandum from James A. Cole, Deputy Attorney Gen., DOJ, on Guidance Regarding Marijuana Enforcement (Aug. 29, 2013), *available at* http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf [hereinafter Cole Memo 2013].

Justice ("DOJ") issued a memorandum on August 29, 2013, to give guidance once again to federal prosecutors on marijuana law enforcement under the Controlled Substances Act. The DOJ reaffirmed its determination "that marijuana is a dangerous drug and that the illegal distribution and sale of marijuana is a serious crime that provides a significant source of revenue to large scale criminal enterprises."[83] Enforcing the Controlled Substances Act and utilizing the federal government's limited resources "to address the most significant threats in the most effective, consistent, and rational way"[84] remains the primary focus of the DOJ. In guiding federal prosecutors in the enforcement of the Controlled Substances Act, the DOJ has provided a list of priorities that are of particular importance to the federal government:

- Preventing the distribution of marijuana to minors;

- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;

- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;

- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;

- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;

- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;

- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and

- Preventing marijuana possession or use on federal property.[85]

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[83] *Id.* at 1.
[84] *Id.*
[85] *Id.* at 1-2.

The department urged that enforcement resources and efforts focus on activity that affects any one or more of these priorities. Outside of these enumerated interests, the federal government has typically relied on, and will continue to rely on, state and local law enforcement agencies to deal with marijuana-related activities and offenses via their own narcotics laws.[86]

This traditional joint effort between federal and state approaches to drug policies is now precarious due to the recent passage of Colorado and Washington marijuana laws and regulatory schemes. Sam Kamin, Professor of Law at University of Denver Sturm College of Law, has made numerous contributions to the issue of marijuana legalization. In a recent essay, Kamin advocates for an ideal of cooperative federalism, where he proposes an amendment to the Controlled Substances Act that would allow states to opt-out of the Act's marijuana provisions.[87] Such a model, according to Kamin, would enable states "to function as laboratories for new ideas with regard to marijuana regulation and taxation."[88] This Comment argues that the model could defuse federal-state tensions, and allow the emerging marijuana industry to naturally establish efficient market conditions within the framework of a rational regulatory system. Unfortunately, Congress has made no indication that it would amend the Controlled Substances Act by including such an opt-out clause, and states are forced to operate in this legally gray area.

The proliferation of possibilities related to marijuana legislation at both the state and federal levels creates an atmosphere of uncertainty. The DOJ has emphasized its expectation that the states formulate robust regulation and enforcement systems that prove to be strong and effective, not just on paper, but in practice.[89] So long as these systems effectively control the cultivation, distribution, sale, and possession of marijuana, the federal priorities listed remain less likely to be threatened.[90] If these systems fail to protect against the harms set forth above, then the federal government reserves the right to challenge the state's regulatory structure, and continue to prosecute individuals and organizations alike in violation of federal law.[91]

In exercising prosecutorial discretion, federal prosecutors are to take a number of factors into consideration including, but not limited to, the size and commercial nature of the marijuana enterprise, and the

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86 *See id.* at 2.

87 *See* Sam Kamin, *Cooperative Federalism and State Marijuana Regulation*, 85 U. COLO. L. REV. 1105, 1120 (2014).

88 *Id*.

89 *See* Cole Memo 2013, *supra* note 82, at 2.

90 *See id.* at 3.

91 *Id.*

operation's compliance with state laws and regulations.[92] However, "[t]he primary question in all cases—and in all jurisdictions—should be whether the conduct at issue implicates one or more of the enforcement priorities"[93] annunciated in the 2013 memorandum. The DOJ concludes with the disclaimer that the federal government retains the authority to enforce any and all federal laws regardless of state law, even in the absence of any one of the factors aforementioned.[94] The memo notes that nothing in this memorandum provides a legal defense to a violation of federal law, and that "[t]his memorandum is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal."[95] Overall, "the decision to limit prosecutions appears to be based on enforcement priorities and the allocation of resources,"[96] and, in exercising its prosecutorial discretion, the DOJ is under no obligation to prosecute *all* violations of federal law.[97]

Just days after the issuance of the DOJ's August 29, 2013 memorandum, the Senate conducted a congressional hearing to discuss the state and federal marijuana laws conflict. Kevin Sabet, current director of project SAM ("Smart Approaches to Marijuana") and former senior drug policy advisor to the Obama Administration, was one of the first to speak to the Senate Judicial Committee. After quickly observing the niceties, Sabet delved into the crux of his speech, remarking that he "found the recent guidance by the U.S. Deputy Attorney General [(Cole Memo 2013)] disturbing on both legal and policy grounds."[98] Sabet believes that by issuing this particular guidance, the DOJ has deferred its right to challenge and preempt state marijuana laws, as well as disregarded the provisions of the Controlled Substances Act and other policies aimed at protecting public health and safety.[99] However, Sabet underemphasizes the DOJ's recognizable attempt to reserve enforcement power in its memorandum, as well as the reserving language in Section 903 of the Controlled Substances Act. Sabet fears that the "new guidance endangers Americans since it will facilitate the creation of a large

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92 *See id.*

93 *Id.*

94 *See id.* at 4.

95 *Id.*

96 Garvey, *supra* note 55, at 16.

97 *Id.* (emphasis added).

98 *Hearing on Conflicts between State and Federal Marijuana Laws Before the S. Comm. on the Judiciary*, 113th Cong. 1 (2013) (statement of Kevin Sabet, Director, University of Florida Drug Policy Institute, Department of Psychiatry, Division of Addiction Medicine; Director, Project SAM (Smart Approaches to Marijuana); Author, Reefer Sanity: Seven Great Myths About Marijuana) [hereinafter Statement of Sabet].

99 *See id.*

industry for marijuana use, production, trafficking, and sale."[100] He commended the Controlled Substances Act for its purpose to promote public health, and how it has been an effective tool used to target drug traffickers and producers.[101] But now, according to Sabet, the DOJ has given its stamp of federal approval to the states of Colorado and Washington to go ahead and "start a massive for-profit, commercial industry for marijuana."[102]

The next major segment of Sabet's speech was devoted to addressing some of the priorities listed in the DOJ's memorandum, and how these federal interests have already been compromised. He pointed out how the DOJ claims to be concerned with minors' access to marijuana; yet, according to Sabet, from the time marijuana was legalized for medical use, minors have been exposed to the drug in larger numbers than ever before, there has been an increase in unintentional marijuana poisonings among children, and "peer-reviewed papers are finding that medical marijuana is [being] easily diverted to youth."[103] Sabet condemned Colorado for its "mass advertising, promotion,"[104] and usage of items that are attractive to kids—"like 'medical marijuana lollipops,' 'Ring Pots,' and 'Pot-Tarts.'"[105] Although, it is not unheard of to disguise medicine for children in order to get them to take it or to alter their perception of treatment. Examples range from a mother waving a spoon-full of cough syrup around like an airplane, to the A.C. Camargo Cancer Center that disguises chemotherapy treatment for children as superhero formula.[106] A young child suffering from something like undifferentiated soft tissue sarcoma, a rare but aggressive form of cancer, may be more inclined to ingest medical marijuana in the form of a lozenge or lollipop to ease intense pain, when morphine has proven ineffective and only continues to cause severe nausea. The very nature of marijuana as a legal business lends itself to all the trappings of any normal business, including advertising aimed at glamorizing a product or service. This is a relatively standard model, and sometimes citizens have to deal with all the consequences of living in a capitalistic society that espouses profit over moral sensibility.

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100 *Id.* at 2.
101 *See id.*
102 *Id.*
103 *Id.* at 4.
104 *Id.* at 3.
105 *Id.*
106 *See* Carmen Chai, *Children's Cancer Wing Transforms into Superhero Ward Offering 'Superformula' Chemotherapy*, GLOBAL NEWS (July 7, 2013, 1:00 PM), http://globalnews.ca/news/623040/childrens-cancer-wing-transforms-into-superhero-ward-offering-superformula-chemotherapy/.

That being said, the federal government has restricted advertising of certain industries (specifically the area of tobacco), and has tightly regulated others (such as alcohol). Sabet, however, closed with a section entitled "experience shows that 'Regulation' is anything but."[107] He referenced two independent reports by the Colorado State Auditor, where both suggest that the newly implemented regulatory system is not well regulated at all.[108] Yet, there are some who believe that this regulatory system is only in the infancy stage of development and needs time to grow and adapt. Colorado has dealt with a legal marijuana industry for more than a decade, and according to Paul Armentano, Deputy Director of NORML (National Organization for the Reform of Marijuana Law), "[w]e've been told that the reason we can't change [marijuana policy] is because if we do, the sky will fall," but "[t]he sky is not falling in Colorado. People that live in Colorado recognize that, and people outside of Colorado will recognize that as well."[109]

The September 10, 2013 judicial committee heard from several other prominent figures directly involved in the marijuana legalization issue and who are dealing with the complex questions arising. James Cole, Deputy Attorney General of the United States Department of Justice, defended his position in the August 29, 2013, memorandum issued as a guide to federal prosecutors all over the nation.[110] He reiterated the list of federal enforcement priorities and emphasized cooperation between federal and state law enforcement efforts in the area of drug policy.[111] He clarified that the DOJ reserves its right to challenge any state law or regulatory scheme, despite that the duty of developing comprehensive laws and well-funded regulation systems falls to the states.[112] The next few speakers—Patrick Leahy, Chairman of the Senate Judiciary Committee; John Urquhart, Sheriff of King County Seattle, Washington; and Jack Finlaw, Chief Legal Counsel for the Office of Colorado

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[107] Statement of Sabet, *supra* note 98, at 8.

[108] *See* Colorado Office of the State Auditor, (June 2013), *Medical Marijuana Regulatory System Part II Performance Audit*, *available at* http://www.leg.state.co.us/OSA/coauditor1.nsf/All/C9112BFFDE1559CE87257BA5007AE40F/$FILE/2194B%20MedMarijPart2%20June%202013.pdf; *see also* Office of the Auditor, Audit Services Division, City and County of Denver, (July 2013), *Medical Marijuana Licensing Performance Audit*, *available at* http://www.denvergov.org/Portals/741/documents/Audits%202013/Medical_Marijuana_Licensing_Audit_Report_07-18-13.pdf.

[109] Jacob Sullum, *Audit rips Denver's Pot Regs as Ineffective, and That's Not a Bad Thing*, (July 26, 2013), http://completecolorado.com/pagetwo/2013/07/26/audit-rips-devers-pot-regs-as-ineffective-and-thats-not-a-bad-thing/.

[110] *See Hearing on Conflicts between State and Federal Marijuana Laws Before the S. Comm. on the Judiciary*, 113th Cong. (2013) (statement of James M. Cole, Att'y Gen. of the United States).

[111] *See id*. at 2.

[112] *See id.* at 3.

Governor John W. Hickenlooper—all highlighted two significant federal obstacles to effective state implementation and regulation of marijuana—existing federal law in the areas of banking and taxation.

Sheriff Urquhart pointed out that "under federal law, it is illegal for banks to open checking, savings, or credit card accounts for marijuana businesses. The result is that marijuana stores will be operated as cash-only businesses, creating two big problems."[113] In terms of public safety, these businesses become targets for criminal activity. Regulation and enforcement issues also arise with cash-only businesses because it is "more difficult to account for and track revenues and audit tax payments of businesses that do not use financial institutions."[114] However, as of February 14, 2014, the Obama administration, via the Department of the Treasury, has issued guidance to the banking industry regarding how to conduct business with these state-legal marijuana industries.[115] This is a potentially major step toward legitimization and could eliminate one of the main hurdles preventing effective implementation and regulation. Budding entrepreneurs may now be able to utilize the federal banking system and achieve some level of financial stability and economic certainty, enabling them to deploy and test their business models more effectively.

In the February 14, 2014 guidance, the Financial Crimes Enforcement Network attempted to clarify the Bank Secrecy Act and the rules for banks providing financial services to marijuana businesses.[116] The banks will be required to assess several factors based on their individual institutional objectives, the associated risks, and their ability to manage such risks effectively when providing financial services.[117] They are to notify federal regulators of any suspicious activity by filing a Suspicious Activity Report ("SAR"), despite any state law that legalizes marijuana.[118] Financial institutions will also be required to file what is

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113 *Hearing on Conflicts between State and Federal Marijuana Laws Before the S. Comm. on the Judiciary*, 113th Cong. 2 (2013) (statement of John Urquhart, Sheriff, King County, Washington) [hereinafter Statement of Urquhart].

114 *Hearing on Conflicts between State and Federal Marijuana Laws Before the S. Comm. on the Judiciary*, 113th Cong. 8 (2013) (statement of Jack Finlaw, Chief Legal Counsel, Office of Colorado Governor John W. Hickenlooper) [hereinafter Statement of Finlaw].

115 *See* Memorandum from the Financial Crimes Enforcement Network, Dep't of the Treasury, on BSA Expectations Regarding Marijuana-Related Businesses (Feb. 14, 2014), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf [hereinafter Treasury Memo 2014].

116 *See* David Blake & Jack Finlaw, *Marijuana Legalization in Colorado: Learned Lessons*, 8 HARV. L. & POL'Y REV. 359, 370 (2014).

117 Treasury Memo 2014, *supra* note 115, at 2.

118 *Id*. at 3.

called a "Marijuana Limited" SAR report when the institution reasonably believes that the marijuana-related business "does not implicate one of the Cole Memo priorities or violate state law."[119] The financial institution should file a more comprehensive "Marijuana Priority" SAR report when it does reasonably believe that one or more of the Cole Memo priorities have been implicated, or state law has been violated.[120] Despite potentially lucrative rewards for participation ($2.57 billion in marijuana sales expected this year),[121] and despite the Department of Justice directing federal prosecutors not to pursue financial institutions that do business with legal marijuana industries,[122] problems still exist. Some banks still harbor a fear that, by accepting money from a business involved in activity considered illegal under federal law, they run the risk of violating money-laundering statutes.[123] Also, this new guidance does not protect banks from the threat of future prosecution in the event that a new administration decides to flip the switch and prosecute these violations of federal drug laws. Doing business with marijuana dealers now may result in the banks painting a target on their backs, attracting the unwanted attention of the federal government.

The Colorado Bankers Association (CBA) was quick to recognize this reality and released a statement immediately following the DOJ and the Department of Treasury's guidance to financial institutions. "The guidance issued today . . . only reinforces and reiterates that banks can be prosecuted for providing accounts to marijuana related businesses."[124] The CBA goes on to say that this guidance is only a modified reporting system and places a heavy burden on banks to know and control their customers' activities.[125] It is a situation where the CBA believes that "no bank can comply."[126] There is currently a bipartisan House bill circulating called the Marijuana Businesses Access to Banking Act, which aims to create protections for depository institutions (*e.g.*, banks, credit unions, etc.) that provide financial services to marijuana-related

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119 *Id*. at 3.

120 *See id*. at 4.

121 *See* Danielle Douglas, *Obama Administration Clears Banks to Accept Funds from Legal Marijuana Dealers*, WASHINGTON POST (Feb. 14, 2014), http://www.washingtonpost.com/business/economy/obama-administration-clears-banks-to-accept-funds-from-legal-marijuana-dealers/2014/02/14/55127b04-9599-11e3-9616-d367fa6ea99b_story.html.

122 *See* Serge F. Kovaleski, *U.S. Issues Marijuana Guidelines for Banks*, N.Y. TIMES, Feb. 15, 2014, at A10.

123 *See* Douglas, *supra* note 121.

124 *CBA Statement Regarding DOJ and Treasury Guidance on Marijuana and Banking*, COLO. BANKERS ASS'N, http://www.coloradobankers.org/?60.

125 *Id*.

126 *Id*.

businesses.[127] The bill was referred for committee review on July 10, 2013[128]; unfortunately, it has a small chance of getting through the committee, and an even smaller chance of being enacted. In truth, as long as marijuana is classified as a Schedule I drug and no legal clearance is provided to remove the threat of future federal prosecution, "bank[s] will remain reluctant to do business with dealers, even if they are operating within the confines of state laws."[129]

In regard to the taxation problem, Jack Finlaw discussed Section 280E of the Internal Revenue Code, which "prohibits a business considered to be trafficking substances under the Controlled Substances Act from claiming any tax deductions on their federal tax returns."[130] This provision effectively bars legally operating marijuana businesses in Colorado from receiving the same kind of tax breaks that other legal businesses enjoy. In order to address this tax issue and provide some assistance to the marijuana businesses, Colorado has enacted legislation to allow for a state income tax deduction, where "owners of medical and recreational marijuana businesses [will be able] to deduct their business expenses from their state income tax returns even though they cannot do so on their federal income tax returns."[131]

IV. A CLOSER LOOK AT COLORADO AND WASHINGTON

A. Colorado's Amendment 64

Jack Finlaw, as Chief Legal Counsel to Colorado's Governor, is uniquely positioned to provide insight into the implementation, enactment, and promulgation of Colorado's new marijuana laws, enabling legislation, and regulatory system. In his address to the Judicial Committee, he discussed the passage of Amendment 64 in November 2012.[132] It became law a month later, codified as Article XVIII, Section 16 in the Colorado Constitution, which states that

> in the interest of the efficient use of law enforcement resources, enhancing revenue for public purposes, and individual freedom, the people of Colorado find and declare that the use of marijuana should be legal for

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127 *See* Marijuana Businesses Access to Banking Act, H.R. 2652, 113th Cong. (2013).
128 *See id*.
129 Douglas, *supra* note 121.
130 Statement of Finlaw, *supra* note 114, at 4 (citing I.R.C. § 280E (1982)).
131 *Id.*
132 Statement of Finlaw, *supra* note 114, at 1-4.

> persons twenty-one years of age or older and taxed in a manner similar to alcohol.[133]

The statute allows for adults, ages twenty-one and older, to possess, purchase, use, and transport up to one ounce of marijuana, and also allows for the personal home growth of up to six marijuana plants.[134] Restrictions on home grows stipulate that growing must be "in an enclosed, locked space, is not conducted openly or publicly, and is not made available for sale,"[135] although Finlaw points out that up to an ounce can be gifted to another adult twenty-one years of age or older.[136]

Section 16 goes on to lay out what constitutes lawful operation of marijuana-related facilities,[137] and mandates the implementation of procedures for the "issuance, renewal, suspension, and revocation of a license to operate a marijuana establishment,"[138] as well as a regulatory system for the "cultivation, harvesting, processing, packaging, display, and sale of marijuana."[139] The statute contains a provision aimed at protecting the privacy of individuals:

> The department shall not require a consumer to provide a retail marijuana store with personal information other than government-issued identification to determine the consumer's age, and a retail marijuana store shall not be required to acquire and record personal information about consumers other than information typically in a financial transaction conducted at a retail liquor store.[140]

Furthermore, the statute "permits local governments in Colorado to regulate the time, place, manner, and number of marijuana establishments in their communities."[141] These local governments have the power to ban marijuana establishments within their jurisdiction.[142] However, if a locality opts-in, then it not only gets to take part in a tax share-back scheme (i.e. as the state collects taxes from marijuana-related businesses, it must "share-back" a certain percentage with the local authorities), it also has the ability to levy a locality tax, thus generating

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133 COLO. CONST. art. XVIII, § 16(1)(a).
134 COLO. CONST. art. XVIII, § 16(3)(a).
135 COLO. CONST. art. XVIII, § 16(3)(b).
136 Statement of Finlaw, *supra* note 114, at 1-2.
137 *See* COLO. CONST. art. XVIII, § 16(4).
138 COLO. CONST. art. XVIII, § 16(5)(a)(I).
139 Statement of Finlaw, *supra* note 114, at 2.
140 COLO. CONST. art. XVIII, § 16(5)(c).
141 Statement of Finlaw, *supra* note 114, at 2.
142 *See id*. at 2.

more revenue.[143] Employers in the state are still able to have restrictive policies regarding the use and possession of marijuana by employees,[144] and property owners may prohibit or regulate "possession, consumption, use, display, transfer, distribution, sale, transportation, or growing of marijuana on or in that property."[145] The statute also authorizes "the cultivation, processing and sale of industrial hemp,"[146] and mandates that an excise tax not to exceed fifteen percent (15%), and a sales tax of ten percent (10%), be imposed on marijuana sold or transferred by businesses.[147] The "first forty million dollars in revenue raised annually from any such excise tax shall be credited to the Public School Capital Construction Assistance Fund . . . or any successor fund dedicated to a similar purpose."[148] The purpose of this tax regime is to ensure that Colorado has the necessary financial resources available for executing a robust regulatory and enforcement system, as well as "for an effective education and prevention program to protect youth . . . and for the health and public safety costs associated with the retail marijuana industry."[149]

During the implementation process, a special task force co-chaired by Jack Finlaw and Barbara Brohl, Executive Director of the Department of Revenue, was commissioned to deal with and resolve any legal, policy, or procedural issues likely to arise.[150] The task force was composed of a diverse group of representatives, who focused on devising a regulatory framework, working with local authorities, dealing with tax, funding, and civil law matters, while helping to develop consumer safety and criminal laws.[151] Enabling legislation was also created during this period to buttress Amendment 64—bills were drafted to address retail stores, tax deductions, drugged driving, and the regulation of industrial hemp.[152] The Department of Revenue performed extensive work in a short timeframe to develop comprehensive rules and regulations governing retail marijuana establishments and medical marijuana businesses, tackling issues like "Licensing, Licensed Premises, Transportation, and Storage; Licensed Entities and Inventory Tracking; Record Keeping, Enforcement and Discipline; Labeling, Packaging, Product Safety & Marketing; and Medical Differentiation."[153] The 401-

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143 Blake & Finlaw, *supra* note 116, at 379.
144 *See* COLO. CONST. art. XVIII, § 16(6)(a).
145 COLO. CONST. art. XVIII, § 16(6)(d).
146 COLO. CONST. art. XVIII, § 16(5)(j).
147 *See* COLO. CONST. art. XVIII, § 16(5)(d).
148 *Id.*
149 Blake & Finlaw, *supra* note 116, at 373.
150 Statement of Finlaw, *supra* note 114, at 3.
151 *See id.*
152 *See id.* at 3-4.
153 *Id.* at 4.

page Permanent Rules Relating to the Colorado Retail Marijuana Code[154] is the manifestation of Colorado's guiding principle throughout the whole process—"to create a robust regulatory and enforcement environment that protects public safety and prevents diversion of Retail Marijuana to individuals under the age of 21 or to individuals outside the state of Colorado."[155]

Colorado's system, however, is not perfect. Seven months after legalization, the state has encountered some unexpected problems. The Colorado Department of Revenue points to the lower-taxed medical marijuana market as the cause for some disappointing revenue figures in Fiscal Year 2014.[156] This illustrates the difficulty of forecasting revenue and other economic effects of marijuana legalization. Colorado has also faced several state law enforcement challenges. The numerosity and complexity of these issues could be the subject of a separate article, but it is important to highlight a few that warrant special attention. Three particular issues have given state law enforcement much difficulty—the definition and application of the "open and public consumption" policy, drugged driving, and the "home-grow grey market."[157] Other important enforcement issues include: "licensing, background checks for owners and employees of marijuana-related businesses, employee rights, addiction in the context of family law, enforcement of marijuana-related contracts, cultivation-practices, potency limits, labeling, advertising, and online sales."[158] Despite these formidable challenges, Colorado is seemingly fulfilling the federalist ideal, and serving as a laboratory for novel social and economic ideas. If its health, public safety, and education initiatives are ultimately effective, Colorado could show the rest of the nation that legalization can yield positive results.

B. Washington's Initiative 502

Colorado's efforts to implement laws and create a regulatory framework in the marijuana legalization movement have served as a model for marijuana advocates around the country. The state of Washington and its representatives have worked closely with Colorado

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154 Retail Marijuana Code, COLO. CODE REGS. § 212-2 (2013).

155 *Id*. (COLO. DEP'T OF REVENUE, MARIJUANA ENFORCEMENT DIV., PERMANENT RULES RELATED TO THE COLORADO RETAIL MARIJUANA CODE *i-ii*, *available at* http://www.colorado.gov/cs/Satellite%3Fblobcol%3Durldata%26blobheader%3Dapplication%252Fpdf%26blobkey%3Did%26blobtable%3DMungoBlobs%26blobwhere%3D1251883847085%26ssbinary%3Dtrue).

156 *See* COLO. DEP'T OF REVENUE, MARKET SIZE AND DEMAND FOR MARIJUANA IN COLORADO (2014).

157 Blake & Finlaw, *supra* note 116, at 373.

158 *Id.*

to become the only other state to legalize and regulate the use and sale of recreational marijuana. The citizens of Washington passed Initiative 502 in November 2012.[159] The new Washington marijuana laws mirror those of Colorado in many respects. Adults (ages 21 and older) are now allowed to possess up to one ounce of marijuana for personal use in both states.[160] Washington has also adopted a similar approach to the issue of drugged driving:

> the department shall suspend, revoke, or deny the arrested person's license, permit, or privilege to drive . . . [i]n the case of an incident where a person has submitted to or been administered a test or tests indicating that the alcohol concentration of the person's breath or blood was 0.08 or more, or that the THC concentration of the person's blood was 5.00 or more.[161]

There are some notable differences however. Washington laws seem to be a little less liberal, and do not allow for home grows or personal production of any kind related to recreational use. The taxes implemented in Washington will be somewhat higher, with a state excise tax equal to twenty-five percent (25%) imposed on three separate transactions—the sale of marijuana from the producer to the processor, from processor to retailer, and from retailer to consumer.[162] Washington's tax structure could run the risk of driving experienced and inexperienced users to search for cheaper prices elsewhere. Such a taxation scheme could spawn a potential growth in sales of marijuana on the black market, ultimately undermining Washington's highest priority—to promote public health and safety.[163] The industry structure in Washington also differs. While Colorado has a vertically integrated market, such a market is not envisioned for Washington.[164] Initiative 502

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159 *See* Wash. Legis. Serv. Ch. 3 (I.M. 502) (2013); *see also* Washington Secretary of State, *Initiative Measure No. 502 Concerns Marijuana*, (Nov. 27, 2012, 4:55 PM), http://vote.wa.gov/results/20121106/Initiative-Measure-No-502-Concerns-marijuana.html (Washington's Initiative 502 passed with 55.7% of the vote.).

160 *See* COLO. CONST. art. XVIII, § 16(3)(a); *see also* WASH. REV. CODE § 69.50.4013(3).

161 WASH. REV. CODE § 46.20.3101(2).

162 *See* WASH. REV. CODE § 69.50.535.

163 *See* Washington State Liquor Control Board Rule Highlights (Dec. 6, 2013), *available at* http://www.liq.wa.gov/publications/Marijuana/I-502/I-502_Draft_Rule_Summary_IIX_12-06-13.pdf [hereinafter Liquor Control Board].

164 *See* John Walsh, *Q&A: Legal Marijuana in Colorado and Washington*, Brookings, May 2013, at 2, available at http://www.brookings.edu/~/media/research/files/papers/2013/05/21%20legal%20marijuana%20colorado%20washington%20walsh/qa%20legal%20marijuana%20in%20colorado%20and%20washington%20web.pdf.

directed Washington's Liquor Control Board to draft and enforce the rules and regulations governing implementation.[165] The commercial market in Colorado, however, is supervised and regulated by the newly created Marijuana Enforcement Division of the Department of Revenue.[166] The Liquor Control Board in Washington sought to create a tightly regulated and controlled market for marijuana. One of the major highlights from the rules includes a three-tier regulatory system covering producers, processors, and retailers.[167] In order to obtain a license on any level, applicants must be a resident of the state, go through extensive background checks, pay an application fee, abide by production limitations, submit to taxation, and carry liability insurance.[168] Unlicensed production and distribution remains a class C felony under state law.[169] The Liquor Control Board has made a commendable attempt to design the rules in a way that supports public health and safety. A traceability system will be employed, violation standards will be adopted, and restrictions on advertising will be enforced.[170] Businesses will also be required to take steps ensuring security and safety, such as installing alarm systems, placing warnings on packages and labels, and adhering to strict record-keeping requirements.[171] The window to register for licenses is now closed, and retail stores are set to open sometime this spring.

In the September 10, 2013, judicial committee hearing, the Sheriff of King County, Washington, John Urquhart, emphasized that what was happening in Washington was "not the Wild Wild West."[172] The state is "committed to continued collaboration with the DEA, FBI, and DOJ for robust enforcement"[173] of the new drug laws. Sheriff Urquhart claimed he is a strong supporter of Initiative 502 because the people have spoken, and it is what the people want.[174] After thirty-seven years as a police officer, twelve of which were spent as a narcotics detective, Urquhart testified that his experience has shown him that "the War on Drugs has been a failure,"[175] and the citizens of Washington have decided "to try

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165 *See* WASH. REV. CODE § 69.50.342.
166 See Walsh, *supra* note 164, at 3.
167 Liquor Control Board, *supra* note 163.
168 *Id.*
169 *See* Nathaniel Counts, *Initiative 502 and Conflicting State and Federal Law*, 49 GONZ. L. REV. 187, 190 (2014).
170 Liquor Control Board, *supra* note 163.
171 *Id.*
172 Statement of Urquhart, *supra* note 113, at 2.
173 *Id.*
174 *See id*. at 1.
175 *Id.*

something new."[176] Sheriff Urquhart may have a valid point regarding the failure of the "war on drugs."

V. THE DETRIMENTAL EFFECTS OF FEDERAL DRUG POLICY AND RECENT REFORM EFFORTS

A. Mass Incarceration and Associated Costs

The demand for, the potency of, and the exposure to drugs has only increased over the years. Beginning in the 1970s, with the rise of tough-on-crime politics and the War on Drugs, America's prison population has increased exponentially. The United States has had the highest incarceration rate in the world for over a decade.[177] The war on marijuana in particular has been "waged at a tremendous cost of money and impact on human lives."[178] According to the Federal Bureau of Investigation (FBI), in 2011 there were over 1,500,000 arrests for drug-related offenses, and approximately eighty-two percent (82%) of those were for possession.[179] A vast majority of these arrests occur at the state and local level.[180] "It has been estimated that enforcement of federal marijuana laws (including incarceration) costs a minimum of $5.5 billion dollars each year."[181]

Of course, these numbers are only estimates because it is practically impossible to calculate the number of people serving prison time for marijuana possession alone and the cost of their incarceration. Convictions for possession often result from the plea bargaining process. Also, whether incarceration follows from a conviction for possession of marijuana is influenced by many factors, such as quantity possessed, the geographic area, prior criminal record, and violations while on probation or parole.[182] Calculating the total cost of incarceration related to marijuana possession is even more difficult. A major factor to consider is whether a person is incarcerated *solely* because of marijuana possession,

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176 *Id.*

177 Tyjen Tasi & Paoloa Scommegna, *U.S. Has World's Highest Incarceration Rate*, (Aug. 2012), http://www.prb.org/Publications/Articles/2012/us-incarceration.aspx.

178 THE PATH FORWARD, *supra* note 31, at 6.

179 *See* FEDERAL BUREAU OF INVESTIGATION, UNIFORM CRIME REPORTS, CRIME IN THE UNITED STATES 2011: PERSONS ARRESTED, http://www.fbi.gov/about-us/cjis/ucr/crime-in-the-u.s/2011/crime-in-the-u.s.-2011/persons-arrested/persons-arrested.

180 *See* Kamin & Wald, *supra* note 18, at 875.

181 THE PATH FORWARD, *supra* note 31, at 6 (citing CRS Report R41535 and CATO Study, "The Budgetary Impact of Ending Drug Prohibition").

182 *See* CAULKINS ET AL., *supra* note 1, at 50

or whether that conviction is coupled with other offenses.[183] Additionally, not every person is sent to prison; many go to city or county jails and are held pending trial, sentencing, and arraignment, which accrue even more costs.[184]

B. Discrimination, Collateral Consequences of Conviction, and For-Profit Prisons

The war on marijuana has resulted in prison overcrowding, has been a substantial drain on federal, state, and local resources, and has been a cancer within society, disproportionately affecting racial minorities.[185] Patterns of discrimination can be found nationwide. According to the American Civil Liberties Union, black Americans are about 3.7 times more likely to be arrested for marijuana possession than white Americans, even though both races use marijuana at equally similar rates.[186] The for-profit prison system may be one of the main reasons for this increasing trend of mass incarceration. These prison companies make contracts with the state, and enforce lockup quotas to guarantee that their "private prisons turn a profit."[187] If a state fails to incarcerate a certain amount of people and does not meet the quota obligation, it must pay these for-profit prisons for their empty beds.[188] One might imagine that an effective way to guarantee occupancy requirements is to increase incarceration for drug-related offenses.

Throughout the years, there has been an abundance of evidence suggesting that large-scale incarceration is not the most effective means of achieving public safety.[189] "Few people still believe the lurid stories spread so widely during 1930s antimarijuana [sic] campaign. And yet marijuana remains a highly controversial subject in our society,"[190] masked with misinformation and uncertainty. Every year, thousands of

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183 *See id.* at 51.

184 *Id.*

185 *See generally* Jesse Wegman, *The Injustice of Marijuana Arrests*, N.Y. TIMES (July 28, 2014), http://www.nytimes.com/2014/07/29/opinion/high-time-the-injustice-of-marijuana-arrests.html?ref=todayspaper&_r=1.

186 *See* AMERICAN CIVIL LIBERTIES UNION, THE WAR ON MARIJUANA IN BLACK AND WHITE 47 (2013), *available at* https://www.aclu.org/files/assets/1114413-mj-report-rfs-rel1.pdf.

187 Katy Hall & Jan Diehm, *One Disturbing Reason for Our Exploding Prison Population (Infographic)*, HUFFINGTON POST (Sept. 9, 2013, 3:41 PM), http://www.huffingtonpost.com/2013/09/19/private-prisons_n_3955686.html.

188 See *id.*

189 *See Hearing on Rising Prison Costs: Restricting Budgets and Crime Prevention Options Before the S. Comm. on the Judiciary*, 112th Cong. (2012) (testimony of Marc Mauer, Executive Director, The Sentencing Project).

190 MEYER & QUENZER, *supra* note 2, at 328.

people's lives are destroyed for simple possession,[191] but the effects of mass incarceration are not confined to the cellblock. Both legal and social barriers exist long after a person has successfully completed their sentence. The collateral consequences of a conviction or an arrest can follow a former inmate for life. Society continues to demonize these individuals long after they have completed their court-imposed sentences. They carry the social stigma of being a "criminal" or a "felon" or a "convict," and they are constantly regulated to second-class citizenship, where they are deprived of certain rights, their property is forfeited, and their financial and employment opportunities are negatively impacted.

Mass incarceration and collateral consequences are the tragic results of the decades-old war on drugs. Legal substances like alcohol, tobacco, and prescription medication have well-documented detrimental effects on public health and safety.[192] So why the animosity toward marijuana? Perhaps people are beginning to recognize that U.S. drug policy in regard to marijuana is both costly and futile at best, and that the system is broken.

What some people fail to see, however, is that the system was never broken, it was built this way. That being said, there have recently been some positive steps signaling a shift in the nation's approach to criminal justice, particularly illegal drugs. In mid-July 2014, the U.S. Sentencing Commission decided that nearly 50,000 federal drug offenders currently in prison are eligible for reduced sentences.[193] Furthermore, state marijuana legalization initiatives are now emerging across the country, indicating a change in both political and social attitude and opinion.

C. State and Local Initiatives

Although faced with staunch opposition, many states are moving away from archaic policies, and modernizing their approach to the issue of legalized marijuana. Florida is one of those states. This Comment notes that Florida's penalties for possessing small amounts of marijuana

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191 *See* Christopher Ingraham, *The Share of Arrests for Marijuana Possession Has More than Tripled Since 1991*, WASH. POST (Aug. 13, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/08/13/the-share-of-arrests-for-marijuana-possession-has-more-than-tripled-since-1991/ (providing a year-by-year and state-by-state comparison of arrest rates for marijuana possession).

192 *See* THE PATH FORWARD, *supra* note 31, at 6 (citing to statistics compiled by the Center for Disease Control from its website, www.cdc.gov.).

193 Press Release, U.S. Sentencing Commission, U.S. Sentencing Commission Unanimously Votes to Allow Delayed Retroactive Reduction in Drug Trafficking Sentences (July 18, 2014), *available at* http://www.ussc.gov/sites/default/files/pdf/news/press-releases-and-news-advisories/press-releases/20140718_press_release.pdf.

are among the country's most draconian. Despite this, Florida Governor Rick Scott signed the Compassionate Medical Cannabis Act (nicknamed the "Charlotte's Web" bill) on June 16, 2014.[194] The law allows for the limited use of medical marijuana with low levels of THC by patients who meet certain requirements.[195] Through the initiative process, the Florida Right to Medical Marijuana Initiative, Amendment 2 is set to appear on the November 2014 ballot.[196] The voter-approved measure would legalize medical marijuana in the state, specifically guaranteeing the following:

> - The medical use of marijuana by a qualifying patient or personal caregiver is not subject to criminal or civil liability or sanctions under Florida law except as provided in this section.
>
> - A physician licensed in Florida shall not be subject to criminal or civil liability or sanctions under Florida law for issuing a physician certification to a person diagnosed with a debilitating medical condition in a manner consistent with this section.
>
> - Actions and conduct by a medical marijuana treatment center registered with the Department, or its employees, as permitted by this section and in compliance with Department regulations, shall not be subject to criminal or civil liability or sanctions under Florida law except as provided in this section.[197]

The measure also defines a "debilitating medical condition" as

> cancer, glaucoma, positive status for human immunodeficiency virus (HIV), acquired immune deficiency syndrome (AIDS), hepatitis C, amyotrophic lateral sclerosis (ALS), Crohn's disease, Parkinson's disease, multiple sclerosis or other conditions for which a physician believes that the medical use of marijuana

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[194] *See* 2014 Fla. Laws 157.

[195] *See* § 381.986 (2), Fla. Stat. (2014).

[196] Use of Marijuana for Certain Medical Conditions 13-02 (2014 GEN), http://election.dos.state.fl.us/initiatives/fulltext/pdf/50438-2.pdf (proposed constitutional amendment art. X, § 29(a)(1)-(3)).

[197] FLA. CONST. art. X, § 29(a)(1)-(3) (Proposed Amendment 2014).

> would likely outweigh the potential health risks for a patient.[198]

The Florida Department of Health would be in charge of regulating production, distribution, and use of medical marijuana in the state.[199] The department would issue identification cards to patients and personal caregivers, as well as develop procedures related to treatment centers.[200]

Other state and local governments have also jumped aboard the marijuana legalization train, and are seeking to implement new marijuana legislation. Portland, Maine became the first east coast city to legalize recreational marijuana for adults twenty-one and older.[201] Citizens in the Michigan cities of Lansing, Jackson, and Ferndale voted to allow the possession of up to an ounce of marijuana on private property.[202] Advocates are reportedly pushing for full commercial legalization of marijuana for recreational use in Alaska, which would then join Colorado and Washington to have such drug laws.[203] Pro-recreational initiatives could be on the 2016 ballot in Oregon, and are expected to appear in Arizona, California, Maine, Massachusetts, Montana, and Nevada.[204] As of July 31, 2014, twenty-three states and the District of Colombia have enacted laws legalizing medical marijuana, the latest being New York and Maryland.[205] Florida, Pennsylvania, North Carolina, and Ohio currently have pending legislation or ballot initiatives to legalize use of medical marijuana.[206]

According to a Gallup poll taken in late October 2013, a majority of Americans, for the first time ever, believe that marijuana should be legalized in some form (the figure stands at fifty-eight percent (58%), a notable increase since Colorado and Washington voted for legalization

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198 FLA. CONST. art. X, § 29(b)(1).
199 *See id*. at (d).
200 *See id*. at (d)(1) and (2).
201 *See* Robin Wilkey, *Portland, Maine, Legalizes Recreational Marijuana*, HUFFINGTON POST (Nov. 5, 2013, 9:56 PM), http://www.huffingtonpost.com/2013/11/05/portland-maine-marijuana_n_4221919.html.
202 Ray Sanchez & Michael Martinez, *Colorado Pot Law Called Springboard for Other States*, CNN (Jan. 6, 2014, 10:29 PM), http://www.cnn.com/2014/01/03/us/marijuana-laws-united-states/.
203 *See id.*
204 *See id.*
205 23 *Legal Medical Marijuana States and DC*, PROCON.ORG (July 31, 2013), http://medicalmarijuana.procon.org/view.resource.php?resourceID=000881.
206 *See Six States with Pending Legislation to Legalize Medical Marijuana*, PROCON.ORG (Aug. 27, 2014), http://medicalmarijuana.procon.org/view.resource.php?resourceID=002481.

back in November 2012).[207] The momentum is building, and the trajectory is unmistakably toward some form of legalization in most states. The structure and fate of these future initiatives and pending propositions depend in large part on the outcomes and successes in Colorado and Washington in the course of the next few years, as well as on the response of the federal government. For now, this transitory period is marked by a dependence on federal discretion, and the necessity to allocate limited investigative and prosecutorial resources. The future of this current policy of restraint, however, remains uncertain, as any shift in executive power after 2016 could unravel any progress made on legalization.

VI. "CANNABUSINESS" AND ITS ETHICAL IMPLICATIONS

Legal marijuana presents numerous business opportunities to those seeking profit in the emergent industry. "This potentially explosive growth in the marijuana business will create large opportunities for investors [and all types of prospectors], but also an exponential increase in the number of people affected by the current web of overlapping and contradictory state and federal regulation[s]."[208] As the industries for both medical and recreational marijuana use expand, more and more people find it increasingly difficult to determine where the line between permissible and impermissible conduct ought to be drawn. The reality of the situation is this: owning and operating licensed dispensaries, legal ventures under state law, are nonetheless subject to felony prosecutions and exist at the mercy of federal discretion.

Professor Sam Kamin posits that Rule 1.2 from the Model Rules of Professional Conduct[209] allows clients much needed access to lawyers in this complex and confusing area of conflicting law.[210] Kamin argues that since the states are choosing to adopt laws contrary to the federal government by implementing regulatory systems to govern the marijuana industry within their borders, "access to law and lawyers becomes a necessary aspect of . . . this policy decision."[211] The current legal climate is in such a state of flux and confusion that this fundamental tenant of our society becomes more important than ever. If state laws create the regulatory scheme, within which clients are permitted to apply for

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207 *See* Art Swift, *For First Time, Americans Favor Legalizing Marijuana*, GALLUP POLITICS (Oct. 22, 2013), http://www.gallup.com/poll/165539/first-time-americans-favor-legalizing-marijuana.aspx.

208 Kamin & Wald, *supra* note 18, at 885-86.

209 MODEL RULES OF PROF'L CONDUCT R. 1.2 (1983).

210 Kamin & Wald, *supra* note 18, at 872.

211 *Id.* at 907.

licenses, negotiate leasing agreements, offer employment contracts, and do all things necessary for a business to legally thrive, "denying [them] the assistance of counsel triggers questions of access to law, lawyers, and legal services."[212]

With the newly emerging marijuana business complicated by the fact that production, sale, possession, and use of the drug remains a federal crime, lawyers are forced to navigate an ethical labyrinth fraught with uncertainty as they counsel and assist their clientele. "Because all lawyers have an obligation not to knowingly assist criminal conduct"[213] pursuant to Rule 1.2, taking on marijuana-related business clients exposes them to ethical, criminal, and disciplinary consequences. In the realm of criminal law, Kamin looks to accomplice and coconspirator liability doctrines as guides in the first step of his analysis, and he draws a critical distinction between mere *knowledge* and requisite *intent* when providing legal services to these marijuana clients.[214] Rule 1.2(d) of the Model Rules is then closely examined, along with its conflicting interpretations and Kamin's proposed reading of it. With the ever-present threat of federal prosecution held at bay by only prosecutorial discretion and restraint, lawyers must tread carefully when representing clients in this newly budding business.

According to Kamin, in order for a lawyer to be criminally liable for providing legal services to marijuana clients under either an accomplice or coconspirator theory of liability, the lawyer must possess the requisite intent, or mental state.[215] An effective way of understanding this difficult concept is to try and determine whether the lawyer intentionally associates himself with a criminal venture or participates in such a way that his actions demonstrate a desire to make it succeed.[216] In expounding on the distinction between a knowledge requirement and an intent standard, Kamin makes a relatively faulty analogy that he later admits is improper, but nonetheless helps to establish his idea. He equates a lawyer with a merchant, and notes that "a merchant is not liable for failing to take steps to keep her lawful goods or services from being misused"[217] by clients. This analogy later unravels because the attorney-client relationship is unique and incomparable to the relationship between a merchant and a customer.

An attorney-client relationship more often than not requires the exchange of confidential communications and the disclosure of

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212 *Id.* at 920.
213 *Id.* at 871.
214 *Id.*
215 *See id.* at 886-92.
216 *See id.* at 898.
217 *Id.* at 889.

information in order to advance the interests and objectives of the client, whereas a merchant-customer relationship does not, being more impersonal in nature. Kamin remarks that "it is intuitive to argue that the case for punishing knowing facilitation of a crime is stronger vis-à-vis lawyers than it is with regard to other merchants."[218] Yet, because the exchange of information and knowledge is more important in the attorney-client relationship, and because lawyers provide an often constitutionally based societal good,[219] punishing them based on a mere knowledge basis severely undermines their purpose and effectiveness. Thus "a mens rea of true intent is an important protection against prosecutorial overreaching in the event of prosecution of marijuana lawyers"[220] as either accomplices or coconspirators to violations of federal law. Although such prosecutions are rare, lawyers are still subject to criminal liability, but are more likely to face some form of professional discipline.[221]

Legal rights exist to protect an individual's autonomy, essential to human dignity. "Access to law and lawyers in a highly regulated society is fundamental to the informed exercise of autonomy by clients."[222] Providing effective representation presupposes the ability to counsel and assist clients with their legal needs, even those with marijuana-related legal quandaries. Rule 1.2 outlines the scope of such representation, and paragraph (d) states that

> [a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with the client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of law.[223]

Federal law makes the production, sale, and possession of marijuana a federal crime.[224] If a client is looking to gain a foothold in the marijuana business by operating a dispensary, he is in violation of federal law. A lawyer called upon to counsel and assist the client in such conduct would seemingly have actual knowledge of his client's criminal activity, thus violating Rule 1.2(d), which prohibits the lawyer from participating in

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218 *Id.* at 896.
219 *See id.*
220 *Id.* at 897.
221 *See id.* at 890.
222 *Id.* at 907.
223 MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (1983).
224 *See* Controlled Substances Act, 21 U.S.C. § 903 (2012).

the commission of crime, regardless of whether the state permits such conduct.[225] Kamin suggests that this plain reading of the Rule with a traditional interpretation is impractical, for such a mechanical approach precludes a lawyer "from drafting documents, representing the client, negotiating on her behalf, or offering any kind of [meaningful] legal services"[226] related to the marijuana business, effectively denying the client access to the law. Whether such a plain reading can be dismissed so easily may well depend on the evolution of both law and societal ethos as it relates to marijuana use and its perceived economic benefits.

Indeed, the argument has been made that counseling clients on how to avoid federal prosecution for marijuana-related offenses using state laws as a shield contravenes the purpose of Rule 1.2.[227] Many believe that the legal advice given should not go beyond explaining legal consequences for certain conduct, and determining the "validity, scope, meaning, or application of the law."[228] In 2010, the Maine Ethics Commission released an opinion regarding the ethical dilemma lawyers might face aiding medical marijuana clients.[229] The Commission proponed a cautionary approach, warning lawyers that "participation in this endeavor . . . involves a significant degree of risk which needs to be carefully evaluated,"[230] and a determination must be made as to "whether the particular legal service being requested rises to the level of assistance in violating federal law."[231] If so, such conduct may represent an ethical breach. On the other hand, the Arizona Bar Ethics Committee released a similar opinion the following year, but came to a vastly different conclusion.[232] The Arizona Committee declined

> to interpret and apply [Rule 1.2] in a manner that would prevent a lawyer who concludes that the client's proposed conduct is in "clear and unambiguous compliance" with state law from assisting the client in connection with activities expressly authorized under state law, thereby depriving clients of the very legal advice and assistance that is needed to engage in the

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225 *See* Kamin & Wald, *supra* note 18, at 903.
226 *Id.* at 902.
227 *See* A. Claire Frezza, *Counseling Clients on Medical Marijuana: Ethics Caught in Smoke*, 25 GEO. J. LEGAL ETHICS 537, 552 (2012).
228 *Id.* (quoting MODEL RULES OF PROF'L CONDUCT R. 1.2(d)).
229 Maine Prof'l Ethics Comm'n, Op. 199 (2010), *available at* http://www.mebaroverseers.org/attorney_services/opinion.html?id=110134.
230 *Id*.
231 *Id*.
232 *See* State Bar of Arizona, Formal Op. 11-01 (2011), *available at* http://www.azbar.org/Ethics/EthicsOpinions/ViewEthicsOpinion?id=710.

> conduct that the state law expressly permits. The maintenance of an independent legal profession, and of its right to advocate for the interests of clients, is a bulwark of our system of government.[233]

The contradiction between these two opinions at first glance seems insurmountable. Maine stresses extreme caution in response to federal prohibition, while Arizona seeks to carve out an area for lawyers to ethically represent marijuana clients within the context of state law. This dichotomy exemplifies the difficulties attorneys have to face, as distinct state landscapes lead to divergent interpretations of the ramifications federal law has on the sphere of legal ethics. In order to bridge the gap between these two conflicting opinions, Kamin relies on his criminal law distinction approach, discussed earlier, between mere knowledge and true intent, which he believes will provide some level of stability for lawyers bemused by the ethical challenges.[234]

Kamin's use of true intent, however, takes on an amorphous quality as he lays out distinctions in an attempt to define its scope and function. The distinctions he makes between different criminal acts, state and federal venues, criminal courts and professional disciplinary hearings, all tend to make "intent" within a particular setting murky at best. Lawyers require some level of certainty to effectively represent their clients, especially in the business world. However, with the fluid status of the state-federal tension, lawyers may just have to cope with speculative analysis and some ambiguities for the time being. Kamin's ingenious analysis attempts to forge clarity, and succeeds to the extent possible in coming to grips with this complex ethical quandary. One distinction Kamin emphasizes is when dealing with *mala in se* crimes, such as murder, rape, robbery, and assault, as opposed to *mala prohibitia* crimes—deemed crimes merely because they are prohibited (for example, violations of the Controlled Substances Act).[235] In relation to *mala in se* crimes, Kamin believes that a mere knowledge requirement on the part of lawyers may be more justified to hold them liable for certain conduct.[236] On the other hand, *mala prohibita* crimes do not warrant such limited access and "strong policy reasons support the reading of an intent requirement into Rule 1.2(d)."[237] Production, possession, use, and sale of marijuana would fall under the category of *mala prohibita* crimes, thus Kamin argues "that an intent to facilitate such behavior is necessary in

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233 *Id.*
234 Kamin & Wald, *supra* note 18, at 905-06.
235 *Id*. at 907-08.
236 *Id.* at 908.
237 *Id.*

order for an attorney to be deemed to have engaged in unethical or criminal conduct."[238]

Whether a lawyer always forms an intent, in the legal sense, to help their clients is a critical question.[239] Rule 1.2(b) reminds us that "a lawyer's representation of a client . . . does not constitute an endorsement of the client's political, economic, social, or moral views or *activities*."[240] Yet, one could argue that the ability to effectively represent a client depends upon an understanding of that client's activities, which could form the requisite intent and trigger a violation of Rule 1.2(d). Throughout this ongoing process of change, however, more questions are raised than answers provided, but according to Kamin, so long as a lawyer provides the same services and issues the same charges to marijuana clients that she does to the rest of her business clientele,[241] and does not form the requisite intent read into Rule 1.2(d),[242] then that lawyer acts ethically and is permitted to provide competent legal representation and assistance. This type of definite fixing of ethical clarity is the main driving force behind Kamin's exhaustive Article.

VII. TAXATION ISSUES AND THE ROLE OF THE FIFTH AMENDMENT

Apart from possible ethical concerns, some federal laws, particularly in the area of taxation, pose other challenges to lawyers and create significant obstacles to the success of these marijuana industries. As noted by several of the speakers in the September 10th, 2013, Senate Judicial Committee hearing, Section 280E of the Internal Revenue Code prohibits a taxpayer from claiming a federal income tax deduction for a "business considered to be trafficking substances under the Controlled Substances Act . . . .Section 280E effectively bars legal marijuana businesses operating in Colorado [and other states] from claiming the types of business expense deductions that other legal businesses can claim."[243] In response, Colorado has enacted legislation that gives both medical and recreational marijuana enterprises the ability to deduct business expenses from their state income tax returns, even though Section 280E bars such action at the federal level.[244] Advocates in Colorado are joined by others from several states in urging Congress to

238 *Id.* at 909.
239 *Id.* at 911.
240 MODEL RULES OF PROF'L CONDUCT R. 1.2(b) (1983) (emphasis added).
241 *See* Kamin & Wald, *supra* note 18, at 920.
242 *See id.* at 921.
243 Statement of Finlaw, *supra* note 114, at 4.
244 *See id.* (referencing H.B. 13-1042, Reg. Sess. (Colo. 2013)).

revise the federal tax code, so that it would allow for marijuana businesses to claim such deductions.[245]

There have also been novel interpretations of current federal tax law that attempt to avoid the impact of Section 280E. One recent Article proposes a resolution to the problem by recasting the marijuana industry in the guise of community based "economic development corporations" that promote social welfare.[246] This would enable these businesses to qualify for tax-exempt status under § 501(c)(4) of the federal tax code.[247] According to the author, some of the federalism concerns would be resolved, specifically in the area of tax law.[248] Under his scheme, federal taxation issues would yield to a genuinely new vision of the emerging marijuana industry. This Comment believes, however, given the economic realities and expectations inherent in the growing legal marijuana market, that this reconfiguring of the new industry probably dissipates in the face of the capitalist imperative to generate revenue and maximize profits. The current tax issue, coupled with the unwillingness of banks and credit card companies to back the marijuana industry, has made it exceedingly difficult for these businesses to function and succeed.

Sophisticated and unsophisticated clients alike may struggle to comprehend the conflicting and complex marijuana regimes of both the state and federal government, turning to lawyers for sound advice and clear guidance.[249] The taxation problem not only deprives marijuana businesses from enjoying the deductions that other legitimate businesses enjoy, but filing federal income taxes potentially invites the federal government to exercise its discretion and enforce federal drug policy. In this context, the Fifth Amendment's right against self-incrimination is implicated. The relevant language states that "no person . . . shall be compelled in any criminal case to be a witness against himself."[250] When filing a federal tax return, how should a marijuana business describe their business activity, or indicate what kind of product or service they provide? Pursuant to the Internal Revenue Code, returns or return

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245 *See id.* at 8.

246 Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523, 537-43 (2014).

247 *See id*.

248 *See id*. at 568.

249 *See* Wei-Chih Chiang, Yong-Gyo Lee & Jianjin Du, *Judicial Guidance on Medical Marijuana Tax Issues*, 92 PRACTXST 266 (2014) (concluding that under the current interpretation of Section 280E, medical marijuana businesses cannot deduct business expenses on their federal tax returns, but they could potentially deduct costs of goods sold to derive gross income, regardless of Section 280E).

250 U.S. CONST. amend. V.

information may be disclosed for use in criminal investigations.[251] With Colorado and Washington dispensaries now manufacturing and selling recreational marijuana, is it only a matter of time before the federal government kicks down their doors, armed with tax records indicating conduct in violation of the Controlled Substances Act? The likely answer is no.

As a general proposition, "Fifth Amendment jurisprudence does not allow the privilege against self-incrimination to be invoked in order to avoid generally applicable reporting requirements that do not target inherently suspect activities."[252] Many federal and state statutes require individuals to submit documents containing information that may prove self-incriminating, but this does not make them unconstitutional *per se*. Generally as a threshold issue, the Fifth Amendment privilege only comes into play if there is a real and substantial threat of prosecution and risk of self-incrimination.[253] The production and sale of marijuana for any purpose, medicinal or recreational, constitutes a federal crime. Although the Department of Justice's August 29, 2013, memorandum instructs federal prosecutors throughout the country to exercise their prosecutorial discretion and direct their use of limited resources to address the most significant threats, the memorandum is careful to reserve the federal government's right to enforce federal law, even in the absence of any one of the listed enforcement priorities.[254] Under the Controlled Substances Act, marijuana dispensaries face a real and appreciable risk of prosecution subject only to federal discretion and restraint.[255] Thus it appears that the "merits of a Fifth Amendment defense to the tax filing requirement"[256] warrants closer examination.

In a pithy opinion published in 1927, the Supreme Court in *United States v. Sullivan* upheld a conviction when a defendant failed to file an income tax return.[257] The Court noted that "[i]t would be an extreme if not extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime."[258] A few years later in *Garner v. United States*, the Court refused to find that the use of a tax statement violated

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251 I.R.C. § 6103(i)(1)(A)(i-iii) (2006).

252 Memorandum from State of Ariz., Office of the Att'y Gen. on Transaction Privilege Tax Upon Med. Marijuana Sales to the Ariz. State S. 7 (July 7, 2011), *available at* https://www.azag.gov/sites/default/files/I11-004.pdf [hereinafter Ariz. Memo].

253 *See id.* at 5.

254 *See* Cole Memo 2013, *supra* note 82, at 4.

255 *See infra* p. 14.

256 Ariz. Memo, *supra* note 252, at 7.

257 United States v. Sullivan, 274 U.S. 259 (1927).

258 *Id.* at 263-64.

defendant's Fifth Amendment privilege.[259] Courts since have analyzed the issue with the presumption that a "statutory reporting requirement is essential to a public, regulatory scheme, rather than designed to obtain private information or evidence of criminal activity."[260] Thus, a company answering a generally innocent question on a tax return form, such as indicating what product or service the business provides, cannot be said to have been *compelled* within the meaning of the Fifth Amendment.[261]

A federal income tax return may pose a real and appreciable risk of self-incrimination, but it is not designed to compel the disclosure of *testimonial* information that would bring it within the purview of the Fifth Amendment. The information generally disclosed in the filing of such a tax statement is essentially considered a "noncriminal and regulatory area of inquiry."[262] Marijuana dispensaries are basically considered to be retail stores engaged in the activity of "selling tangible personal property at retail . . . [and] can hardly be characterized as a selective group inherently suspect of criminal activities."[263]

The case of *California v. Byers* delivers an enlightening summary that provides some clarity on the taxation issue and the role of the Fifth Amendment:

> An organized society imposes many burdens on its constituents. It commands the filing of tax returns for income; it requires producers and distributors of consumer goods to file informational reports on the manufacturing process and the content of products, on the wages, hours, and working conditions of employees. Those who borrow money on the public market or issue securities for sale to the public must file various information reports; industries must report periodically the volume and content of pollutants discharged into our waters and atmosphere . . . .
>
> In each of these situations there is some possibility of prosecution—often a very real one—for criminal offenses disclosed by or deriving from the information that the law compels a person to supply . . . .But under our holdings the mere possibility of incrimination is

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259 *See* Garner v. United States, 424 U.S. 648 (1976).

260 CHARLES H. WHITEBREAD & CHRISTOPHER SLOBOGIN, CRIMINAL PROCEDURE: AN ANALYSIS OF CASES AND CONCEPTS 403-4 (2008).

261 *See id.* at 401.

262 California v. Byers, 402 U.S. 424, 430 (1971) (internal citations omitted).

263 Ariz. Memo, *supra* note 252, at 9 (internal quotation marks omitted).

> insufficient to defeat the strong policies in favor of disclosure called for by [federal] statutes.[264]

Following the majority, Justice Harlan's concurring opinion in *Byers* articulates this policy approach.[265] In balancing the state's interests against those of the individual, Harlan contends that the "assertedly non-criminal governmental purpose in securing information, the necessity for self-reporting as a means of securing the information, and the nature of the disclosure required"[266] effectively estops a defendant from raising a valid Fifth Amendment defense "to a generally applicable requirement to report sales revenues and remit sales tax."[267] Whether Harlan's reasoning waters down constitutional guarantees is open for debate. Regardless, the key consideration to address in this potentially problematic area is whether the taxation scheme (in this case the federal income tax return) "is designed to facilitate the government's legitimate needs for regulatory information rather than undercut the adversary system by covertly aiding the investigation and prosecution of crime."[268] Thus far, the former inference has prevailed; but with much change on the marijuana legalization horizon, it is difficult to determine what the future might hold. Will this seemingly well-settled area of law remain resolute, or will legalized marijuana force it to evolve and adapt as this movement gains momentum?

VIII. FUTURE MUSINGS

There has been an undeniable shift in the United States regarding marijuana legalization. The topic has fluttered in and out of national conversation and debate for almost a century, and according to recent opinion polls, public perceptions about the drug have come a long way. History has shown time and time again that progress is a powerful and ultimately inevitable force. Prohibition has been a "blunt" tool before, and was shown to be ineffective. Nationwide prohibition of alcohol began in 1920 with the ratification of the Eighteenth Amendment.[269] Despite prohibitionist efforts, alcohol consumption continued to rise in several areas of the country, and organized crime increased in an effort to produce and distribute the highly demanded product. A "disconnect

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264 *Byers*, 402 U.S. at 427-28.
265 *Byers*, 402 U.S. at 434-58 (Harlan, J., concurring).
266 *Id*. at 454.
267 WHITEBREAD & SLOBOGIN, *supra* note 259, at 405.
268 *Id.* at 406.
269 *See* U.S. CONST. amend. XVIII.

between strong official condemnation and widespread popular acceptance led to the failure of Prohibition,"[270] and the Twenty-First Amendment was passed, repealing the ban on alcohol.[271] Scholars, however, point to an inherent difference between alcohol and marijuana, noting that history, custom, and practicality played a vital role because "centuries of tradition and decades of marketing . . . left alcohol use a deeply ingrained feature" of our societal psyche.[272] Marijuana, on the other hand, is not as equally entrenched . . . at least, not yet.[273]

With so much ongoing change, and more guaranteed to come, many people speculate on what the future holds. Marijuana advocates are constantly trying to decriminalize marijuana at both the state and federal level and ignite reform. Legislative bills like the Ending Federal Marijuana Prohibition Act[274] and the Respect State Marijuana Laws Act[275] have been presented to Congress as part of the decriminalization effort.

On July 28, 2014, the Charlotte's Web Medical Hemp Act was introduced in the House of Representatives.[276] This bipartisan bill seeks to amend the Controlled Substances Act by excluding "therapeutic hemp" and "cannabidiol" from the definition of marijuana.[277] Furthermore, a bipartisan coalition of House members voted on an appropriations amendment that seeks to restrict the DEA from utilizing funds "to prevent such States from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana."[278] Advocate groups have also attempted to reschedule marijuana by navigating the alternative route of judicial review. In October 2002, Americans for Safe Access, the Coalition to Reschedule Cannabis, and Patients Out of Time petitioned the DEA to reschedule marijuana as a Schedule III, IV, or V drug. Nine years later, in July 2011, the DEA denied the petition. The petitioners subsequently filed for a timely review of the DEA's action. Unfortunately in January 2013, the United States Court of Appeals in the District of Colombia Circuit struck down the petition to reschedule the drug in *Ams. for Safe Access v. Drug*

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[270] Sam Kamin, *Medical Marijuana in Colorado and the Future of Marijuana Regulation in the United States*, 43 MCGEORGE L. REV. 147, 166 (2012).

[271] *See* U.S. CONST. amend. XXI.

[272] CAULKINS ET AL., *supra* note 1, at 136.

[273] *See id.*

[274] Ending Federal Marijuana Prohibition Act of 2013, H.R. 499, 113th Cong. (2013).

[275] Respect State Marijuana Laws Act of 2013, H.R. 1523, 113th Cong. (2013).

[276] Charlotte's Web Medical Hemp Act of 2014, H.R. 5226, 113th Cong. (2014).

[277] *See id*.

[278] The Commerce, Justice, Science, and Related Agencies Appropriations Act of 2015, H.R. 4660, 113th Cong. (as amended by House, May, 30, 2014).

Enforcement Admin.[279] The Court held that there was substantial evidence supporting the DEA's findings that no adequate and well-controlled studies have established any currently accepted medical uses for marijuana.[280] A future determination as to the federal-state law conflict issue could clear the air of uncertainty surrounding many topics of concern.

With "any potential conflict between state and federal authority, . . . lawyers have a critical role to perform in the activities that will lead to the proper resolution of the controversy."[281] The legal profession is comprised of individuals endlessly "pursing a learned art as a common calling in the spirit of public service."[282] This "calling" encourages lawyers to represent their clients without fear and to the fullest extent possible, although it is necessarily bound by ethical and legal constraints, which may sometimes dictate a cautionary approach.

Significant obstacles still lie ahead for the marijuana legalization movement,[283] and lawyers will continue to work on resolving such issues. Present and future state implementation and regulation efforts remain hindered by current uncertainty connected with the fluid state of federal banking regulations. If forced to be cash-only enterprises, marijuana dispensaries will continue to be targets for criminal activity. Banks and credit companies may still be hesitant to do business with marijuana industries while federal enforcement remains unpredictable in the absence of new congressional legislation. On top of such frustration, these businesses cannot claim the tax deductions that other legitimate businesses enjoy. Now although the invocation of the Fifth Amendment in regard to federal tax returns has been considered generally ineffective, in the context of the rising recreational marijuana industry, the Amendment poignantly highlights a growing constitutional uneasiness that must soon be addressed.

Marijuana use will continue to increase—whether for medical or recreational purposes—and the confusion and conflict over the current legalization movement will eventually prompt federal action because "when it comes to the overlapping regulation of marijuana in the United

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279 *See* Ams. for Safe Access v. DEA, 706 F.3d 438 (D.C. Cir. 2013).

280 *Id*. at 452.

281 State Bar of Arizona, Formal Op. 11-01 (2011), *available at* http://www.azbar.org /Ethics/EthicsOpinions/ViewEthicsOpinion?id=710.

282 *Id.* at 910 (quoting ROSCOE POUND, THE LAWYER FROM ANTIQUITY TO MODERN TIMES 5 (1953)).

283 *See infra* pp. 20-23.

States, the status quo is clearly untenable."[284] The federal government may elect to respond in a manner of different ways.[285] It could attempt to

> (1) sue to invalidate the state laws under the Supremacy Clause and to enjoin state authorities from issuing licenses to marijuana growers and sellers; (2) use injunctions, threats of asset forfeiture, or criminal prosecution to shut down state-licensed marijuana businesses; (3) unilaterally establish a set of enforcement priorities to de-emphasize attacks on state-legal businesses; or (4) enter into cooperative enforcement agreements with the states that could implicitly allow state-regulated systems to function, though without making them legal under federal law.[286]

Under the Supreme Court's federalism jurisprudence however, "the federal government is prohibited from commandeering the state legislatures or state executive officials by mandating that states enact certain legislation or implement or enforce a federal law."[287] The preemptive language in the Controlled Substances Act limits Congress' power to compel the states to enforce its provisions, and gives leeway to the states to pass marijuana-related legislation so long as a "positive conflict" is not created. Thus far, states have taken advantage of this, steadily increasing their control over the production, possession, sale, and use of marijuana within their borders. Now, the federal government most likely cannot direct the states to completely prohibit marijuana or repeal their existing exemptions and regulations, but they may be able to elicit support for federal policy among the states by directing monetary incentives in the form of federal funds in return for cooperation to further a federal interest (for example, state legislation consistent with the Controlled Substances Act.[288] As far as option (2) is concerned (see above), limited investigative and prosecutorial resources already hamper

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[284] Kamin, *supra* note 270, at 165.

[285] *See generally* Counts, *supra* note 169, at 209 (providing some general recommendations and possible responses of the federal government if it wishes to continue pursuing policies underlying the Controlled Substances Act, or if it wishes to reconsider these policies in light of changing public opinion on marijuana).

[286] John Walsh, *supra* note 164, at 5.

[287] *See* New York v. United States, 505 U.S. 144, 188 (1992) ("The Federal Government may not compel the States to enact or administer a federal regulatory program."); *see also* Printz v. United States, 521 U.S. 898, 925 (1997) ("[T]he Federal Government may not compel the States to implement, by legislation or executive action, federal regulatory programs.").

[288] *See* South Dakota v. Dole, 483 U.S. 203, 203 (1987) ("Incident to the spending power, Congress may attach conditions on the receipt of federal funds.").

drug enforcement, and have already led to options (3) and (4) taking effect. The August 29, 2013, DOJ memorandum established a set of enforcement priorities to guide federal prosecutors across the country in the allocation of their resources. The memorandum also developed the expectation that state and local governments will enact and enforce strong and effective regulatory systems that promote the enumerated federal interests.[289] This reliance is an important step in the development of cooperative enforcement efforts.

Such an alliance could yield several potential advantages. Federal, state, and local governments can lend a hand in shaping the marijuana industry and benefit from its success; such a joint effort and pooling of resources could focus enforcement on more significant concerns. If marijuana was to be declassified as a Schedule I drug, and the federal government implemented regulatory and taxation systems similar to those in place for alcohol and tobacco, the resulting revenue could help reduce the national debt, allow for reallocation of law enforcement resources, and fund education and medical studies.[290] This new kind of regulatory framework, bound by principles of common sense and clear priorities, could enhance individual freedom, while at the same time, further the important goal of public safety. Lawyers will play an important part in formulating and implementing such a legalization regime, which will encompass both law enforcement and the regulation of the new marijuana industry. Such a movement will certainly pose practical obstacles and ethical dilemmas for legal practitioners, made more difficult by having to adapt to the fluid state of the law. Serious thought should be given to these issues now before the increasing momentum for legalization forces haphazard responses and empty rhetorical flourishes. Whatever the case may be, the prospect of some federal action seems inevitable.

IX. CONCLUSION

The social, political, and economic implications of this pro-marijuana movement are difficult to anticipate. How might legalization affect past, present, and future drug violations, incarceration rates, allocation of state and federal resources, and use and dependence among society? Answers remain unclear, for even the wisest cannot foresee all ends. The efforts of Colorado and Washington will be like the falling of small stones that start an avalanche of change. Something has begun. Amendment 64 and Initiative 502 have come to embody an expression of

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289 *See* Cole Memo 2013, *supra* note 82, at 2.
290 *See* THE PATH FORWARD, *supra* note 31, at 14.

state sovereignty, a manifestation of individual liberty, and an opportunity to be a part of a potentially multi-billion dollar “green rush.” Have these steps toward legalization been part of a smarter, more common-sense approach? Or will Kevin Sabet’s cautionary closing declaration come to fruition—”would we open the floodgates, hope for the best, and try with limited resources to patch everything up when things go wrong?”[291] Only time will tell.

[291] Statement of Sabet, *supra* note 98, at 11.

Mandating the Supersize Option: The Legality of Government Intervention in the Fast Food Industry to Address Insufficient Wages and Close the Public Assistance Gap

Joshua A. Berman*

Several prominent studies have recently highlighted how the federal government tacitly subsidizes insufficient wages paid in certain industries–notably, major corporations within the fast-food sector. Historically, the government addressed insufficient wages by implementing a minimum standard-of-living wage. Since the New Deal inception of this remedy, the Judiciary has regularly upheld the minimum wage in the face of challenges to its constitutionality. Given the recent passage of a substantial increase in the minimum wage and the toxic political cloud hovering over the United States Congress, President Obama likely will have a difficult time in passing another increase, as he has promised since his first campaign. Even if passed, the constitutionality of such a hike will likely face a more rigorous test by a conservative Supreme Court that features five Justices appointed by Republican Presidents. This Comment seeks to understand the kind of test that the Court might use, and to analyze the constitutionality of a wage increase through the lens of potential tests.

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INTRODUCTION

Suppose that Liam, an unmarried 29-year-old employee at McDonald's, earns the minimum wage while working a traditional forty-hour week. The $15,080 annual pay[1] he receives would represent a figure roughly twenty-six percent higher than the federally established poverty threshold,[2] which is a dollar amount that somewhat reflect a family's

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[1] The total, $15,080, is borne by calculating $7.25 per hour times forty hours per week times fifty-two weeks per year. This figure reflects the full enactment of the Fair Minimum Wage Act of 2007, a supplemental appropriations bill that raised the minimum wage established by the Fair Labor Standards Act of 1938 from $5.25 per hour. Fair Minimum Wage Act, 29 U.S.C. § 206 (2007).

[2] The poverty threshold in 2012 was $11,945 for a one-person household. The calculation is wages earned less poverty line, quantity divided by the poverty line. CARMEN DENAVAS-WALT ET AL., U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2012, 51 (Sept. 2013). The U.S. government measures poverty with two different standards, poverty thresholds and poverty guidelines. Poverty thresholds were first published by the Social Security Administration in January 1965 and are updated annually by the Census Bureau for statistical purposes. Poverty guidelines are issued annually by the Department of Health

most basic needs to determine poverty status.[3] Liam, cast in a different light, would be counted among the three-quarters of Americans who live paycheck-to-paycheck.[4] Modify the hypothetical such that Liam is instead the sole earner for a family of four, and Liam's income is only sixty-five percent of the federal poverty guideline.[5]

Liam's choice of theoretical plights represents the unfortunate realities facing many Americans today. In the United States, more than forty-five million individuals live below the poverty line,[6] and "[f]ewer than one in four Americans have enough money in their savings account to cover at least six months of expenses, enough to help cushion the blow of a job loss, medical emergency or some other unexpected event."[7]

The federal government provides a buffer by way of welfare for most of these individuals against their falling into abject poverty. In 2012, the federal government was projected to combat poverty by spending $668 billion on at least 126 different programs,[8] including food stamps and Medicaid.[9] State and local governments were projected to supplement federal welfare spending with an additional $284 billion, totaling government spending at all levels at roughly $952 billion.[10] As of Labor Day 2013, "welfare currently pays more than a minimum-wage job in 35

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and Human Services in the Federal Register and are used for administrative purposes. Report from Gordon M. Fisher, United States Census Bureau, titled *The Development of the Orshansky Poverty Thresholds and Their Subsequent History as the U.S. Poverty Measure* (last revised September 1997) (on file with the United States Census Bureau, 202-690-6143). This Comment will take both definitions into account, but will mostly rely on poverty guidelines in its discussion of welfare benefits.

3 U.S. CENSUS BUREAU, How the Census Bureau Measures Poverty, http://www.census.gov/hhes/www/poverty/about/overview/measure.html (last visited Oct. 14, 2014); *see also* Danielle Kurtzleben, *50 Years Later, a War Over the Poverty Rate*, U.S. NEWS (Jan. 6, 2014, 3:16 PM), http://www.usnews.com/news/articles/2014/01/06/50-years-later-a-war-over-the-poverty-rate.

4 Angela Johnson, *76% of Americans Are Living Paycheck-to-Paycheck*, CNN (June 24, 2013, 2:53 PM), http://money.cnn.com/2013/06/24/pf/emergency-savings/ (citing BANKRATE, June 2013 Financial Security Index Charts, http://www.bankrate.com/finance/consumer-index/financial-security-charts-0613.aspx (last visited Oct. 14, 2014).

5 CTR. FOR POVERTY RESEARCH, *What Are the Annual Earnings for a Full-Time Minimum Wage Earner?*, U.C. DAVIS, http://poverty.ucdavis.edu/faq/what-are-annual-earnings-full-time-minimum-wage-worker (last visited Sept. 28, 2014).

6 DENAVAS-WALT, *supra* note 2, at 12.

7 Johnson, *supra* note 4.

8 Michael Tanner, The American Welfare State: How We Spend Nearly $1 Trillion a Year Fighting Poverty—And Fail, CATO INST., Policy Analysis No. 694, 2012, at 1.

9 *Id.* at 2-3.

10 *Id.* at 1.

states, even after accounting for the Earned Income Tax Credit,"[11] "which offers extra subsidies to low-income workers who take work." [12]

Those who do take minimum wage jobs often find themselves scrambling to make ends meet to pay for their homes, meals, healthcare, and other basic expenses.[13] Many times, minimum wage earners generate bills that must be paid, in part, by means-tested government welfare programs.[14] Twenty-five percent of the workforce as a whole, which includes workers in nearly every sector of the economy,[15] receives public assistance.[16]

No industry had a greater share of workers enrolled in public programs than the fast food industry, which counted fifty-two percent of its workers as welfare recipients.[17] The biggest culprit of the industry: McDonald's, whose employees are estimated to receive $1.2 billion annually from the government.[18] According to a data brief issued by the National Employment Law Project, "low wages and lack of benefits at the [ten] largest fast-food companies[19] in the United States cost taxpayers an estimated $3.8 billion each year."[20] Meanwhile, the seven corporations of these ten that are publically traded combined for a profit of $7.44 billion and distributed $7.7 billion in shareholder benefits.[21]

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11 MICHAEL TANNER & CHARLES HUGHES, THE WORK VERSUS WELFARE TRADE-OFF: 2013, CATO INST., 1 (2013).

12 Avik Roy, *On Labor Day 2013, Welfare Pays More Than Minimum-Wage Work in 35 States*, FORBES (Sept. 2, 2013, 11:50 AM), http://www.forbes.com/sites/theapothecary/2013/09/02/on-labor-day-2013-welfare-pays-more-than-minimum-wage-work-in-35-states/.

13 *See generally* Alan Feuer, *Life on $7.25 an Hour*, N.Y. TIMES, Dec. 1, 2013, at MB.1.

14 *See generally* Tanner, *supra* note 8.

15 SYLVIA ALLEGRETTO ET AL., FAST FOOD, POVERTY WAGES: THE PUBLIC COST OF LOW-WAGE JOBS IN THE FAST FOOD INDUSTRY 7 (October 15, 2013). The report includes calculations of workers enrolled in public programs who are employed in the following industries: restaurant and food services; agriculture, forestry, and fisheries; other services; other leisure and hospitality; retail trade; construction; health and social services; transportation and utilities; manufacturing; professional and business services; wholesale trade; mining; educational services; information; financial activities; and public administration.

16 *Id.* at 1.

17 *Id.*

18 NAT'L EMP'T LAW PROJECT, SUPER-SIZING PUBLIC COSTS: HOW LOW WAGES AT TOP FAST-FOOD CHAINS LEAVE TAXPAYERS FOOTING THE BILL 2 (October 2013) (citing ALLEGRETTO, *supra* note 15).

19 The ten largest fast-food companies ranked by size of U.S.-based restaurant workforce are McDonald's, Yum Brands (which includes Pizza Hut, Taco Bell, and KFC), Subway, Burger King, Wendy's, Dunkin' Donuts, Dairy Queen, Little Caesars, Sonic, and Domino's. *Id.*

20 *Id.*

21 *Id.* at 3.

Liam is, both in his imaginary bachelorhood and in his theoretical family life, a strong representation of the majority of fast-food workers in the modern era. The fast food industry, once dominated by acne-pocked teenagers, is now populated by workers with an average age of 29, many of whom attempted college and more than a quarter of whom are parents raising children.[22] Many fast-food workers must work multiple jobs to make ends meet for their families.[23] The president of the International Franchise Association asserted that the fast-food industry's wages, like all minimum wages, were "never meant to be a living wage,"[24] and our imaginary friend Liam would most certainly agree. With traditionally limited occupational mobility and low median wages, the fast food industry's likelihood of identifying and correcting the public assistance gap is small.[25]

This Comment contends that the duty to protect an individual's basic standard of living and prudently invest taxpayers' dollars falls squarely on the shoulders of the federal government. Recent data strongly indicates that many companies—specifically those in the fast-food industry—are functionally using federal money as a subsidy to supplement workers' insufficient wages. Such a knowing reliance on taxpayers to augment industry wages is, at a minimum, questionable behavior. This Comment argues that such behavior constitutes a negative externality tacitly–and wrongfully–paid by a Congress that turns a blind eye towards the practice. Accordingly, Congress ought to pass new legislation that adjusts the industry's minimum-wage floor upwards to better reflect a calibrated poverty threshold and account for business externalities in the form of public assistance to minimum-wage earners.

This Comment proceeds as follows. Part I revisits the original legal justifications for a minimum wage and updates those rationales to apply to the modern-day workforce. Part II examines the efficacy of the current minimum wage in light of both the poverty threshold and poverty guidelines, with particular attention given to the fast-food industry. Part III analyzes the possible legal implications of a company's cognizant reliance on taxpayers to bridge the gap between earned wages and the basic threshold for living expenses. Part IV discusses possible remedies. Part V concludes by arguing that the federal government has a duty to regulate the cost of the public assistance gap so as to more prudently appropriate taxpayer dollars.

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22 Feuer, *supra* note 13, at MB.1.

23 *See generally id.*

24 Feuer, *supra* note 13, at MB.1.

25 *See generally* NAT'L EMP'T LAW PROJECT, GOING NOWHERE FAST: LIMITED OCCUPATIONAL MOBILITY IN THE FAST FOOD INDUSTRY (2013).

II. JUSTIFYING THE MINIMUM WAGE IN THE TWENTY-FIRST CENTURY

The federal minimum wage was signed into law during the New Deal Era as part of the Fair Labor Standards Act of 1938. Legend has it that "when he felt the time was ripe, [President Roosevelt] asked [Secretary of Labor] Perkins, '[w]hat happened to that nice unconstitutional bill you had tucked away?'"[26] The Act set the minimum hourly wage at twenty-five cents, in addition to banning oppressive child labor and capping the workweek at forty-four hours.[27]

American economists touted the idea of establishing a minimum wage since the early 1900s,[28] while other nations[29] implemented similar standards of compulsory arbitration.[30] The minimum wage was floated as a means to help the factory system better compete "in its struggle against small workshops and home work."[31] However, given that Americans generally assumed that such a measure would prove unconstitutional as a violation of the freedom of contract, economists did not fully engage in discourse revolving the economic validity of a minimum wage.[32]

A. Legal Theories for Establishing a Federal Minimum Wage Policy

One of the early legal theories was that "[t]here is no constitutional objection to the limitation of the freedom of contract, provided that the limitation is not accomplished without due process of law."[33] The theory, advanced by A.N. Holcombe, is predicated on the notion that the

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26 Jonathan Grossman, *Fair Labor Standards Act of 1938: Maximum Struggle for a Minimum Wage*, 101 MONTHLY LAB. REV., June 1978, at 22, 24.

27 Fair Labor Standards Act, 29 U.S.C. § 201 (1938); *see also* Victor M. Valarde, *On the Construction of Section 203(O) of the FLSA: Exclusion Without Exemption*, 21 U. Miami Bus. L. Rev. 253, 255 (2013) ("Congress enacted the FLSA in a period of widespread unemployment in order to eliminate labor conditions that were 'detrimental to the maintenance of the minimum standard of living . . . without substantially curtailing employment.").

28 *See generally* H.B. Lees Smith, *Economic Theory and Proposals for a Legal Minimum Wage*, 17 ECON. J. 504, (1907); A.N. Holcombe, *The Legal Minimum Wage in the United States*, 2 AM. ECON. REV. 21, (1912).

29 Holcombe, *supra* note 28, at 21.

30 Smith, *supra* note 28, at 508 ("When every industry in which wages are below a certain minimum is brought within operation of a wages board . . . the minimum wage gradually becomes university. Similarly, a system of compulsory arbitration . . . has the same effect, if the workers in the ill-paid trade appeal for arbitration, and the court in each case fixes the lowest wages at a certain minimum.").

31 *Id.* at 512.

32 *See generally* Holcombe, *supra* note 28, at 21.

33 *Id.* at 27.

limitation must be justified by the "social necessity for the maintenance of the family"[34] and presupposes that the oppressive employment of women and minors threatens that family structure.[35] Holcombe asserts that the limitation may be accomplished through the exercise of the ordinary police power, under which the federal government has the ability to regulate interstate commerce.[36]

Having established that a limitation to the freedom of contract may be constitutional and, further, that the United States government has a mechanism available at its disposal to enact such a control, Holcombe continues by assessing the reasonableness of federal action. So long as the *public perception* is that the federal wage is reasonable—"the American public should be convinced that some action for the protection of the American standard of living is necessary, and that the proposed remedy is appropriate"[37]—there ought to be no difference between the regulation of work hours and of wages.[38]

With the logical framework in place establishing the constitutionality of the laws, Holcombe arrives at what he signals is the proper definition for minimum standard-of-living wage laws, as defined by legislation pending (at the time) in Wisconsin:

> [To protect] the public against the evil results of employment at less than standard-of-living wages . . . [define] the minimum wage as such compensation for labor performed under reasonable conditions as should enable employees to secure for themselves and those who are, or may be, reasonably dependent upon them, the necessary comforts of life.[39]

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34 *Id.* at 27.

35 *Id.* at 26-27. Holcombe notes that the constitutional freedom of contract may be exercised solely by men, which allows the "industrial exploitation" of woman and minors. Minimum wage advocates attempted to secure legislation that would protect those two classes of people, but Holcombe argues that as women have a familial interest against wage exploitation, men do, too, in their joint capacity as heads of the household. As such, Holcombe advances the theory that a minimum standard-of-living wage should be universal in application.

36 *Id.* at 27. This logic would therefore hold that state regulation of wages, while not inherently unconstitutional, might be violative of the Constitution insofar as those regulations apply to persons whose activities are intertwined with interstate commerce.

37 *Id.* at 29.

38 Holcombe, *supra* note 28, at 29. Holcombe refers here to the Illinois Supreme Court's reversal of a previous decision that the regulations of hours of labor of women was unconstitutional to show that "social reformers who can prove their case for the minimum wage may expect equally favorable consideration from the courts." *See also* W.C. Ritchie & Co. et al. v. Wayman et al., 244 Ill. 509 (Ill. 1910).

39 *Id.* at 30-31.

The bill, however, failed to define the phrase "the necessary comforts of life," which had also been used in seven[40] state constitutions without further clarification.

B. Supreme Court Rulings on Minimum Wage Law

Holcombe's argument for the constitutionality of a minimum wage law appeared incorrect, however, in 1923 when the Supreme Court nullified a District of Columbia law establishing a minimum wage for women.[41] Had this case come before the Supreme Court a mere six years earlier, the minimum wage ordinance would very likely have been held constitutional.[42]

By 1936, the Court's composition had yet to shift in favor of minimum wage laws. In *Morehead v. Tipaldo*,[43] the Supreme Court voted 5-4 against a New York-legislated minimum wage law that established a minimum weekly wage for women, on the grounds that the law violated the employer's liberty of contract.[44] The decision was met

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40 *Id.* at 31. Seven states used the phrase "necessary comforts of life" in their state constitutions: Indiana, Minnesota, Montana, Nevada, North Dakota, South Dakota, and Wisconsin. The phrase was generally used "in connection with the grant to their respective legislatures of the power to enact debtors' exemption laws."

41 Adkins v. Children's Hosp., 261 U.S. 525 (1923).

42 Thomas Reed Powell, *The Judiciality of Minimum-Wage Legislation*, 37 HARV. L. REV. 545, 546 (1924). Powell relates the story of a case originating out of Oregon on the matter of minimum wage to demonstrate how:

> The law of constitutional due process . . . upon the composition of the court of last resort at the particular time when the issue comes before it . . . .
>
> The question [on the constitutionality of minimum-wage legislation] first came before the Oregon court in 1914, and in two decisions seven judges declared themselves in favor of the legislation and none was opposed. The Oregon case went to the Supreme Court of the United States, and in 1917 the decree of the state court was sustained by a vote of four to four. Mr. Justice Brandeis, having been of counsel, did not sit. His general outlook on what is called social legislation is so well known that there can be no doubt that, had he not been of counsel, he would have voted in favor of the law. In that event, the consequent five-to-four vote almost certainly would have established the constitutionality of such legislation against subsequent attack in the federal courts. Though conceivably a favorable decision might later have been overruled by a differently composed Supreme Court, the experience is that police issues of this general character are finally settled by such favorable decision.

Id. In the six-year period between the four-four decision in the two Oregon cases and the five-three decision in *Adkins*, four changes in the Supreme Court would take place. *Id*. at 547.

43 Morehead v. New York *ex rel.* Tipaldo, 298 U.S. 587 (1936).

44 *Id.* at 611.

with widespread hostility and labor standards became a central tenet of President Roosevelt's re-election campaign.[45] It was during this time that President Roosevelt famously advocated his court-packing scheme.[46]

Roosevelt's blustering realized its intended impact when Justice Owen Roberts sided with the Court's liberal contingency to uphold minimum wage legislation[47] in *West Coast Hotel Company v. Parrish*.[48] This decision empowered liberals to push for labor legislation that offered further protection for workers.[49] In 1938, that work was realized in the passage of the Fair Labor Standards Act (FLSA).[50] The FLSA was ruled constitutional as a matter of interstate commerce in *U.S. v. Darby Lumber Company*, and with it, the federal minimum wage was upheld.[51]

C. The Economic Components of the Minimum Wage Debate

By the end of World War II, the public was declaring that the "minimum wage provisions of the Fair Labor Standards Act of 1938 have been repealed by inflation" and was advocating a higher wage floor.[52] Dr. George Stigler, the 1982 Nobel Prize for Economics recipient and long-time University of Chicago Economics professor,[53] countered the public's opinion and contended that minimum wage legislation did not diminish poverty.[54] Stigler argued that "unless the minimum wage varies with the amount of employment [in a family], number of earners, non-wage income, family size, and many other factors, it will be an inept device for combatting poverty even for those who succeed in retaining employment."[55] Other economists have corroborated Stigler's theoretical point that "the link between low wages and low family incomes is imperfect."[56]

In contrast, Dr. Arin Dube, Associate Professor of Economics at the University of Massachusetts–Amherst, finds in a recent empirical study that "[t]he totality of evidence from the 12 published studies for which I

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45 Grossman, *supra* note 26, at 23.
46 *Id.* at 23.
47 *Id.* at 23-24.
48 West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937).
49 Grossman, *supra* note 26, at 24.
50 Fair Labor Standards Act, 29 U.S.C. § 202 (1938).
51 United States v. Darby, 312 U.S. 100 (1941).
52 George J. Stigler, *The Economics of Minimum Wage Legislation*, 36 AM. ECON. REV. 358, 358 (1946).
53 *George J. Stigler*, THE CONCISE ENCYCLOPEDIA OF ECON., *available at* http://www.econlib.org/library/Enc/bios/Stigler.html.
54 Stigler, *supra* note 53, at 358.
55 *Id.* at 363.
56 Arindrajit Dube, Minimum Wages and the Distribution of Family Incomes 32 (Dec. 30, 2013) (unpublished manuscript) (on file with author).

could obtain or construct minimum wage elasticities point towards some poverty reduction from minimum wage increases."[57] Dube acknowledges Stigler's findings that there is not a $1-to-$1 relationship of dollars the minimum wage is raised to dollars less in poverty a family finds itself, but he argues that raising the minimum wage is a big part of the equation.[58] If the minimum wage were to increase from $7.25 per hour to $10.10 per hour,[59] families with an income in the bottom ten percent of America would realize an increased income of about twelve percent, which is the annual equivalent of roughly $1,700.[60]

Stigler and Dube are not, however, in contradiction as they might appear facially. Stigler analyzes the minimum wage efficacy in a theoretical vacuum with (relative to today) little available data, concluding that the minimum wage is not an effective means to fight poverty; Dube incorporated twelve other studies on minimum wage into his own, including some that initially concluded against minimum wage, and he found that the minimum wage plays an important role in poverty reduction. Dube agrees with Stigler, however, in that he states "the minimum wage is a blunt tool when it comes to fighting poverty"[61] and prefers "more targeted policies like cash transfers, food stamps, and programs that raise the employment rate for highly disadvantaged groups."[62]

D. Applying the Legal Theory of Minimum Wages to Present-Day

Dube echoes past studies that advance justifications for establishing minimum wages that go beyond poverty reduction.[63] While it is clear that alternate reasons for minimum wage policy—raising the earnings of low and moderate earning families,[64] concerns for fairness of wages,[65] and

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[57] Dube, *supra* note 56, at 30.
[58] *Id.* at 33-34.
[59] Dube's analysis stems from a legislative proposal in the 113th Congress to raise the minimum wage to $10.10 per hour. Minimum Wage Fairness Act, S. 1737, 113th Congress (2013).
[60] *Id.* at 34.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] Dube, *supra* note 56, at 34 (suggesting that "concerns of fairness [should] seek to limit the extent of wage inequality") (citing David A. Green & Kathryn Harrison, *Minimum Wage Setting and Standards of Fairness* (Inst. for Fiscal Stud., Working Paper W10/09, 2010)).

interest in curtailing an employer's market power[66]—do exist, the overarching rationale for such laws is to combat poverty.[67] While the Supreme Court has allowed for the introduction of minimum wage laws, several opponents of a hike argue that such a policy shift would demonstrate an unconstitutional overabundance of government intervention.[68]

Should the Supreme Court rely on historical precedent, however, to determine the constitutionality of a second modern era[69] increase in the minimum wage, it will look to social sciences data to determine whether government intervention would be justified.[70] The question of justification will turn on the basis of whether the government has an appropriate regulatory concern, and not on whether the financial hardship imposed on minimum wage earners provides recourse under the law.[71]

In the period since *Darby Lumber* was decided, which entrenched minimum standard-of-living wage policy as constitutional, the federal

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66 *Id*. at 34 (citing Ernst Fehr & Urs Fischbacher, *Third-party Punishment and Social Norms*, 25 EVOLUTION AND HUMAN BEHAV. 63 (2004); Daniel Kahneman et al., *Fairness as a Constraint on Profit-Seeking: Entitlements in the Market*, 76 AM. ECON. R. 728 (1986)).

67 Stigler, *supra* note 53, at 358.

68 *See generally* Jeff Scully, *Repeal Minimum Wage Laws, Restore Employment*, FREEDOMWORKS (Feb. 6, 2012), http://www.freedomworks.org/blog/jbscully/repeal-minimum-wage-laws-restore-employment ("Government intervention includes . . . simply setting minimum wages for hourly wage earners. All of these policies do the exact opposite of what they are intended to do."); Jonathan Karl, *Alaska's Joe Miller Wants to Abolish Federal Minimum Wage*, ABC NEWS, Oct. 4, 2010, http://abcnews.go.com/Politics/alaskas-joe-miller-abolish-federal-minimum-wage/story?id=11790828&page=1 ("There should not be [a federally-established minimum wage]," Miller answered. "That is not within the scope of the powers that are given to the federal government."); Stephen Dinan, *Raese Won't Hide Conservative Views*, THE WASHINGTON TIMES (Oct. 13, 2010), http://www.washingtontimes.com/news/2010/oct/13/raese-wont-hide-conservative-views/?page=all ("Mr. Raese . . . has taken fire for saying he would abolish the minimum wage. But he has refused to back down, saying it's not only bad policy, but it's not constitutional. 'I don't think it is. And the reason I don't think it is, is the same reason the [National Recovery Administration] was not constitutional in 1936,' [Raese] said. 'It was declared unconstitutional because it was government micromanaging an intervention into the private sector. Well, what are price controls, or what are wage controls? They're the same thing.'")

69 Note that the Fair Minimum Wage Act of 2007 already increased the minimum wage from $5.25 an hour in 2006 to $5.85 an hour in 2007, $6.55 an hour in 2008, and finally, $7.25 an hour in 2009. Fair Minimum Wage Act, 29 U.S.C. § 206(a)(1) (2006).

70 *See generally* ROSEMARY J. ERICKSON & RITA JAMES SIMON, THE USE OF SOCIAL SCIENCE DATA IN SUPREME COURT DECISIONS (1997) (describing the Supreme Court's use of social science research in its decision-making capacity).

71 *See* Maybrick v. SSA, No. 2:13-CV-508, 2013 WL 6571819 at *3 (D. Utah Dec. 13, 2013) (District Court found that a plaintiff did not plead the "deprivation of a federal right" in alleging that "the income he receives is inadequate because it falls below the poverty level and below what a worker could take home earning minimum wage").

government has established a working definition for poverty.[72] This development is of the utmost importance: whereas the Supreme Court approved minimum wage laws to combat gender discrimination in the workplace[73] and affirmed use of the policy in the context of interstate commerce,[74] today's advocates seek to identify the minimum wage as a tool to regulate a compelling government interest, poverty.[75] Without poverty metrics, advocates would have a tough time of gaining Justices' support for a data-driven policy.

III. MEASURING THE EFFICACY OF THE MINIMUM WAGE IN PROVIDING ACCESS TO NECESSITIES

The important question, therefore is whether the data on poverty accurately represents the plight facing many Americans today. This Comment contends that, inherently, a minimum standard-of-living wage ought to be sufficient for a family of three or more with a sole wage earner to exceed any reasonably-calculated[76] poverty metric. As such, the Comment agrees in large part with Stigler's assessment of why fighting poverty is a worthwhile goal:

> We seek to abolish poverty in good part because it leads to undernourishment. In this connection, dietary appraisals show that in any income class, no matter how low, a portion of the families secure adequate diets, and in any income class, as high as the studies go, a portion do not. The proportion of ill-fed, to be sure, declines substantially as income rises, but it does not disappear.[77]

It is on this basis that Mollie Orshansky of the Social Security Administration published the first poverty thresholds in 1965.[78] By calculating

> poverty thresholds for families of three or more by taking the dollar costs of the economy food plan for families of those sizes and multiplying the costs by a

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[72] *See* Fisher, *supra* note 2, at 7.

[73] West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937).

[74] United States v. Darby, 312 U.S. 100 (1941).

[75] *See* Dube, *supra* note 56, at 34.

[76] That is to say, poverty metrics should be calculated regularly to accurately reflect the basic needs of individuals and updated to reflect any inflationary considerations that have arisen since those metrics were first introduced.

[77] Stigler, *supra* note 53, at 365.

[78] Fisher, *supra* note 2, at 6.

> factor of three . . . she [effectively] took a hypothetical average family spending one third of its income on food, and assumed that it had to cut back on its expenditures sharply.[79]

This calculation is roughly identical to that which is used to calculate expenses for purposes of poverty determinations today.

A. The Impact of Poverty Considerations on the Minimum Wage

For that reason, the American poverty threshold is in dire need of a recalibration. Whereas Americans may have spent a third of their budgets on food in 1965, the Gates Foundation estimated that "Americans now spend only [six] percent of their money on food."[80] As a result of the flawed federal poverty calculation, "[t]here's almost a universal acknowledgement that the number we use now doesn't make a whole lot of sense."[81] According to the National Academy of Sciences, which uses experimental measures of poverty, the poverty threshold may be understating the issue by 1.9 percent–excluding 5.9 million impoverished Americans from the statistics.[82]

Poverty guidelines, which are used for administrative purposes in determining the financial eligibility for certain programs, are updated from the weighted average poverty thresholds using the urban consumer price index (CPI-U).[83] As a result, this Comment argues that many Americans, who might otherwise qualify for certain programs of welfare assistance, may currently be wrongfully excluded from such a designation. Adjusting the poverty threshold to include such impoverished Americans would remedy this issue.

The problems facing many Americans hovering around the poverty threshold is compounded by their employment in minimum wage earning jobs. Adjusting for inflation, the minimum wage introduced in 1938 would be worth $4.07 per hour today.[84] Four years after President

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79 *Id.*

80 Kurtzleben, *supra* note 3 (citing BILL GATES, GATES FOUNDATION, Annual Letter 2012 (2012), *available at* http://www.gatesfoundation.org/who-we-are/resources-and-media/annual-letters-list/annual-letter-2012).

81 *Id.* (internal quotation marks omitted).

82 *Id.*

83 42 U.S.C. § 9902 (2013).

84 CPI Inflation Calculator, BUREAU OF LABOR STAT., http://www.bls.gov/data/inflation_calculator.htm (set $ to "0.25"; then select "1938" from the first "in" drop-down menu; then select "2013" from the second "in" drop-down menu; then follow the "Calculate" hyperlink); *see also* Annalyn Kurtz, *A History of the Minimum Wage Since*

Lyndon B. Johnson declared a "War on Poverty,"[85] the adjusted value of minimum wage was $10.56 per hour.[86] Today, minimum wage is $7.25 per hour[87]; "[i]n terms of purchasing power, its value is 30 percent lower today than it was in 1968."[88] As demonstrated through the discussion of poverty metrics, what might have been sufficient in 1938, before the average family's housing and medical costs grew, is simply insufficient today. The aforementioned reduction in the minimum wage's buying power has priced many families back into the dark abyss of poverty.

B. Analyzing Whether Government Intervention is Appropriate

The rationale behind the government intervention necessary to establish a minimum standard-of-living wage is often steeped in poverty considerations and fairness concerns regarding the relative strength of many employers' market power to exploit workers.[89] For these reasons, studies that examine the impact of a rise in minimum wage serve this Comment well in examining whether such a rise would lift an individual out of poverty without proverbially ending modern capitalism.

While campaigning for the presidency in 2008, candidate Barack Obama promised that a central tenet of his agenda would be to raise the minimum wage to $9.50 an hour by 2011[90] and adjust it annually for inflation.[91] Obama addressed the minimum wage again in his 2013 State of the Union address, pushing for an incremental increase of the wage floor to $9 an hour in 2015, and indexing the minimum wage to adjust for inflation annually.[92] President Obama reaffirmed his commitment to

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1938, CNN MONEY, Feb. 14, 2013, 10:24 AM, http://economy.money.cnn.com/2013/02/14/minimum-wage-history/.

85 President Lyndon Baines Johnson, State of the Union Address (Jan. 8, 1964).

86 CPI Inflation Calculator, *supra* note 84 (set $ to "1.60"; then select "1968" from the first "in" drop-down menu; then select "2013" from the second "in" drop-down menu; then follow the "Calculate" hyperlink); *see also* Kurtz, *supra* note 84.

87 Fair Minimum Wage Act, 29 U.S.C. § 206(a)(1) (2006).

88 NAT'L EMP'T LAW PROJECT, BIG BUSINESS, CORPORATE PROFITS, AND THE MINIMUM WAGE 1 (2012).

89 *See* Dube, *supra* note 56, at 34.

90 *See Agenda–Poverty*, THE OBAMA-BIDEN TRANSITION TEAM, change.gov/agenda/poverty_agenda/ (last visited on Jan. 13, 2014); *see also* David G. Taylor, *Increase the Minimum Wage to $9.50 an Hour*, POLIFACT, Aug. 29, 2011, 2:47 PM, http://www.politifact.com/truth-o-meter/promises/obameter/promise/316/increase-the-minimum-wage-to-950-an-hour/; Paul R. La Monica, *Behind the Minimum Wage Debate*, CNN MONEY, Sept. 5, 2008, 11:22 AM, http://money.cnn.com/2008/09/05/markets/thebuzz/.

91 E.g., Barack Obama, Remarks at the Iowa Jefferson-Jackson Dinner in Des Moines (Nov. 10, 2007), http://www.presidency.ucsb.edu/ws/index.php?pid=77021.

92 President Barack Obama, State of the Union Address (Feb. 12, 2013).

raising the minimum wage in the 2014 iteration of the State of the Union address by announcing "an executive order raising the minimum wage to $10.10 an hour for future federal contract workers."[93] Such a plan has been met with resistance, despite arguments that "raising the minimum wage would help boost the economy by putting more money in to the hands of lower-income Americans, who are likely to spend it,"[94] as it would preclude future legislatures from needing to periodically adjust the minimum wage and effectively end debate on the policy.

Obama's calls to action have spurred criticism. Worker advocates contended that the annual income of a $9-minimum-wage earner would bring home an annual pay less than the poverty level for a family of four,[95] while employer groups point to studies projecting jobs losses totaling roughly 467,500 jobs.[96] One Forbes contributor pointed out that minimum wages enacted by foreign governments have most perversely affected youth employment opportunities.[97] In New Zealand, for example, unemployment jumped from an expected fourteen percent to twenty percent when the special youth minimum wage–a lower minimum wage than that imposed for adult workers–was abolished.[98] Companies are more inclined to hire and provide training for young employees when doing so is cheaper than hiring more experienced workers.

Other studies, still, evaluate minimum wage as an industry-specific issue. One analysis of restaurant financials found that if the minimum wage in the fast-food industry were raised to $15, it would drive fast-food prices twenty-five percent higher, adding $1 to the cost of a Big

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93 President Barack Obama, State of the Union Address (Jan. 28, 2014).

94 Tami Luhby, *The Impact of a $9 Minimum Wage*, CNN MONEY (Feb. 13, 2013, 9:57 AM), http://money.cnn.com/2013/02/12/news/economy/obama-minimum-wage (citing MICHAEL SALTSMAN, EMPLOYMENT POLICIES INSTITUTE, THE IMPACT OF A $9.80 FEDERAL MINIMUM WAGE 3 (2012)).

95 *Id.*

96 *Id.*

97 Tim Worstall, *Youth Unemployment Shows the Effects of a Minimum Wage That is Too High*, FORBES (Mar. 2, 2014, 9:11 AM), http://www.forbes.com/sites/timworstall/2014/03/02/youth-unemployment-shows-the-effects-of-a-minimum-wage-that-is-too-high/.

98 *Id*. When the special, lower minimum wage for youths was abolished in New Zealand,

> The unemployment rate for 16 and 17 year olds, which had always tracked a fairly predictable but noisy path above the adult unemployment rate, instead took a jump. Where we might have expected a youth unemployment rate around 14%, it instead touched 20%. Two quarters later, when adult unemployment rates hit 4.5%, and we would have expected youth unemployment rates around 16%, the youth unemployment rate instead hit 27%. *Id.*

Mac.[99] This Comment cautions against such studies, however, because of the same fairness concerns that guide minimum wage policy in the first instance: why should Liam, our hypothetical McDonald's worker, earn more for his minimum wage position than he would otherwise earn sweeping the floors at the Pet Supermarket next door? While it is true and demonstrated herein[100] that corporations in the fast-food industry are prone to allow their workers to rely on public assistance, such an argument for different standards of minimum wages are considered by this Comment to be insufficient solutions to resolving the issue at hand.

On the determination of whether government intervention is appropriate, this Comment would be remiss, however, if it were to omit the political obstacles that any minimum wage hikes would face. In the first, John Boehner–whose expansive powers as Speaker of the House of Representatives give him wide latitude over government policy–has been quoted as saying, "I'll commit suicide before I vote on a clean minimum-wage bill."[101] Rather than follow through on the rather morbid and surely hyperbolic threat, Speaker Boehner has voted no on all but one bill aimed to raise the minimum wage since 1996.[102] The Speaker's voting history likely reduces the likelihood of his caving and allowing a vote on the minimum wage this year.[103]

For that reason, President Obama is taking a different tact to try to raise the minimum wage: he is appealing to Democratic governors to

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99 Vanessa Wong, *This is What Would Happen If Fast-Food Workers Got Raises*, Bloomberg BusinessWeek (Aug. 2, 2013), http://www.businessweek.com/articles/2013-08-02/this-is-what-would-happen-if-fast-food-workers-got-raises.

100 *See* Part I.

101 Fred Barnes, *Maximum Meltdown*, 1 THE WEEKLY STANDARD (Apr. 29, 1996), available at http://www.weeklystandard.com/Content/Protected/Articles/000/000/007/621qdhht.asp?page=2.

102 JOHN A. BOEHNER'S POLITICAL SUMMARY, *available at* http://votesmart.org/candidate/27015/john-boehner?categoryId=3&type=V#.
VD8LHildXOY. Four months after the interview in which Speaker Boehner issued his threat, President Clinton signed a minimum wage hike into law that lifted the wage by ninety cents. When Democrats took over the House in 2007, Boehner again voted against raising the minimum wage. The only instance in which Boehner voted in support of a minimum wage hike was in 2006, when he strategically voted with the hope that passing an increase in the minimum wage would preclude Democrats from being able to campaign with the intent of taking over the House. Molly K. Hooper & Bob Cusack, *Boehner: Suicide Over Minimum Wage Hike*, THE HILL (Feb. 21, 2014), http://thehill.com/homenews/house/198856-boehner-id-rather-kill-myself-than-raise-the-minimum-wage.

103 Hooper, *supra* note 102. There has been some suggestion that Boehner might be forced to cave as a result of political pressure, as happened in 2006 when the Democrats last threatened to take over the House of Representatives.

support his initiative at the state level.[104] Four governors in particular–Dannel Malloy of Connecticut, Deval Patrick of Massachusetts, Peter Shumlin of Vermont, and Lincoln Chafee of Nebraska–have joined the President in pushing for a higher minimum wage, and six states[105] have enacted higher minimum wages since Obama's 2013 State of the Union address.[106]

The Democrats' push finds support in reports that an increase in minimum wage would likely augment consumer spending,[107] which has been a chief concern of the Federal Reserve during the economic recovery.[108] Such a raise would most benefit the Democrats' base given that

> a raise would help lower-income earners contend with a decrease in government assistance such as the food-stamp program and the increase in the payroll tax that have hurt household purchases, which account for over 70 percent of the economy.[109]

As a result of an increased borrowing power from a higher wage earnings, "a $1 increase in minimum pay leads to $250 in extra income per quarter for households with adult minimum-wage earners, spurring $700 in quarterly spending in the year following the escalation."[110]

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104 Dave Boyer, *New England Governors, Obama to Push Minimum Wage*, WASHINGTON TIMES, Mar. 2, 2014, http://www.nydailynews.com/news/politics/obama-push-minimum-wage-wednesday-governors-conference-article-1.1708078.

105 These states are California, Connecticut, Delaware, New York, New Jersey, and Rhode Island. Labor Code, CAL. STAT., § 1182.12 (2013); CONN. STAT., § 31-58 (2014); DEL. STAT. tit. 19, § 902(a) (2014); N.Y. STAT., § 652 (2014); N.J. STAT., § 12:56-3.1 (2013); R.I. STAT., § 28-12-3 (2014).

106 *Obama to Push Minimum Wage Increase Wednesday at Governors' Conference*, New York Daily News, Mar. 2, 2014, 1:20 PM, http://nydn.us/1eR0aO7.

107 President Barack Obama, State of the Union Address (Jan. 28, 2014).

108 LaVaughn Henry, *Consumer Spending Reflects New Priorities after the Recession*, FED. RESERVE BANK OF CLEVELAND ECONOMIC TRENDS, Feb. 5, 2014, at 7, 7-9.

109 Jeanna Smialek, *Minimum Wage Increase in U.S. Will Probably Promote Spending*, BLOOMBERG PERSONAL FIN. (Feb. 27, 2014, 4:32 PM), http://www.bloomberg.com/news/2014-02-27/minimum-wage-increase-in-u-s-will-probably-promote-spending.html (citing DANIEL AARONSON & ERIC FRENCH, THE FEDERAL RESERVE BANK OF CHICAGO, HOW DOES A FEDERAL MINIMUM WAGE HIKE AFFECT AGGREGATE HOUSEHOLD SPENDING? (2013)).

110 *Id.* (citing AARONSON, *supra* note 109, at 3) ("real spending in households with adult minimum wage workers rises, on average, by approximately $700 per quarter during the first few quarters following a $1 hike in the hourly minimum wage. This additional spending, which exceeds the immediate income gain of $250 per quarter, is primarily on durable goods, particularly new vehicles (financed with credit)").

The fact that the presented social science data is conflicting should not have any bearing on the ultimate issue of constitutionality of a minimum wage hike; rather, any dispute in data merely points to whether such an intervention would be good or bad public policy to combat poverty. There exist additional justifications for raising the minimum wage, and, this Comment argues, chief among them is regulating the negative externalities produced by industries.

IV. ANALYZING THE LEGAL RAMIFICATIONS OF WIDESPREAD INDUSTRY EXTERNALITIES

The federal government is no stranger to regulating industries in order to protect the public from paying the costs generated by negative externalities. In its landmark decision upholding the constitutionality of the Affordable Care Act, the Supreme Court held that an Act of Congress that mandates the purchase of a particular product—health insurance—is not constitutional under the Commerce Clause,[111] but that the levying of a tax on individuals who did not purchase healthcare insurance is constitutional under the government's Tax Power.[112] While the fact pattern between the argument for healthcare insurance and a higher minimum wage is largely similar–a big part of the reason for the healthcare legislation was to account for the large share of taxpayer dollars that went towards uncompensated care covered by Medicaid,[113] which is simply a narrower version of using taxpayer dollars covering a broader array of expenses with public assistance money–this Comment contends that it would be inefficient to resolve the public assistance gap through a tax on employers.

Whereas the question of whom and how to tax for healthcare purposes is simple–does an individual have healthcare insurance and, if given a negative answer, including a tax on the individual–the same question in a minimum wage context offers the unpleasant remedy of taxing businesses per minimum wage employee. Aside from being political suicide, such a tax connotes a punishment for hiring someone at the minimum legally sanctioned going-rate. It is important to note that using a tax rationale similar to that of the Affordable Care Act for the purposes of justifying a higher minimum wage amounts to nothing more

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111 Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S.Ct. 2566, 2591 (2012).

112 *Id.* at 2600.

113 JANUARY ANGELES, CENTER ON BUDGET AND POLICY PRIORITIES, HOW HEALTH REFORM'S MEDICAID EXPANSION WILL IMPACT STATE BUDGETS: FEDERAL GOVERNMENT WILL PICK UP NEARLY ALL COSTS, EVEN AS EXPANSION PROVIDES COVERAGE TO MILLIONS OF LOW-INCOME UNINSURED AMERICANS 1 (2012).

than a mental exercise, given that *Darby Lumber* held the minimum wage to be within the constraints of the Commerce Clause.

The appropriate government regulation, therefore, is mandating a higher minimum wage. There are two strong precedents for action to regulate an actor's behavior through mandated action. The first pertains to environmental regulations on factories that, in their current form, serve to protect the public health and, in proposed forms, quantify the external costs of production and charge the factories that rate. The second pertains to regulations on motorcycles that are structured to reduce the taxpayer's burden of paying for injuries to helmetless riders who get into accidents and endure severe head trauma.

A. Environmental Regulations

Environmental regulations are the classic example of a negative externality. Take, for example, a consumer's purchase of power from the electric grid:

> When I buy power from my electric company, a generator somewhere in Victoria's Latrobe valley works a little bit harder and makes some extra greenhouse gases. I pay for the electricity and that money compensates the electricity retailer, distributor, transmission company and the generator. But people who are adversely affected by the pollution receive no compensation. They suffer a 'negative externality.'[114]

The United States regulates against environmental harms at the national, state, and local levels.[115]

Congress derives its authority to regulate the environment from the Commerce Clause.[116] However, "[w]hich school of Commerce Clause jurisprudence controls a challenge to federal environmental law is critically important"[117] as there are two theories: (a) *Raich*, under which the Court held that Congress had to apply a rational basis test to conclude whether the aggregate effects of the regulation affected interstate

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114 Stephen King, *Global Warming, Externalities and Government Failures*, ECON. STUDENT SOC'Y OF AUSTL (June 24, 2013), http://economicstudents.com/2013/06/global-warming-externalities-and-government-failure/.

115 *E.g.*, United States Environmental Protection Agency; Florida Environmental Regulations Commission; Miami-Dade County Environmental Ordinances.

116 James R. May, *The Intersection of Constitutional Law and Environmental Litigation*, *in* ENVIRONMENTAL LITIGATION: LAW AND STRATEGY 359, 370 (Cary R. Perlman ed., 2009).

117 *Id.* at 372.

commerce[118]; and (b) *Lopez*, which limits congressional regulation to certain types of activity,[119] and *Morrison*, which establishes guidelines for Congress to follow in conducting such regulation.[120] *Raich* is considered the easier theory under which a negative externality may be regulated.[121]

For nearly the same reasons as have been established to allow Congress to regulate the environment, government may act to regulate the wage market under the authority of the Commerce Clause. The guidelines under *Raich* and *Lopez* are satisfied by the same factors under which *Darby Lumber* was legitimized, and the wealth of information that has been collected about minimum wage would certainly satisfy the *Morrison* guidelines for control. Still, the remedies offered by issues that arise in environmental regulation—which are mainly punitive in nature[122]—fail to satisfy the craving for a more preemptive solution to justify a minimum wage hike under the Commerce Clause.

B. Motorcycle Regulations

While of a slightly different nature, motorcycle helmet laws seem to satisfy this craving. While there is no federally established motorcycle helmet mandate, only three states in the country have not passed at least a partial helmet law.[123] On their face, motorcycle helmet laws are incredibly similar to minimum wage laws in that they both force an actor

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118 Gonzalez v. Raich, 545 U.S. 1, 22 (2005); *see also* May, *supra* note 116, at 371 ("the majority in [*Gonzalez v.*] *Raich* simply asked whether Congress had a 'rational basis' for concluding that the 'aggregate effects' of those regulated activities collectively significantly affect interstate commerce").

119 U.S. v. Lopez, 514 U.S. 549, 557 (1995); *see also* May, *supra* note 116, at 370 ("In *United States v. Lopez* (involving the Gun-Free School Zones Act), the Court explained that the Commerce Clause only allows Congress to regulate (i) channels of, (ii) instrumentalities of, and (iii) activities that 'substantially affect' interstate commerce").

120 U.S. v. Morrison, 529 U.S. 598, 617-618 (2000); *see also* May, *supra* note 116, at 370-371 ("In *United States v. Morrison*, (involving the Violence Against Women Act), the Court elaborated on the third of these, explaining that activities that 'substantially affect' interstate commerce are those in which (1) the underlying activity is 'inherently economic,' (2) Congress has made specific findings about the regulated activity's effect on interstate commerce, (3) the law contains a jurisdictional element establishing that the cause of action is pursuant to Congress's Commerce Clause power, and (4) the overall effects of the activity actually are substantial").

121 May, *supra* note 116, at 372.

122 *See* Jonathan M. Karpoff et al., *Environmental Violations, Legal Penalties, and Reputation Costs* 7 (Univ. of Chi. Law Sch., Working Paper No. 71, 1999).

123 The three states without such laws are Illinois, Iowa, and New Hampshire. CDC, *Save Lives, Save Money – How Does Your State Measure Up?*, http://www.cdc.gov /Motorvehiclesafety/mc/states/index.html?s_cid=fb_tbi529 (last visited Sept. 30, 2014).

to act preemptively by imposing costs on an actor to protect a societal interest.[124]

Motorcycle helmet laws have been ruled constitutional by the highest courts in more than twenty-five states as a means to protect society from incurring the costs borne to society by helmetless riders who consume taxpayer dollars after an accident. The Supreme Court held this reasoning to be sound in *Simon v. Governor of the Commonwealth of Massachusetts*:

> From the moment of the injury, society picks the person up off the highway; delivers him to a municipal hospital and municipal doctors; provides him with unemployment compensation if, after recovery, he cannot replace his lost job, and, if the injury causes permanent disability, may assume the responsibility for his and his family's continued subsistence. We do not understand a state of mind that permits plaintiff to think that only he himself is concerned.[125]

In affirming the helmet law, the *Simon* Court specifically cites the various costs to society that show the impact of a decision to not wear a helmet extends beyond the individual.

Similarly, the public assistance costs to society, arising out of an employment contract that engages an individual in a traditional workweek for less than is necessary to sustain a family of three, extend beyond the parties to that contract. To use the framework of the *Simon* analysis, from the moment of the contract, society assists the individual and his dependents with the funds necessary to make up the public assistance gap; protects his family during times of unemployment as minimum wage earners generally lack savings[126]; provide him with the potential of vocational training, if he qualifies; and, if he gets sick, pays for his healthcare with Medicaid. The reasoning in motorcycle helmet laws is parallel to that which may be put forth to lend credence to minimum wage as a regulatory tool.

C. Minimum Wage As a Regulatory Tool

The minimum wage has long been thought of more of a redistributional tool than anything else. Economists have noted that

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124 *See Common Myths About Motorcycle Helmets and Motorcycle Helmet Laws*, NAT'L HIGHWAY TRAFFIC SAFETY ADMIN., http://www.nhtsa.gov/people/injury/pedbimot/motorcycle/safebike/myths.html (last visited Feb. 4, 2014).

125 *Id*. (quoting Simon v. Sargent, 409 U.S. 1020 (1972)).

126 *See* Johnson, *supra* note 4.

"[t]he goal of a minimum wage is not, of course, to reduce employment, but to redistribute earnings to low-paid workers."[127] While Barack Obama gave a 2001 interview that suggested that the judicial system might be the best medium through which an economic redistribution could transpire,[128] the courts have not ruled on this Robin Hood theory.[129] More than likely, any potential assessment of minimum wage legislation will be borne out of its potential as a regulatory tool and handled as such.

The reasoning behind motorcycle helmet laws is parallel to that which may be put forth to lend credence to minimum wage as a regulatory tool; after all, what is the minimum standard-of-living wage if not a helmet to protect workers from poverty? Defining minimum wage as a regulatory tool is important to its constitutionality because, having once been established as a means against workplace gender and age discrimination and later affirmed as a matter of interstate commerce, the initial reasons for establishing the floor are not necessarily sufficient to protect against an argument that raising the minimum wage constitutes overregulation. Having established that the minimum wage is functionally equivalent of a wage market motorcycle helmet law, this Comment deems its status as a regulatory tool is sufficient to protect the constitutionality of an increase.

V. REMEDYING THE TAXPAYERS' SUPERSIZED BURDEN

The reality of raising the minimum wage is that the floor is legislatively set, and there is a partisan impasse in Congress that has precluded deserving legislation from reaching the White House for approval. Without legislative passage, there can be no true remedy to remedy the taxpayers' supersized burden.

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127 Richard B. Freeman, *The Minimum Wage as a Redistributive Tool*, 106 THE ECON. J. 639, 639 (1996).

128 Audio Tape: Interview with Barack Obama, WBEZ CHI. 91.5 FM (2001), *available at* https://www.youtube.com/watch?v=OkpdNtTgQNM#t=11.

129 The Robin Hood theory concerns the notion of redistributing wealth from the rich to the poor; alas, such redistribution here is not orchestrated by arrow-wielding outcasts clad in tights, but instead by the courts. In *Edgewood v. Kirby*, the Supreme Court of Texas did adjudicate a dispute of the Robin Hood theory in which education money was collected by counties and redistributed to the school districts, declaring that the system was unconstitutional where funds were funneled from wealthier to poorer school districts. Edgewood Indep. Sch. Dist. v. Kirby, 777 S.W.2d 391 (Tex. 1989). When that court held Robin Hood redistribution to be an unconstitutional method of raising and allocating education money, the legislature sought to enact an amendment to the state constitution to ratify the plan. Kathy J. Hayes & Daniel J. Slottje, RETHINKING ROBIN HOOD (1993).

This Comment contends that the President does, however, have soft power tools at his disposal to effectuate a higher minimum wage, or to put pressure on Congress to actualize that result. For example, the President may urge a blue-ribbon study on poverty to determine whether the poverty thresholds and guidelines are accurate, or whether they need to be updated. That study, which would be completed after the Obama administration has been term-limited, would almost certainly reflect the conclusions reached in Part I of this Comment: the poverty threshold is an outdated metric based on an anachronistic calculation.

The result of such a study would be a reconfiguration of the terminology that would house more people under a "poverty" designation, without burdening this President or the next with the politically damaging brand of "causing" a higher poverty rate. This reclassification would also serve to allow families that are wrongly considered above the poverty line to qualify for needed aid under a more encompassing poverty guidelines.

More traditional means are also available for the President to enact change on minimum wage legislation. One such example would be taking advantage of the Presidential bully pulpit to showcase a personable Chief Executive who wowed people with his eloquence and feel for the needs of the middle class during his two campaign cycles. The President may prioritize a higher minimum wage in speeches such as his State of the Union address and when campaigning around the country for Democratic candidates for the House and Senate during the 2014 election cycle. Placing populist pressure on Republican candidates may serve to shift their campaign rhetoric towards the President on this issue or perhaps result in the election of Democratic candidate to traditionally Republican seats.

VI. CONCLUSION

The minimum wage must be raised to mitigate the societal costs of public assistance due to insufficient hourly pay to low-income workers. As minimum wage is sufficiently similar to a motorcycle helmet law that preemptively imposes a cost on an actor to protect a societal interest, it follows that the minimum wage may function as an effective regulatory tool against corporations that are inclined to externalize their business costs as a burden of the general public.

Given that Congress seems unwilling, or unable, to pass legislation at the moment, the President may act on his authority as the Chief Executive to use soft law as a means to protect workers from employers' relatively strength in determining the wage market. Ultimately, the minimum wage must be raised as part of an overall strategy to combat poverty. That increase will be held constitutional in this nation’s highest court.

Barter, Bearer, and Bitcoin: The Likely Future of Stateless Virtual Money

Cara R. Baros*

Over the past few years, virtual money has emerged via the Internet. Although currently unregulated, Internal Revenue System Notice 2014-21 will most likely cause virtual money to lose its mass appeal in the United States. Historically, other means of tax avoidance, including barter transactions and bearer bonds, have suffered the same fate. Virtual money will likely have more success as a technology than as a means of value.

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I. INTRODUCTION

By definition, "money" is something that is "generally accepted as a medium of exchange, a measure of value, or a means of payment."[1] Money is constantly evolving and, over time, it has assumed different roles. The role of money has moved progressively from barter transactions, to physical money, to virtual money.

At one time, barter transactions were favored as a means to avoid taxation.[2] In fact, barter transactions were popular as recent as the 1980s through barter exchanges.[3] In a barter transaction, a person can directly exchange a good for a service[4] or, in a barter exchange, a person can indirectly barter.[5] However, the Tax Reform Act of 1984[6] taxed barter exchanges, which were previously able to escape taxation.[7]

Similar to barter transactions, bearer bonds were used as a means to avoid taxation.[8] Bearer bonds are "bonds that are not registered on the books of the issuer."[9] The owner of the bond is able to receive interest payments by physically detaching a portion of the bond.[10]

Today, virtual money is one of the most recent evolutions of money. Virtual money is "unregulated digital currency that is issued and often controlled by its developers."[11] The most prevalent form of virtual money is Bitcoin,[12] which was introduced in 2009.[13] Since Bitcoin's

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1 MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 801 (11th ed. 2003).

2 Robin Kaufman, *"Living on the Cheap," is Barter Better?: Revenue Rulings and a Selective Analysis of the Effect of TRA 84 on Barter Transactions*, 37 U. FLA. L. REV. 641, 641 (1985) [hereinafter Kaufman].

3 *Id.*

4 The I.R.S. provides an example of a bartering transaction where a plumber exchanges plumbing services for the dental services of a dentist. *See Topic 420 – Bartering Income*, I.R.S. (August 19, 2014), http://www.irs.gov/taxtopics/tc420.html.

5 The I.R.S. recognizes a barter exchange as "an organization with members who contract with each other (or with the barter exchange) to exchange property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis." *Id.*

6 Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (Div. A).

7 Kaufman, *supra* note 2, at 645 (citing Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 678).

8 Guy Bernfeld, *Bearer Bonds: From Popular to Prohibited*, INVESTOPEDIA, http://www.investopedia.com/articles/bonds/08/bearer-bond.asp (last visited Sept. 16, 2014) [hereinafter Bernfeld].

9 BEARER BOND DEFINITION, NASDAQ, http://www.nasdaq.com/investing/glossary/b/bearer-bond (last visited Sept. 16, 2014).

10 *Id.*

11 Aleksandra Bal, *Stateless Virtual Money in the Tax System*, 53 EUR. TAX'N 351, 351 (2013).

12 Ryan Tracy, *Authorities See Worth of Bitcoin*, WALL ST. J. (Nov. 18, 2013), *available at* http://online.wsj.com/articles/SB10001424052702304439804579205740125297358.

inception, more than a handful of virtual money systems have surfaced on the market.[14] Although virtual money is currently unrefined and fluctuating,[15] it is being used as money,[16] as currency,[17] and as a store of value.

Many individuals, professionals, and organizations are drawn to virtual money because it seems to be a way to avoid taxation.[18] However, the Internal Revenue Service (IRS) has issued a Notice on how to tax Bitcoin and similar types of virtual money.[19] Because the IRS has suggested tax implications for Bitcoin it is likely that virtual currency will lose its mass appeal. This Comment looks at historical tax avoidance in order to predict how Bitcoin will progress as a means of value.

This Comment will look at barter transactions in Part II and bearer bonds in Part III and their respective treatments and outcomes after being recognized by the IRS. Then, this Comment will discuss how Bitcoin works, Bitcoin's challenges, and other virtual money in Part IV. Finally, this Comment considers tax consequences of virtual money, including its tax classification as property.

II. BARTER TRANSACTIONS

A. BARTER TRANSACTION HISTORY

According to the IRS a barter exchange is:

> [A]ny person or organization with members or clients that contract with each other (or with the barter exchange) to jointly trade or barter property or services. The term does not include arrangements that provide

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13 *See* Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System 1 (unpublished manuscript), *available at* http://Bitcoin.org/Bitcoin.pdf [hereinafter Nakamoto].

14 Joe Light, *Virtual-Currency Craze Spawns Bitcoin Wannabes*, WALL ST. J. (Nov. 20, 2013), *available at* http://online.wsj.com/articles/SB10001424052702304607104579210051252568362.

15 *Id.*

16 "Money" is defined as, "[t]he medium of exchange authorized or adopted by a government as part of its currency; esp., domestic currency." *See* BLACK'S LAW DICTIONARY 1158 (10th ed. 2009).

17 "Currency" is defined as, "[a]n item (such as coin, government note, or banknote) that circulates as a medium of exchange." *Id.* at 465.

18 Daniela Rosette, *The Application of Real World Rules to Banks in Online Games and Virtual Worlds,* 16 U. MIAMI BUS. L. REV. 299 (2008) (discussing tax avoidance and virtual money).

19 I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

> solely for the informal exchange of similar services on a noncommercial basis.[20]

In a barter exchange, there is often no exchange of cash.[21] "Barter may take place on an informal one-on-one basis between individuals and businesses, or it can take place on a third party basis through a barter exchange company."[22] Barter exchanges have been popular throughout time as a way for people to acquire the goods and services that they want, usually without paying tax. It is seen as its own economy; considered to be part of the underground or shadow economy.[23] "For businesses that barter, barter is a way to get rid of 'distress merchandise' or to acquire inventory without cash outflow or the cost of stockpiling."[24]

Barter exchanges typically operate using trade credits or trade dollars in order to keep track of the value of the goods or services that they receive.[25] However, according to the IRS "[e]arning trade or barter dollars through a barter exchange is considered taxable income, just as if your product or service was sold for cash."[26] Thus, trade credits are reportable income. The IRS has stated that "[t]he recipient of bartered property or services must treat the fair market value of that property or services the same as cash for federal income tax purposes regardless of whether the recipient was bartering on a commercial basis or merely informally."[27]

At one time, barter transactions were a way to avoid taxation.[28] However, as soon as there was a public insurgence in bartering transactions, the IRS tightened-up on tax compliance in order to prevent income tax evasion.[29] Although the IRS concentrates its regulation on all types of barter transactions, its focus is on the regulation of barter exchanges.[30]

Since the regulation of barter exchanges, "bartering has no tax advantages over cash transactions any more. Before, the only advantage

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20 BARTERING TAX CENTER, I.R.S., http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Bartering-Tax-Center (last visited Oct. 28, 2014).
21 BARTER EXCHANGES, I.R.S., http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Barter-Exchanges (last visited Oct. 28, 2014).
22 *Id.*
23 Kaufman, *supra* note 2, at 642.
24 *Id.* at 643.
25 Barter Exchanges, *supra* note 21.
26 *Id.*
27 Sergio Pareja, *It Taxes a Village: The Problem with Routinely Taxing Barter Transactions*, 59 CATH. U. L. REV. 785, 787 (2010) [hereinafter Pareja].
28 Kaufman, *supra* note 2, at 641.
29 *Id.* at 641.
30 *Id.*

was the ability to avoid taxation and that was only because the Service did not have the manpower to catch the tax evaders. New filing requirements and a powerful computer have alleviated this problem."[31]

In *U.S. v. Barter Systems, Inc.*, an issue arose on how to properly issue a summons to investigate tax liabilities on named and unnamed parties. While that issue is not pertinent to this discussion, the explanation of the way a barter exchange works is useful.[32]

> A barter exchange acts as a clearinghouse for the purchase of goods and services by exchange members. Trading between exchange members is conducted in "barter units" with no cash changing hands. If an exchange member wishes to purchase certain goods or services, he [or she] obtains a referral by the exchange to a "providing member" who supplies the desired goods or services. When the purchasing and providing members have agreed on prices and terms, the providing member contacts the exchange. If the exchange determines that the purchasing member has sufficient barter units in his account, it authorizes the trade. For facilitating such barter exchanges . . . [the barter exchange] charges its members a fee of ten percent of the value of each transaction, payable in barter units and credited to [the exchange's] account. [It] also charges it members an imitation fee and annual dues, both paid in cash. These transactions result in tax consequences for [the exchange] as well as for exchange members engaging in them.
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> On September 19, 1979, the IRS issued a directive establishing the Barter Exchange Project Unreported Income Program. The purpose of the project was to 'identify and select returns in need of examination that are associated with organized barter exchanges . . . .[including] the returns of bartering exchanges, owners and operators and members of such exchanges' . . . .The procedures described in the September 19, 1979, directive were formally

31 *Id.* at 670.
32 *See generally* U.S. v. Barter Systems, Inc., 694 F.2d 163, 164 (8th Cir. 1982).

> incorporated into the IRS' Manual Supplement on March 11, 1980.[33]

The summons issued by the IRS revenue agent auditing the defendant in *Barter Systems Inc.* included requests for the following items:

> 1. Books, papers, account cards or other records upon which the following information is recorded:
>
> (A) All members' names and account numbers;
>
> (B) Exchange member transactions including the price and/or trade units assigned to goods or services rendered or received
>
> (C) All initiation or membership fees, and other income, including commissions on members' transactions.
>
> 2. The disbursements journal and trade credit ledger.
>
> 3. All monthly account statements for each exchange member.[34]

The district court found that one of the purposes of the barter exchange audit was to aid in the investigation of unknown members of the exchange as a part of the IRS' barter exchange initiative.[35]

> Under section 7602 of the Internal Revenue Code, the IRS has broad powers 'to examine any books, papers, records, or other data which may be relevant' to investigating a person's compliance with the internal revenue laws.[36]
>
> If the IRS wishes to examine the tax liabilities of unnamed or unknown taxpayers, it may issue 'John Doe' summons to a third party who possesses that information necessary to identify the unnamed taxpayers.[37]

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33 *Id.*
34 *Id.* at 165.
35 *See generally Barter Systems, Inc.*, 694 F.2d at 165.
36 *Id.* (citing 26 U.S.C. § 7602 (1976)).
37 *Id.*

In order to qualify what might turn into an unregulated "hunt" of unnamed or unknown taxpayers, Congress enacted section 7609(f) as part of the Tax Reform Act of 1976, which provides additional standards in order for the IRS to pursue a John Doe summons.[38] The controls are as follows:

> Any summons described in subsection (c) which does not identify the person with respect to whose liability the summons is issued may be served only after a court proceeding in which the Secretary establishes that-
>
> (1) the summons relates to the investigation of a particular person or ascertainable group or class of persons,
>
> (2) there is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law, and
>
> (3) the information sought to be obtained from the examination of the records (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.[39]

In reviewing the district court's decision, the Eighth Circuit Court of Appeals concluded that the summons issued to the barter exchange was for a legitimate purpose.[40] Thus, the IRS can issue a summons in order to gain information about unknown or unnamed taxpayers.

The IRS has the power to command information from exchanges. This notion has a large impact on how the IRS will affect Bitcoin. The IRS could simply serve a request under section 7602 and find out who is participating in a Bitcoin exchange. This takes away from one of the allures of Bitcoin, that it is, mostly, an anonymous form of payment.

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38 *Id.*

39 *Id.*

40 *Id.*

B. BARTER TRANSACTION AND BITCOIN

There is also a lot to learn from the complicated way that the IRS chose to tax barter transactions. The IRS definition of barter has mislead many people in reporting their taxable income:[41]

> A barter exchange is any person or organization with members or clients that contact with each other (or with the barter exchange) to jointly trade or barter property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.[42]

This definition has caused people to argue that noncommercial barter transactions are not taxable—which is not correct.[43] The law actually means that the person or organization conducting the transaction has the responsibility of reporting the transaction.[44]

It is easy to predict that the same miscommunication will happen with Bitcoin. Just like barter transactions, all exchanges of Bitcoin will be subject to tax, and not just those that are converted on a Bitcoin exchange.

However, it does seem probable that the IRS would attempt to regulate the taxation of Bitcoin in a similar way. The largest volume of Bitcoin transactions will occur through the major exchanges and trusts, which will make Bitcoin interaction easier for people and companies because the exchanges will shoulder the IRS-mandated reporting responsibilities.

III. BEARER BONDS

A. BEARER BOND HISTORY

Bearer bonds are a type of bond that was popular in the 1980s. Bearer bonds are still in circulation today, but they are not nearly as popular as they used to be because of IRS treatment.[45]

"Bearer bonds are bonds that are owned by whoever is holding them, rather than having registered owners like most other securities."[46] People

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41 Kaufman, *supra* note 2, at 788.

42 Bartering Tax Center, *supra* note 20.

43 Kaufman, *supra* note 2, at 644 n. 35.

44 *Id.*

45 Michael Quint, *Elements in Bearer Bond Issue*, N.Y. TIMES, (August 14, 1984), *available at* http://www.nytimes.com/1984/08/14/business/elements-in-bearer-bond-issue.html.

generally choose bearer bonds because their interest is easily transferred.[47] "However, in the 20th century, that ease of ownership transfer and the characteristic anonymity afforded holders of bearer bonds were very often exploited to evade taxes or conceal business transaction. In response, new issuances of bearer bonds were banned in the United States in 1982."[48]

The bonds are still issued by U.S. businesses in foreign markets to foreign individuals according to the IRS."[49] "Bearer bonds are also called coupon bonds because the physical bond certificates have coupons attached to them that can be redeemed at an authorized agent bank for biannual interest payments . . . ."[50]

Ultimately, "[t]he Internal Revenue Service, as expected, proposed regulations today that would virtually destroy the attractiveness of a new type of bank deposit that has proliferated because of the tax evasion opportunity it offers to small investors."[51] Thus, because bearer bonds created a type of tax haven, the IRS caught on and restricted their issuance.

In 2010, Congress passed restrictions on the issuance of bearer bonds in foreign countries,[52] which took effect in 2012.[53] The IRS issued guidance on how to treat bearer bonds, which are often used by companies in the United States to issue debt in foreign countries.[54] "This repeal will likely dissuade many U.S. issuers from issuing bearer bonds, as they will no longer be entitled to tax the benefit of deductions for interest paid on such bonds."[55] "The IRS cannot determine for tax purposes who receives interest payments from bearer bonds because of the way they are sold and held in foreign countries."[56]

Now, an issuer may not deduct interest paid with respect to such obligation and is subject to an excise tax equal to one percent of the

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46 Bernfeld, *supra*, note 8.

47 *Id.*

48 Tax Equity and Fiscal Responsibility Act of 1892, Pub.L. No. 97–248, 96 Stat. 324 (1982) [hereinafter Tax Equity and Fiscal Responsibility Act].

49 Patrick Temple-West, *IRS Bearer Bond Tax Guidance Leaves Issuers Uneasy*, REUTERS, (Mar. 7, 2012, 6:23 PM), http://www.reuters.com/article/2012/03/07/usa-tax-irs-bearerbonds-idUSL2E8E6CDP20120307 [hereinafter Temple-West].

50 Bernfeld, *supra* note 8.

51 Deborah Rankin, *I.R.S. Moves to Bar Tax Evasion on 'Bearer Bond' Certificates*, N.Y. TIMES, Mar. 10, 1978, at D2.

52 Hiring Incentives to Restore Employment Act, 26 U.S.C. §§1471–1474 (2010).

53 Temple-West, *supra* note 49.

54 Tax Equity and Fiscal Responsibility Act, *supra* note 48.

55 Kristen Chang Winckler & Marcia N. Persaud, *Repeal of Bearer Bond Exception Effective March 19, 2012*, PAUL HASTINGS (Mar. 2012), *available at* http://www.paulhastings.com/Resources/Upload/Publications/2135.pdf [hereinafter Winckler].

56 Temple-West, *supra* note 49.

principal amount of the obligation multiplied by the number of calendar years (or portions thereof) between the issue date and the maturity date of such obligation.[57]

The law issues penalties on companies and bondholders for not reporting bearer bond interest to the IRS.[58] "Companies have already started shifting away from issuing bearer bonds. That trend could accelerate without 'iron-clad' guidance from the U.S. government . . . ."[59]

Now, in an effort towards tax reporting and transparency, "[i]n order to locate the owners of currently outstanding bearer bonds, it is now required that anyone depositing coupons must furnish a name, address and Social Security number to the bank at the time of each deposit."[60] The information then becomes immediately available to the IRS.

In Publication 1212, the IRS addressed how bearer bonds should be handled.[61] "If a coupon from a bearer bond is presented to you for collection before the bond matures, you generally must report the interest on Form 1099-INT."[62] Further, "[b]ecause you cannot assume the presenter of the coupon also owns the bond, you should not report Original Issue Discount ("OID") on the bond on form 1099-OID. The coupon may have been 'stripped' (separated) from the bond and separately purchased."[63]

B. BEARER BONDS AND BITCOIN

Bearer bonds highlight some of the same issues that are brought up with Bitcoin:

> Bearer bonds are easily transferable, easily negotiable and anonymous, and in certain circumstances, they have distinct advantages over other forms of currency, such as cash. However, these same advantages have been misused to cover up criminal activity or otherwise circumvent the law. As a result, the future of bearer bonds is uncertain, United States–issued bonds to

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57 Winckler, *supra* note 55.
58 Temple-West, *supra* note 49.
59 *Id.*
60 *Id.*
61 I.R.S. Pub. No. 1212, *Guide to Original Issue Discount (OID) Instruments* (Dec 20, 2013).
62 *Id.*
63 *Id.*

> become nearly extinct in the years to come and payment being uncertain even for those still in existence.[64]

Similarly, Bitcoin is easily transferable, easily negotiable and anonymous and in has distinct advantages over currency. It operates like cash, but also has the potential to gain more value, like bearer bonds. The two are similar, for example, once a Bitcoin is stolen, it cannot be retrieved or replaced. Thus, there is a criminal element in the types of transactions that a person can enter using Bitcoin, and there is an advantageous criminal element related to stealing another individual's Bitcoin, straight from his or her computer.

It is likely that the IRS will replicate this forced reporting—which will cripple Bitcoin in the same way that it crippled bearer bonds.

IV. BITCOIN

A. HOW BITCOIN WORKS

Bitcoin was first introduced in 2009 as an online monetary system.[65] It was created by an anonymous programmer or group of programmers under the pseudonym, Satoshi Nakamoto.[66] Nakamoto created a peer-to-peer network that allows semi-anonymous online payments to be sent directly from one party to another.[67] The transactions are made without the interference of financial institutions,[68] operating like Internet cash.

The Bitcoin process begins with a procedure called "mining."[69] It is helpful to think of it like mining for gold. Mining is a competitive process in which Bitcoin "miners" use special network processors and hardware to process transactions, secure the network, and solve algorithms that generate new Bitcoin.[70]

Bitcoin are created at a fixed rate, which instigates the competitive process. There are only a finite number of Bitcoin that can ever be mined, which are created at a decreasing and predictable rate.[71] Bitcoin issuance will come to an end once there are twenty-one million in

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64 Bernfeld, *supra* note 8.

65 Sarah Meiklejohn et al., A Fistful of Bitcoin: Characterizing Payments Among Men with No Names (unpublished manuscript), *available at* http://cseweb.ucsd.edu/~smeiklejohn/files/imc13.pdf.

66 *FAQ*, BITCOIN.ORG, https://bitcoin.org/en/faq (last visited Sept. 17, 2014).

67 *Id.*

68 *See* Nakamoto, *supra* note 13.

69 *FAQ*, *supra* note 66.

70 *Id.*

71 *Id.*

existence.[72] Although there is a finite number of Bitcoin, it is important to keep in mind that with technology, it is divisible. A Bitcoin can be divided up to eight decimal places at this moment and potentially infinitely divisible if required in the future.[73] This means that Bitcoin can retain value—a person will be able to own a fraction of a Bitcoin. Thus, the twenty-one million unit ceiling is not as limiting as it initially seems. However, as more miners join the network, systems have to work harder, more efficiently and effectively in order to make a profit.

There is an argument that Bitcoin has value because it is backed by mathematics, not properties like silver, gold, or governmental credit.[74] "With these attributes, all that is required for a form of money to hold value is trust and adoption."[75]

In order to mine a Bitcoin, a computer system performs mathematical calculations to ultimately gain a newly created Bitcoin.[76] Once the Bitcoin is mined, the network timestamps the transaction by placing the transaction in a "block". A block is a record in the larger block chain that contains and confirms many waiting transactions.[77] Every ten minutes, a new block, which includes information on transactions is added to the "block chain."[78] The "block chain" is a public record of Bitcoin transactions in chronological order.[79] The "block chain" is shared between all Bitcoin users.[80] This is a component of the peer-to-peer network, called the proof-of-work chain.[81] Thus, the block chain proves that the sequence of events that took place, providing the entire network with a record of the transaction.[82] Then, the users on the network check the block chain to "confirm" that a proper transaction occurred.[83]

A "confirmation" is a transaction that has been processed by the network and is extremely unlikely to be reversed.[84] The transaction receives a confirmation when it is included in a block and a confirmation for every block that follows.[85] For low values, a single transaction can be

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72 *Id.*
73 *Id.*
74 *Id.*
75 *Id.*
76 Nakamoto, *supra* note 13, at 2.
77 *Id.*
78 *Id.*
79 *Id.*
80 *Id.*
81 *Id.* at 3.
82 *Id.*
83 *Id.*
84 VOCABULARY, https://bitcoin.org/en/vocabulary (last visited Sept. 7, 2014).
85 *Id.*

secure.[86] The Bitcoin website recommends waiting for at least six confirmations for larger transactions before making a transaction. Every confirmation increases the security of the transaction while decreasing the risk that that transaction is reversed.[87]

As soon as a transaction is confirmed, a "private key" is sent to the "wallet" that successfully mined the Bitcoin.[88] A private key is a confidential piece of data that proves the right to spend the Bitcoin. That piece of information goes to your "wallet" on your computer, which functions in the same way that a real wallet would hold cash. Some people use software wallets on their own computers while others use remote servers called web wallets.[89] Regardless, the private key is sent to the wallet via a cryptographic signature.[90]

Private keys are a combination of numbers, which should never be revealed because the private key is what allows a person to spend the Bitcoin.[91] The private key is not published on the block chain and therefore, keeps the process semi-anonymous.[92]

The last piece to understanding the Bitcoin mining process involves what is called a cryptographic signature. First, Cryptography is a branch of mathematics which enables the Bitcoin network to create mathematical proofs that provide high levels of security, which then make it impossible for one person to spend another's Bitcoin or corrupt the block chain.[93]

It is important to note that spending another person's Bitcoin is different than the term "double spend."[94] Double spending is where a user tries to spend his or her Bitcoin in different places at the same time.[95] This is why the confirmation process is necessary. Mining and the block chain create a consensus on the network where one of the transactions will be confirmed and considered a valid transaction.[96]

Second, a "signature" is really a cryptographic identity that enables someone to prove ownership.[97] The signature is the public component of

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86 *Id.*
87 *Id.*
88 *Id.*
89 *Id.*
90 *Id.*
91 *Id.*
92 *Id.*
93 *Id.*
94 *Id.*
95 *Id.*
96 *Id.*
97 *Id*.

the transaction, which allows the whole network to match the signature to the Bitcoin that is being spent.[98]

B. CHALLENGES

Bitcoin is a risky investment. The Winklevoss Bitcoin Trust articulated 60 risk factors in the Trust registration that it filed with the Securities and Exchange Committee.[99] Among those risk factors is the reason Bitcoin is doomed to fail as a currency: "[a] lack of expansion by Bitcoin into retail and commercial markets, or a contraction of such use, may result in increased volatility or a reduction in the Blended Bitcoin Price."[100]

Additionally, prosecutors want Bitcoin to be regulated at a higher standard than other financial instruments.[101] Bitcoin is risky because of its ability to hide criminal activity. For example, the Silk Road was a website that dealt exclusively in Bitcoin and bought and sold black market items.[102] It has been described as a "dizzying elicit emporium" selling "fake IDs, bogus passports, driver's licenses, social security cards."[103]

Another key risk is Bitcoin's susceptibility to hackers:

> Bitcoin's three largest exchanges have been disabled by hackers who took advantage of transaction malleability, meaning that transactions can be cloned or disguised before completion. Transaction malleability is a long-standing bug in Bitcoin. The hackers fomented denial of service attacks that succeeded in renaming the user identification before confirmation of the transaction.[104]

Flexcoin, a Bitcoin bank, is shutting down.[105] On March 2, 2014 Flexcoin was hacked and all 896 Bitcoin that it held were stolen.[106]

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98 *Id.*

99 Winklevoss Bitcoin Trust, Amendment No. 1 to Form S-1 Registration Statement (Form S-1/A) (Oct. 8, 2013).

100 *Id.*

101 Carter Dougherty, *Bitcoin Needs Tighter Rules Than Banks, Say Prosecutors*, BLOOMBERG (Jan. 30, 2014), http://www.bloomberg.com/news/2014-01-29/prosecutor-warns-of-wild-west-without-Bitcoin-oversight.html.

102 Matthew Goldstein, *Online Black Market, Shut Down in Fall, Had a Digital Outpost in Pennsylvania*, N.Y. TIMES, Mar. 5, 2014, at B.6.

103 David Kushner, *Dead End on Silk Road*, ROLLING STONE, Feb. 13, 2014, at 52.

104 Lee A. Sheppard, News Analysis: Busting the Bitcoin Myths, TAX NOTES TODAY, 2014 TNT 41-1. [hereinafter Busting the Bitcoin Myths].

105 FLEXCOIN-THE BITCOIN BANK, http://flexcoin.com/ (last visited Oct. 28, 2014).

106 *Id.*

Flexcoin announced that it is permanently closing because it does not have the resources to rebuild from a total annihilation of all of their resources.[107] The only people who will be able to recover their Bitcoin are those who put their physical coins with Flexcoin because the computer hacker was obviously unable to reach the physical coins.[108]

The Flexcoin flaw was in the coding. Apparently, the attacker was able to take advantage of a programming flaw, which allowed transfers between users.[109] Thousands of requests were sent at once, during which the hacker overhauled the system and sent coins from one account to the next before balances were updated.[110] Flexcoin left its users and investors empty handed saying, "[w]e've failed our customers, our businesses, and ultimately the Bitcoin community."[111]

Additionally, MtGox, Bitcoin's largest exchange, disappeared overnight.[112] The Tokyo-based exchange was experiencing technical issues for months, including attempts at hacking the exchange.[113] The exchange lost 750,000 Bitcoin, which accounts for roughly six percent of the total circulation of Bitcoin and is worth around $400 million.[114] The fall of the exchange made Bitcoin's prices fall twenty-three percent.[115] Those who had their Bitcoin invested in MtGox have little or no chance of getting their Bitcoin back.[116]

Although Bitcoin has its benefits, it is a risky investment. Professor Josh Lerner, a professor of investment banking at Harvard Business School suggests that investing in Bitcoin is an uncommon and risky strategy for a venture capital fund.[117] He adds that most venture capital agreements have provisions strictly prohibiting investment in futures and currency.[118] Lerner adds that buying risk assets is the type of investment for a hedge fund, not for traditional venture capital funds.[119]

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107 *Id.*
108 *Id.*
109 *Id.*
110 *Id.*
111 *Id.*
112 Robin Sidel et al., *Shutdown Rattles Bitcoin Market*, WALL ST. J., Feb. 26, 2014 at A.1.
113 *Id.*
114 *Id.*
115 *Id.*
116 *See generally* Sidel et al., *supra* note 112.
117 *Id.*
118 *Id.*
119 *Id.*

C. OTHER VIRTUAL MONEY

Bitcoin is not the only type of virtual money on the market. The several alternatives to Bitcoin are commonly referred to as altcoins.[120] Altcoins are on the market as a response to the inefficiencies and difficulties that Bitcoin has produced. Since Bitcoin is open-sourced and available anyone, users can modify the Bitcoin code—in order to create their own cryptocurrency.[121] Currently, there are at least five popular alternatives to Bitcoin: Litecoin, Peercoin, Freicoin, Ripple, and Linden Dollar.[122]

D. TAX CONSIDERATION

As the government becomes more assertive in the dealings of Bitcoin, it will lose most of its appeal.[123] The Financial Crimes Enforcement Network ("FinCEN") is a bureau of the U.S. Department of the Treasury.[124] FinCEN's mission is to "safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities."[125] By its very nature, FinCEN has the responsibility to look into Bitcoin and its use.

FinCEN defines currency as "the coin and paper money of the United States or of any other country that (i) is designated as legal tender and that (ii) circulates and (iii) is customarily used and accepted as a medium of exchange in the country of issuance."[126] Virtual currency is like currency in that it operates like a currency in some situations; however, it does not have all the attributes of currency, such as the status of legal tender.[127] A convertible virtual currency "either has an equivalent value in real currency, or acts as a substitute for real currency."[128] Bitcoin is classified as a convertible virtual currency.[129]

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120 Saumya Vaishampayan, *Five Virtual Currencies Other than Bitcoin*, MARKETWATCH (Nov. 18, 2013, 4:18 PM), http://www.marketwatch.com/story/five-virtual-currencies-other-than-Bitcoin-2013-11-18.

121 *Id.*

122 Each alternative essentially modifies or improves on a Bitcoin element. *Id.*

123 Timothy Lavin, *Bitcoin is Still Doomed*, BLOOMBERG VIEW (Nov. 20, 2013, 1:03 PM), http://www.bloomberg.com/news/2013-11-20/Bitcoin-is-still-doomed.html.

124 *What We Do*, FINCEN, http://www.fincen.gov/about_fincen/wwd/ (last visited Sept. 17, 2014).

125 *Id.*

126 31 C.F.R. § 1010.100(m) (2014).

127 FIN-2013-G001 (Mar. 18, 2013).

128 *Id.*

129 *Id.*

FinCEN regulates money services businesses (MSBs).[130] Thus, the individual "user" of Bitcoin is not subject to regulation by FinCEN, but exchanges are subject to the regulation.[131]

As exchanges are finding, the Bank Secrecy Act[132] is "burdensome, costly, and annoying."[133] Thus, exchanges will have a disincentive to continue doing business in Bitcoin.

There are instances in the past that mirror the current Bitcoin situation. Specifically, the way the government taxed bartering and bearer bonds provide an indication of the future of Bitcoin. Essentially, people entered into barter transactions and used bearer bonds because they were essentially untaxed. However, as soon as a tax ruling was issued, the popularity of each method of exchange lost popularity.

The IRS issued Notice 2014-21, addressing the following sixteen issues related to the treatment of convertible virtual currency:

> 1. Under Federal Tax law, virtual currency is treated as property.
>
> 2. Virtual currency is not treated as a currency that could generate foreign currency gain or loss.
>
> 3. A taxpayer who receives virtual currency as payment must include in his or her income, the fair market value of the virtual currency on the date that he or she was paid.
>
> 4. The basis of the virtual currency is the fair market value of the date of receipt.
>
> 5. A taxpayer must calculate the virtual currency's exchange rate, in a reasonable and consistent manner, in U.S. Dollars, on the date it was received as payment.

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130 *Id.*

131 "A user who obtains convertible virtual currency and uses it to purchase real or virtual goods or services is ***not*** an MSB under FinCEN's regulations. Such activity, in and of itself, does not fit within the definition of 'money transmission services' and therefore is not subject to FinCEN's registration, reporting, and recordkeeping regulations for MSBs." *Id.*

132 The Bank Secrecy Act requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. "Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities." 31 U.S.C. § 310 (2010).

133 *Id.*

6. When a taxpayer exchanges virtual currency for other property, the taxpayer realizes a gain or loss.

7. The character of the gain or loss depends on the way in which the taxpayer uses the virtual currency.

8. When a taxpayer successfully “mines” virtual currency, the taxpayer realizes gross income when they receive the virtual currency which he or she has mined.

9. An individual who “mines” virtual currency as a trade or business is subject to self-employment tax

10. When an independent contractor receives virtual currency as payment, it constitutes self-employment income.

11. When an employer pays an employee in virtual currency, it constitutes wages for employment tax purposes.

12. A payment made using virtual currency is subject to information reporting when it has a value of $600 or more.

13. When a taxpayer makes a payment to an independent contractor in the amount of $600 or more, the taxpayer is required to report the payment on Form 1099-MISC.

14. Payments made with virtual currency are subject to backup withholding.

15. There are reporting requirements for payments made with virtual currency by third parties on behalf of merchants.

16. Taxpayers may be subject to penalties for failure to comply with tax laws.[134]

The IRS addresses many issues in its Notice. However, there are still valid arguments that treating Bitcoin as property is inefficient and inaccurate. One such argument contends that Bitcoin and other virtual currencies are international by nature. Therefore, under the IRS notice,

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[134] I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

simply incorporating or "mining" in another country would allow a taxpayer to avoid much of the reporting requirements. Thus, Bitcoin is a transactional currency and should be taxed as a foreign currency. Other arguments include that it is a store of value and should be taxed as a capital asset. Each classification of tax is discussed below in turn.

E. CURRENCY

The first argument is that Bitcoin should be treated as a transactional currency. The Financial Crimes Enforcement Network (FinCEN) defines currency as follows:

> (m) Currency. The coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance. Currency includes U.S. silver certificates, U.S. notes and Federal Reserve notes. Currency also includes official foreign bank notes that are customarily used and accepted as a medium of exchange in a foreign country.[135]

In other words, currency is "the money that a country uses."[136] This definition would seem to include Bitcoin within the definition of currency. A person might reason that as long as members of a country use Bitcoin, it is a currency.

Further, in *AMP Inc. and Consol. Subsidiaries v. U.S.*, the court defined "functional currency" as follows:

> [t]he primary currency of the economic environment in which the entity operates. It is presumed that an entity's functional currency would be the currency of the country in which the entity is located and the currency of the country in which the books of record are maintained. In some instances, however, a foreign entity's functional currency may not be the currency of the country where the entity is located even though that currency is used in the books of records [sic].[137]

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135 31 C.F.R. § 1010.100(m) (2014).

136 MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 306 (11th ed. 2003); *see also* BLACK'S LAW DICTIONARY, *supra* note 17.

137 AMP Inc. and Consol. Subsidiaries v. U.S., 185 F.3d 1333 (U.S. App. 1999).

However, Bitcoin is not a currency. A thing is not a currency just because it has value. "If Bitcoin is a currency, any tradable store of value would be a currency. Gold bullion would be a currency. Rolex watches would be a currency. Airline miles would be a currency. Money market fund shares would be a currency."[138]

Additionally, an important point is made about the stagnant nature of Bitcoin:

> The people who have Bitcoin have no reason to spend them, and the people who don't have no reason to get them. They don't want a currency whose value you can't predict from one hour to the next. They don't want to buy things anonymously. And they don't want transactions to be irreversible.[139]

And finally, the erratic nature of Bitcoin erases it plausibility as a currency. "If a retailer accepts Bitcoin for a product and the Bitcoin price declines sharply the next day, he's made a terrible mistake. If the price increases sharply, the buyer has made a terrible mistake."[140]

Although the federal government had respectful remarks about Bitcoin, it acknowledges that a currency, by definition, is something the government controls.[141] However, individual users and companies are accepting payment for goods and services in Bitcoin, meaning that even though it is not officially qualified as a currency, it is still functionally operating as a currency.

F. SECURITY

Others argue that Bitcoin should be classified as a security. A security is defined as follows:

> [A]ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided

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138 Busting the Bitcoin Myths, *supra* note 104.

139 Timothy B. Lee, *No, Bitcoin Isn't the Segway of Currencies*, THE WASHINGTON POST (Nov. 22, 2013), http://www.washingtonpost.com/blogs/the-switch/wp/2013/11/22/no-bitcoin-isnt-like-a-segway/.

140 Lavin, *supra* note 123.

141 31 C.F.R. § 1010.100(m) (2014).

> interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[142]

In *Securities and Exchange Commission v. Shavers*, the Eastern District of Texas addressed the issue of whether investments in Bitcoin were securities under Federal Securities Law.[143] In that case, the defendant was the founder and operator of Bitcoin Savings and Trust.[144] The defendant solicited business from people in order to "invest in Bitcoin-related investment opportunities."[145] The defendant advertised that he was in the business of selling Bitcoin to a local group of people and that investors would receive one percent interest daily.[146] The SEC alleged that the defendant made misrepresentations and defrauded the investors.[147]

The defendant argued that the investments he made did not fall under the definition of "securities" "because Bitcoin is not money, and is not part of anything regulated by the United States."[148] Additionally, the defendant argued that all transactions were Bitcoin transactions, that no actual money was ever exchanged.[149]

However, the SEC argues that the defendant's investments were investment contracts and notes, meaning that they did qualify as securities.[150]

The Eastern District of Texas first looked at whether the Defendant's investments were an investment of money:

> It is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as [the defendant] stated, used to pay for individual living

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142 Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2006).
143 *SEC v. Shavers*, No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013).
144 *Id.* at *1.
145 *Id.*
146 *Id.*
147 *Id.*
148 *Id.* at *2.
149 *Id.*
150 *Id.*

> expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan.[151]

The *Shavers* decision held that the defendant's Bitcoin investments are securities.[152]

G. *PROPERTY-CAPITAL ASSET*

As stated in IRS Notice 2014-21, Bitcoin and similar virtual currencies are classified as property.[153] Property seems to be the correct classification because property does not have to be physical, Bitcoin is operating as a store of value[154] and "Bitcoin held by taxpayers for investment purposes rather than as a means to purchase goods or services may meet the definition of capital asset."[155] Property is a carryover category, and anything that is not a liability is qualified as property.[156]

Under the property classification, even Bitcoin miners will be taxed as they provide a service in exchange for property.[157] Under section 83 of the Tax Code,[158] the miners are taxed on the fair market value of the Bitcoin that they receive in exchange for their services in mining. Under this analysis, it is easy to see how burdensome the tax consequences become once they are practically applied to the Bitcoin process.

Some taxpayers have difficulty understanding when they will actually have to pay taxes. Unlike regular cash, a person will not only be paying taxes on the item that they are currently purchasing, but they will have to pay taxes at the time they purchase the item because a taxpayer will owe taxes on the change in value of the Bitcoin. This is a different concept than that with which most people are familiar and a reason why Bitcoin will not catch on as a currency among the masses.

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151 The final sentence of the Court's reasoning states, "[t]herefore, Bitcoin is a currency or form of money, and investors wishing to invest in [the defendant's investment] provided an investment of money." *Id.* at *2. This is an interesting perspective but most likely not controlling. Although the court reasons that Bitcoin are a currency, that is not the focus of the case. The Shavers case holds that Bitcoin are a security. *Id.*

152 Busting the Bitcoin Myths, *supra* note 104.

153 *Id.*

154 Michael Santoli, *Bitcoin's Price Swings Threaten Its Chance of Being a Real Currency*, YAHOO FINANCE (Nov. 19, 2013, 11:43 AM), http://finance.yahoo.com/blogs/daily-ticker/bitcoin-price-swings-threaten-chance-being-real-currency-164359902.html.

155 *Id.*

156 Busting the Bitcoin Myths, *supra* note 104.

157 *Id.*

158 26 I.R.C. § 83 (2004).

H. THE FUTURE OF BITCOIN

Regardless of who is right in the debate about Bitcoin, people and companies are getting involved in the Bitcoin hype:

> Funds are exploring the prospect of investing in virtual currencies and this year alone several funds have been launched with the intention of gaining exposure to [virtual currencies]. For example on July 1, [2013] celebrity entrepreneurs Cameron and Tyler Winklevoss filed a registration statement with the SEC for an exchange-traded fund gaining exposure to the Bitcoin, the most popular form of virtual currency.[159]

As Bitcoin struggles to maintain a stable value, its future value is speculative. Bitcoin will most likely be used as a way to transfer money quickly and efficiently. It might be the future of credit cards. Large amounts of money will not need to take a substantial amount of time; Bitcoin transactions are processed almost instantly. Using Bitcoin, in a matter of minutes, money can circumnavigate the world.

V. CONCLUSION

As the press has recognized, it is an exciting time for Bitcoin and virtual money. The new technology has a lot of people talking about its potential as a currency, store of value, or even as a technology to transfer money.

Bitcoin is a complicated process that has enabled a de-centralized, semi-anonymous store of value to take the world by storm. It has inspired innovation. It created multiple Bitcoin exchanges where billions of dollars are being traded.

It is the monetary experiment of our time. As the black-market allure of Bitcoin fades away, it has come into the homes of regular consumers and investors around the world. The only question that remains is if it is here to stay.

While Bitcoin is still new, its consequences are unknown and undetermined. Many are anxiously waiting to hear whether the IRS will create new rules for the treatment of Bitcoin and other similar virtural currencies. Instead of creating new classifications for Bitcoin, the IRS has the option to treat Bitcoin in the same way it treated barter exchanges and bearer bonds. If the IRS chooses to go that route, Bitcoin will surely

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[159] Mindi Lowy and Miriam Abraham, *Taxation of Virtual Currency*, TAX NOTES TODAY, (Nov. 11, 2014).

fade off of the market, just as barter and bearer bonds did—Bitcoin will lose all of its original appeal.

There should be an official virtual money tax. Future tax laws may draw from a combination of categories in order to fit this quasi-currency-security-property type of virtual currency. Regardless of what tax laws are passed, Bitcoin will lose its luster as a means to evade taxes when it becomes a currency for the masses. It will most likely suffer the same fate as bartering transactions and bearer bonds, which confused users, who consequently under-utilized the devices and dismissed their usefulness.

Export Control Proliferation: The Effects of United States Governmental Export Control Regulations on Small Businesses—Requisite Market Share Loss; A Remodeling Approach

Jared A. Borocz-Cohen*

Made in the USA. This phrase, stamped on the bottom of many domestic items, is becoming increasingly difficult to find abroad. The United States government, of course, regulates almost every good manufactured in America. The obvious federal regulations encompass topics such as, but not limited to, consumer safety, durability, and warranty. However, perhaps the most important of these regulations are those aimed at national security. Federal regulations concerning national security is the junction at which export controls come into play. The central goal of export controls in the United States, and globally, is to promote security. The main issue this raises for businesses–especially smaller manufacturing businesses–is that, in the process of compliance with national security protocols, business productivity may be adversely affected.

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I. INTRODUCTION

The primary task of this Comment is to give an overview of the export control regime that affects most small businesses in the exporting industry. This Comment will highlight some of the most important challenges that small businesses are facing when striving to export those goods deemed "dual-use." The term dual-use encompasses goods that can be used both for civilian and weapons purposes. While this may sound less than sinister for most small business, when delving deeper into the degree of federal regulation employed, the effects thereof can be widespread. Many items that most Americans use every day–such as computers, navigation devices, smartphones, and gaming consoles–are actually regulated by stringent export controls. The task for small businesses that produce items such as microchips, radio devices, computers, and navigation equipment, is one of navigation and expertise.

II. EXPORT CONTROLS IN GENERAL

Whether a shipment requires an export license depends on a multitude of factors: what is the actual item being shipped, where it is going, who is the end-user, and for what purposes will the end-user be utilizing the shipment.[1] The control lists, which will be discussed in the

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1 U.S. DEP'T OF COMMERCE, KNOW THE FACTS BEFORE YOU SHIP: A GUIDE TO EXPORTING LICENSING REQUIREMENTS 2.

proceeding section of this Comment, only encompass the items controlled. The item may, however, be controlled to certain destinations and not others.[2] An item is considered a "controlled" good when it requires a license to export from the United States to a foreign country.[3]

Items shipped to many embargoed countries are controlled, but those same items may be shipped without a license to a range of other, non-embargoed countries.[4] For example, a corporation is required to apply for an export license from the Department of Commerce for goods deemed "EAR99" being shipped to embargoed countries,[5] such as Iran,[6] Cuba[7] and Syria.[8] "EAR99 items generally consist of low-technology[9] consumer goods"[10] that would not normally require a shipping license.[11] Additionally, any materials on the ITAR control list are prohibited from being shipped to multiple other restricted states around the world.[12] Various other items most likely require an export license as well, even for EAR99 goods,[13] as these countries are embargoed countries.

In order to know if an item is controlled, each exporter must know the item's Export Control Classification Number (ECCN).[14] This

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2 *Id.* at 2-3.

3 U.S. DEP'T OF COMMERCE, INTRODUCTION TO COMMERCE DEPARTMENT EXPORT CONTROLS 2.

4 *Id.*

5 *See Commerce Control List*, BUREAU OF INDUS. & SEC., U.S. DEP'T OF COMMERCE, https://www.bis.doc.gov/index.php/regulations/commerce-control-list-ccl (last visited Oct. 1, 2014).

6 31 C.F.R. Part 560.

7 31 C.F.R. part 515.

8 31 C.F.R. part 542; *see also* Jeffery A. Van Detta, *Politics and Legal Regulation in the International Business Environment: An FDI Case Study of Alstom, S.A., in Israel*, 21 U. MIAMI BUS. L. REV. 1, 92 (2013).

9 Low-technology consumer goods consist of general household goods, such as pencils, pens, jewelry, and pharmaceuticals.

10 Kimberly Orr & Betty Lee, *Demystifying Department of Commerce Export Controls for the Biosafety Professional* 14 Applied Biosafety 70 (2009).

11 *Id.*

12 Amendment to the International Traffic in Arms Regulations: Updates to Country Policies, and Other Changes, 76 Fed. Reg. 152 (August 8, 2011) (to be codified at 22 CFR part 126). Other embargoed countries include: Libya, Lebanon, Somalia, Belarus, Sudan, North Korea, Iraq, Yemen, Myanmar (formerly Burma), Liberia, Zimbabwe, Balkans, the Cote D'Ivoire (formerly Ivory Coast).

13 Export Administration Act of 1979, 50 U.S.C. §§ 2401-2420 (2006); *see also Export Controlled or Embargoed Countries, Entities and Persons*, STANFORD UNIVERSITY, DORESEARCH, https://doresearch.stanford.edu/research-scholarship/export-controls/export-controlled-or-embargoed-countries-entities-and-persons (last visited Oct. 6, 2014).

14 U.S. DEP'T OF COMMERCE, *supra* note 1, at 3.

identifier tells the exporter from which shipment destinations the item is prohibited and whether such shipments require a validated license.[15]

It is imperative that each export company understands the regulations in place. A better understanding of each regulation affecting one's business directly translates to a more efficient and competitive business. Large companies seemingly already dominate the export market for electronics and other technology products, which places smaller trade businesses at a disadvantage. Further, export controls add an additional layer of separation in the competition for market share as larger businesses, which designate teams of experts to work on compliance issues, are inherently better equipped to handle these export controls.[16]

In order for small businesses to have a fighting chance in this already barren market, understanding the existing regulations is key. Small businesses must prepare for and adapt their policies and procedures to any new regulations. Such compliance is perhaps their best chance at competing in the market as a better and quicker understanding of these regulations allows for more streamlined exports. This is not to say, however, that the regulations are easily understood and adaptable.

There are a vast amount of regulations on businesses of all sizes that are expensive and unnecessarily burdensome. This Comment strives to highlight the issues with regards to the United States' export control regime, eliminate the cons already in place, and make suggestions for future alterations to the regulatory regime.

III. INTRODUCTION TO EXPORT CONTROLS (U.S.)

The production of hazardous materials for both civilian and military purposes has led the United States government to establish its own list of controls–for example the Department of Commerce's Implementation of the Wassenaar plenary agreements[17]–in order to curb the proliferation of potentially risky materials falling into the wrong hands,[18] a relatively new concern in this age of international terrorism. Following the devastating attacks of September 11, 2011 on domestic soil, the U.S. Department of Commerce, Bureau of Industry and Security significantly

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15 *Id.*

16 COAL. FOR SEC. & COMPETITIVENESS, RECOMMENDATIONS FOR A 21ST CENTURY TECHNOLOGY CONTROL REGIME (2010).

17 Department of Commerce, Wassenaar Arrangement 2013 Plenary Agreements Implementation: Commerce List, Definitions, and Reports; and Extension of Fly-by-Wire Technology and Software Controls, 79 Fed. Reg. 149 (August 4, 2014) (to be codified at 15 C.F.R. 734).

18 *Regulations*, BUREAU OF INDUS. & SEC., U.S. DEP'T OF COMMERCE, http://www.bis.doc.gov/index.php/regulations (last visited Oct. 1, 2014).

revamped its export control regime. The sections that were subsequently revamped apply to export licensing, control lists, brokering regimes, and sanctions.[19]

Currently, the United States government has three primary licensing departments with subsidiary agencies that work with companies exporting potentially sensitive armaments and dual-use items and technology outside of the U.S. borders: the Departments of Commerce, State, and Treasury.[20] The involvement of so many government entities can prove overwhelming and confusing for small businesses trying to export their goods. As a result, the U.S. government is pursuing alternative means to achieve a more streamlined and liberalized process of licensing, pushing for a Single Licensing Agency, which would act as a "one-stop shop" for businesses pursuing export licenses.[21] Further, the U.S. government strives to achieve these goals through: enforcement, coordination, and end-use agreements.[22]

A. Regulations

The problematic issue for small business lies in the vast amount of U.S. export control legislation and governing authorities.[23] The main law governing export controls is the Arms Export Control Act (AECA),[24] which set forth the International Traffic in Arms Regulations (ITAR) that have been implemented by the Department of State[25] The AECA deals primarily with defense-related goods. Thus, any business desiring the

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19 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-234, DEFENSE TRADE: ARMS EXPORT CONTROL SYSTEM IN THE POST-9/11 ENVIRONMENT (2005) (Report to the Chairman, Committee on International relations, House of Representatives) [hereinafter U.S. GAO].

20 *Overview of U.S. Export Control System*, U.S. DEP'T OF STATE, http://www.state.gov /strategictrade/overview/ (last visited Oct. 1, 2014) [hereinafter *U.S. Export Control*].

21 *Id.*

22 The U.S. government bases its export control regime on four outlying principles. First, the U.S. government has a broad national commitment to the regime. The U.S. follows each multilateral export control regime to the letter by incorporating each and every controlled item on those lists into the US list, and even adds more of its own regulations for added security. Second, the U.S. establishes authority to control dual-use goods through: comprehensive controls, enforcement, directives, and interagency coordination. Third, it establishes clear modes of authority and a control list. Fourth, the U.S. government focuses on preventative enforcement such as: end-use agreements, screening, and educating the market. *See Overview of U.S. Export Control System*, U.S. DEP'T OF STATE, http://www.state.gov/strategictrade/overview/ (last visited Oct. 1, 2014) [hereinafter *U.S. Export Control*].

23 *See infra* Section IV.

24 Arms Export Control Act, 22 U.S.C. § 2780(d) (2013).

25 *Id*.

manufacture and exportation of goods used for defense purposes will have to meet the Act's strict licensing criteria.[26]

Many small businesses are also affected by the Export Administration Act of 1979 ("EAA"),[27] which established the Export Administration Regulations (EAR) coordinated by the Department of Commerce.[28] This Act controls software and other technology related dual-use items. The Treasury, mentioned briefly here for completeness but not in the scope of this Comment, deals mainly with sanctions relating to embargoed countries and fines for violations of export controls.[29]

B. Control Lists

The U.S. government implements all of the multilateral export control regime regulations,[30] in addition to various unilateral measures for state security in the form of three main control lists. First, the Commerce Control List (CCL)[31] includes each item on the Wassenaar Arrangement Dual-Use List,[32] all items on the other three control lists, and then also various additional items that the United States deems as security risks.[33] The CCL is organized numerically, with each number, 0-9, corresponding to a different area of product control.[34] The larger the number, the more controlled the substance[35]

The other two control lists are the U.S. Munitions List[36] and the Nuclear Regulatory Commission Controls.[37] Because these lists affect a smaller portion of the businesses discussed previously, this Comment will mainly focus on the previous lists, primarily the CCL.

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26 *Id*.

27 Export Administration Act of 1979, Pub. L. No. 96-72, § 50 U.S.C. App. 2403(e).

28 *Id*.

29 U.S. DEP'T OF COMMERCE, *supra* note 1, at 2-3.

30 Amendment to the International Traffic in Arms Regulations: Updates to Country Policies, and Other Changes, 76 Fed. Reg. 152 (August 8, 2011) (to be codified at 22 CFR part 126).

31 *Commerce Control List*, BUREAU OF INDUS. & SEC., U.S. DEP'T OF COMMERCE, https://www.bis.doc.gov/index.php/regulations/commerce-control-list-ccl (last visited Oct. 1, 2014).

32 *See infra* Section IV.

33 *Wassenaar Arrangement Introduction*, WASSENAAR ARRANGEMENT, http://www.wassenaar.org/introduction/index.html (last visited Oct. 1, 2014).

34 *Id.*; *see infra* Figure I.

35 *Wassenaar Arrangement Introduction*, *supra* note 33.

36 United States Munitions List, 22 CFR Ch. 1 (4-1-13 Edition).

37 Nuclear Regulatory Commission, 10 CFR 37; *Security Orders and Requirements*, U.S. NRC, http://www.nrc.gov/security/byproduct/orders.html (last visited Oct. 1, 2014).

C. Licensing

Companies desiring to export any item on the aforementioned lists must submit a license request with the qualifying agency. These license requests may ultimately be reviewed by five different agencies.[38] The process to determine whether to approve a license includes a review of the applicant, all parties to the transaction, and quantity and quality of export, including end-use agreements, national security concerns, and international concerns.[39] These government entities receive a vast amount of licensing requests, with the Office of Defense Trade Controls and the Department of Commerce receiving some 55,000 and 12,000, respectively, per year.[40]

IV. Introduction to Multilateral Export Control Regime

Multilateral Export Control Regimes (MECR) are international bodies that govern the export and licensing of potentially high risk and hazardous materials.[41] While there are various types export control regimes, such as those for hazardous waste, there are four particular international regimes, governing the export of controlled materials, equipment, and technology for defense-related purposes, which are applicable herein: the Nuclear Suppliers Group, the Australia Group, the Missile Technology Control Regime, and the Wassenaar Arrangement.[42]

a. The **Nuclear Suppliers Group** (NSG) is a multinational body consisting of 49 member states that controls the export of nuclear related technology.[43]

b. The **Australia Group** (AG) is an informal collection of 42 member states that controls the export of chemical and biological technology that has the potential to be weaponized.[44]

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38 *U.S. Export Control*, *supra* note 20.

39 *Id.*

40 *Id.*

41 *See Multilateral Export Control Regimes*, BUREAU OF INDUS. & SEC., U.S. DEP'T OF COMMERCE, http://www.bis.doc.gov/index.php/policy-guidance/multilateral-export-control-regimes (last visited Oct. 1, 2014).

42 *See id.*

43 *Organisation*, NUCLEAR SUPPLIERS GROUP, http://www.nuclearsuppliersgroup.org/en/organisation-information (last visited Oct. 1, 2014).

44 THE AUSTRALIA GROUP, http://www.australiagroup.net/en/index.html (last visited Oct. 1, 2014).

c. The **Missile Technology Control Regime** is likewise an informal collection of states that seeks to control rockets and other aerial vehicles capable of delivering weapons of mass destruction.[45]

d. The **Wassenaar Arrangement** (WA) is a MECR consisting of 41 participating states designed to control the exportation of various dual-use goods and technologies.[46] This MECR will be the focus of this article, detailing the actual controlled items, and the effect on businesses with regards to exporting the respective item. (The WA is the crux of this Comment's purpose).

V. WASSENAAR AND DUAL-USE GOODS

The ultimate goal of the WA is "to contribute to regional and international security and stability, by promoting transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies, thus preventing destabilizing accumulations."[47] The WA's primary purpose is to establish a control list for recommendation to all countries around the world.[48]

A. Control List

The WA list of restricted items is broken into two categories: Dual-Use Goods and Technologies (Basic List), and the Munitions List.[49] This Comment does not concern the latter, focusing instead on the list of Dual-Use Goods and Technologies. The Basic List, which is nearly identical to the control list espoused by the U.S. government,[50] comprises of ten categories of goods, organized in increasing levels of sophistication.

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45 *The Missile Technology Control Regimes at a Glance*, ARMS CONTROL ASS'N, http://www.armscontrol.org/factsheets/mtcr (last updated Dec. 2012).
46 *Wassenaar Arrangement Introduction*, WASSENAAR ARRANGEMENT, http://www.wassenaar.org/introduction/index.html (last visited Oct. 1, 2014).
47 *Id.*
48 *Id*.
49 *Control Lists – Current*, WASSENAAR ARRANGEMENT, http://www.wassenaar.org/controllists/index.html (last visited Oct. 1, 2014) [hereinafter *Wassenaar Arrangement Control Lists*].
50 *See infra* Figure 1.

Figure I: Dual-Use Goods and Technologies[51]

Category 0	Special Materials and Related Equipment
Category 1	Materials Processing
Category 2	Electronics
Category 3	Computers
Category 4	Part 1 – Telecommunications
Category 5	Part 2 – “Information Security”
Category 6	Sensors and “Lasers”
Category 7	Navigation and Avionics
Category 8	Marine
Category 9	Aerospace and Propulsion

VI. INTERACTION OF DUAL-USE GOODS AND SMALL BUSINESS

The main issue that most small businesses face is one of understanding exactly which shipped items are covered by federal regulation. Small businesses in this field frequently lack the expertise necessary to thrive due to the pervasiveness of burdensome regulations and [52] control lists.[53] Due to governmental administrative inefficiencies, this Comment believes it logically follows that many companies have difficulties ascertaining which federal agency is regulating a certain product.[54] As a result of the vast overlap in dual-use and defense-related goods, many items may be subject to either ITAR or EAR,[55] depending on the item’s classification.[56] Examples of issues that have been subject to overlapping control include: public domain, defense services, fundamental research and technical data definitions.[57]

A. Navigation Issues

As these lists are not streamlined, navigating them requires extreme specificity and knowledge of each individual product, down to its

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51 *Id*.
52 NATIONAL SMALL BUSINESS ASSOCIATION, 2013 SMALL BUSINESS EXPORTING SURVEY 3 (2013).
53 *See* 15 C.F.R. § 730.3 (2012) (stating that EAR is applicable to “dual-use” items); 22 C.F.R. § 120.1 (2011) (showing that ITAR is applicable to defense services and articles).
54 *Consent Agreements*, U.S. DEP’T OF STATE, http://www.pmddtc.state.gov/compliance/consent_agreements.html (last updated June 18, 2014).
55 Items may include technical data, diagrams, models, and engineering designs.
56 15 C.F.R. § 730.3.
57 DIRECTORATE OF DEFENSE TRADE CONTROLS, NOV. 2012 PRIORITIES LIST, *available at* http://pmddtc.state.gov/dtag/documents/plenary_Nov2012_Priorities.pdf.

component makeup.[58] Many companies need to submit queries into exactly what components are regulated by which departments, and often are subjected to a significant time waiting period simply receive an answer—not to mention the wait period for being approved for the particular license.[59] With various agencies taking on the decision-making role and, sometimes representing competing interests, the tribulations for small businesses are quite clear.[60]

These issues are further underscored when looking at the myriad of departments that regulate goods: Departments of Defense, State, Commerce, Homeland Security, the Treasury, Energy, and Justice. Coordination among these departments is lackluster to say the least.[61]

B. Multi-Agency Interaction Delays

The setbacks for small businesses are even more evident when comparing the interactions between the two main regulatory agencies, the Department of State, for weapons-related material[62], and the Department of Commerce, for dual-use items.[63] In most instances, the Commerce list is much less restrictive than the list produced by State.[64] Thus, determining which items are controlled by each list is a fundamental concern for companies in the business of exporting. However, the departments have disagreed in the past, sometimes claiming jurisdiction of identical items.[65]

This Comment posits that a competing business can seemingly choose which system to apply to–the State list or the Commerce list—based on which is the less restrictive list.[66] Herein lies the problem.[67] Small businesses with less experienced export track records will invariably be disadvantaged to the larger businesses that can exploit these systemic flaws—thus creating an uneven playing field for the small business producers.

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58 *Id*.

59 U.S. GAO, *supra* note 19, at 2.

60 *Id.*

61 *Id.* at 31.

62 *Id*. at 32.

63 *Id*. at 36.

64 *Id.* at 37.

65 *Export Control List Review and Creating A Single Control List*, EXPORT.GOV, http://export.gov/ecr/eg_main_027617.asp, (Last visited on Oct. 6, 2014).

66 Businesses can, in essence, chose the department that reviews their lists by submitting a request to the department or agency it wishes to use—this only applies when there is overlap in agency or department licensing.

67 *Id*.

Licensing is another issue borne of these multi-agency and inter-agency deficiencies.[68] Licenses, prior to 2003, were usually granted within 13 days. As of 2006, the licensing time had doubled; pushing a 26-day turn-around.[69] These extra two weeks could easily cost businesses valuable opportunities as competitive businesses position their goods to be rapidly shipped across the global daily. Continuing in this vein, the turnaround time listed above does not even take into account backlogs in each department's review process.[70] In Fiscal Year 2006, the backlog of State Department license applications reached a peak of 10,000 cases.[71]

C. New Changes as of October 15th, 2013

On October 15th, 2013, the U.S. government began implementing new regulations and reforms on the export control arena that even further undermined business productivity.[72] The U.S. government has begun to incorporate the new 600-series export control classification lists,[73],which are designed to distinguish those items that are "critical to maintaining a military or intelligence advantage to the United States" (i.e., military items) and those that necessitate a more flexible control program.[74] The

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[68] *Id*.

[69] U.S. GAO, *supra* note 19, at 2.

[70] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-767T, EXPORT CONTROLS: FUNDAMENTAL REEXAMINATION OF SYSTEM IS NEEDED TO HELP PROTECT CRITICAL TECHNOLOGIES: TESTIMONY BEFORE THE SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS, COMM. ON ENERGY AND COMMERCE, HOUSE OF REPRESENTATIVES, STATEMENT OF ANNE-MARIE LASOWSKI, DIRECTOR ACQUISITION AND SOURCING MANAGEMENT 2-3 (2009); *see also* Nadine Tushe, *Export Controls: Do They Undermine the Competitiveness of U.S. Companies in the Transatlantic Defense Market*, 41 PUB. CONT. L.J. 57, 62 (2011).

[71] *Id.*

[72] CCL Based Controls, National Security 15 C.F.R. §742.4(b)(ii)(2014); *see also* Export Control Reform—New Order of Review and the "600 Series," BIS.GOV, *available at* http://www.bis.doc.gov/index.php/forms-documents/doc_view/789-600-series-and-ccl-order-of-review; Nicholas A. Rosenberg, *The 600 Series: As part of Export Control Reform, the U.S. government shifts former Munitions List items to a new category on the Commerce Control List*, Nixon Peabody, http://www.nixonpeabody.com/US_government_shifts_former_Munitions_List_items.

[73] *Id*.

[74] Eric L. Hirschorn, Remarks of Under Secretary Eric L. Hirschorn at the Export Control Reform Workshop, Colorado Springs, CO, Bureau of Industry and Security, U.S. Dep't of Commerce (May 19, 2014); *see also* Lindsay A. Meyer et al., *United States: October 15th Export Control Reform Changes Are Around the Corner: Take Time Now To Understand The Impact On Your Existing Licenses & Authorizations*, Mondaq (Dec. 5, 2013), http://www.mondaq.com/unitedstates/x/262702/Export+controls+Trade+Investment+Sanctions/October+15th+Export+Control+Reform+Changes+Are+Around+the+Corner+Take+Time+Now+To+Understand+The+Impact+On+Your+Existing+Licenses+Authorizations.

program claims its main goal is to facilitate and encourage exports to U.S. allies.[75] This Comment views these regulations as a double-edged sword, trying to help, but possibly hindering, the smaller and less-savvy exporters.

The new 600-series has altered the makeup of the existing control lists by transferring many items covered by ITAR and the Defense Department to the CLL, under the jurisdiction of the Department of Commerce.[76] As aforementioned, the Commerce list is less restrictive. Thus, these recent regulations can aid businesses that export the transferred goods.

The main issue for small-businesses, however, is implementation and industry understanding of the necessary license.[77] With these new regulations taking effect only months ago, businesses will still be applying for licenses under ITAR. The Defense Department must then return this request, forcing resubmission through Commerce—wasting time and valuable expenses on the company's part.[78] One saving grace of these regulations, however, allows for the existing license, within two years of the series' implementation, to be carried out until its expiration for the requisite department.[79]

1. Subparagraph Provisions

The new regulations do not stop with the item transfers. One of the most important features of the new 600-series is the subparagraph provision, designed to alter the replaced regulations,[80] which basically brought certain items under the control of ITAR.[81] Presently, the new rules designate a "catch and release" provision which, according to the series' creators, was adopted because the agencies found that it would be easier to explain what the term *did not* or *should not* encompass as opposed to what it actually includes.[82] Businesses must thus examine and possibly reclassify certain exports to match this definition.[83]

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[75] Hirschorn, *supra* note 74.

[76] CCL Based Controls, *supra* note 72; *see e.g.*, Airworthiness Directives; Airbus Airplanes, 78 Fed. Reg. 22431, 22432 (April 16, 2013) (to be codified at 14 CFR Part 39).

[77] Meyer, *supra* note 74.

[78] Export Control Reform, *supra* note 72.

[79] U.S. DEPT. OF COMMERCE, BUREAU OF INDUSTRY AND SECURITY, EXPORT CONTROL REFORM—NEW ORDER OF REVIEW AND THE "600 SERIES," http://www.bis.doc.gov/index.php/forms-documents/doc_view/789-600-series-and-ccl-order-of-review.

[80] *Id*.

[81] *Id*.

[82] *Id*.; Meyer, *supra* note 74.

[83] *Id*.

The new program creates a catch and release program, with subparagraph "A" catching multiple goods, but subparagraph "B" releasing these goods.[84] Understanding these new provisions and classifying goods accordingly is a very important task for exporters. The problem with the catch and release program for small businesses lies in the ability to understand these new rules and designate the goods accordingly. This is a major step in becoming competitively viable in the larger export market. As of now, while the smaller businesses try to incorporate and understand the new provisions, larger, more sophisticated businesses may leave the smaller ones in the dust.

2. Benefits

This is not to say, however, that the new regulations are completely detrimental to small business owners. There are many benefits to such individuals of the new regulations, which should inform the existing regulations on export controls. If the present regulations could incorporate the positive features of these new 600-series regulations, the result would be a more streamlined and user-friendly approach for small businesses.

First, the migration feature permits goods that were previously controlled by ITAR and now controlled by CCL, to operate under a single license requirement[85] by amending the existing rules to eliminate the need for multiple licenses.[86]

Second, the new provisions also aid companies desiring to concurrently ship multiple items that are controlled by different departments.[87] The company must simply apply for licenses for all of the goods to the requisite agency.[88] For example, if a company needs to ship items controlled by both ITAR and CCL, they may ship both goods together under one license.

VII. OVERLAP ANALYSIS (DUAL-USE AND SMALL BUSINESS)

The interaction between dual-use regulations and business competitiveness seem to have become increasingly interwoven in recent

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[84] *Id.*; *see also Skadden*, *Export Control Reform Initiative: The Obama Administration Proposes New Transition Rules For Companies Affected By Recently-Proposed Changes to the Current Export Control System*, (Dec. 5, 2013), http://www.skadden.com /newsletters/Export_Control_Reform_Initiative.pdf.

[85] CCL Based Controls 15 C.F.R. § 742.1(f)(20140); Meyer, *supra* note 74.

[86] *Id*.

[87] *Id*.

[88] *Id*.

decades. Businesses are frequently at the mercy of the licensing departments when waiting for licenses to be processed.[89] Many domestic businesses lament that these regulations hinder their competitive advantages in the global market.[90] For example, K & F Electronics, a small circuit board producer based out of Detroit, had professed a serious loss of profits due to confusion in the licensing market.[91] It has seen multiple requests for identical items rejected at times and at other times granted.[92] The uneven application of controls is clearly hurting small businesses like K & F, which also expressed difficultly in identifying which parts of its circuits require which licenses—Commerce or State.[93] Further, because of the fact that circuit boards may actually be regulated by the State Department, K & F must obtain explicit authorization to export products falling under ITAR.[94] Considering identical items have been stamped ITAR and non-ITAR upon license request, the problems confounding small businesses alike are evident.[95]

A. U.S. Market Share Issues

Many foreign companies actually avoid U.S. companies when searching for products due to the increasingly strict export regulations.[96] One such domestic company described issues with French and British customers, stating that those customers "will always buy a non-U.S. sourced part even for substantially more money to avoid [the] EAR and especially ITAR."[97] Some multinational companies, most notably Thales Alenia Space,[98] have also adopted this buying philosophy by adopting an "ITAR-Free" unofficial trade practice.[99]

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[89] Jason Harrison, *For Small Exporters, Security-Related Regulations Can Be A Thicket*, THE WASHINGTON POST (Jan. 4, 2013), *available at* http://www.washingtonpost.com/business/for-small-exporters-security-related-regulations-can-be-a-thicket/2013/01/04/f9eedf34-5448-11e2-a613-ec8d394535c6_story.html.

[90] *Id.*

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *Id.*; *see also* 15 C.F.R. § 734.2(b)(2)(ii) (2009).

[95] Items stamped ITAR or non-ITAR refers to goods that have been designated to be controlled by the ITAR list or similarly, not on the ITAR list.

[96] Tushe, *supra* note 70, at 69.

[97] Nadine Tushe, *Export Controls: Do They Undermine the Competitiveness of U.S. Companies in the Transatlantic Defense Market*, 41 PUB. CONT. L.J. 57, 70 (2011).

[98] Peter Selding, Thales Athenia Space: U.S. Suppliers at Fault in "ITAR-free" Misnomer, SPACENEWS, http://www.spacenews.com/article/military-space/36706thales-alenia-space-us-suppliers-at-fault-in-%E2%80%9Citar-free%E2%80%9D-misnomer, (last visited October 28, 2014).

[99] U.S. GAO, *supra* note 19; *see also* JEFFERY P. BIALOS ET AL., FORTRESSES AND ICEBERGS: THE EVOLUTION OF THE TRANSATLANTIC DEFENSE MARKET AND THE

Further, in a 2006 accompanying report to a UK survey to evaluate British-based companies' attitudes towards controlled American electronics and technologies, British companies were found to be increasingly adopting "an unofficial and unstated 'Buy American Last' policy due to unsatisfactory experiences with U.S. export control bureaucracy."[100]

American-based companies are clearly suffering a competitive disadvantage as a result of these issues. Larger American businesses are able to traverse these issues by purchasing products on a larger scale,[101] which can be more appealing to foreign customers as only one license must be procured for the same product, thusly offsetting the underlying export control disadvantages.[102]. Further, these larger companies' expertise in the field also aids in their global dominance and sales.[103]

Smaller companies, however, are unable to compete with their larger counterparts' ability to lower prices by mass production. In the end, however, the export and technology industry will suffer as such lower-tier companies are often the "source of much innovation [and are] normally the most engaged in the global market place in the aerospace/defense sector."[104]

B. Competitive Market Loss

The problem highlighted above is compounded by the fact that these countries can find the goods elsewhere with little export control hassle.[105] Even if U.S. exporters have the ability and requisite licenses to ship items abroad, the time and hassle of waiting for an export license may drive many buyers to seek alternative sources, with much fewer limitations on the exact items.[106]

IMPLICATIONS FOR U.S. NATIONAL SECURITY POLICY 693 (2009) (citing the GAO's criticism of the system for over a decade and the existence of over 60 reports by private and government groups on export controls from 1997 to 2007).

100 Response of Brinley Salzmann to Request for Public Comments on the Effects of Export Controls on Decisions to Use or Not Use U.S.-Origin Parts and Components in Commercial Products and the Effects of Such Decisions, 74 Fed. Reg. 263, 263-264 (Jan. 5, 2009), *available at* http:// efoia.bis.doc.gov/pubcomm/records-of-comments/record_of_comments_index_for_ design_out_of_us_controlled_parts.pdf.

101 Bialos, *supra* note 99.

102 *Id*.

103 COAL. FOR SEC. & COMPETITIVENESS, *supra* note 16.

104 Ctr. For Strategic & Int'l Studies, Briefing of the Working Group on the Health of the U.S. Space Industrial Base and the Impact of Export Controls 10 (2008).

105 *See* IAN F. FERGUSSON, CONG. RESEARCH SERV., CRS-2, THE EXPORT ADMINISTRATION ACT: EVOLUTION, PROVISIONS, AND DEBATE (2003).

106 U.S. GAO, *supra* note 19, at 2.

This idea is illustrated by a recent market loss example in which a U.S. company lost business and market share as a result to unnecessary export controls.[107] The shipment of krypton electric switches (used by doctors to breakup kidney stones, but also listed as dual-use on the CCL because the part can be used as a component of a nuclear launcher) is prohibited for sale in varying countries in the Middle East, including Iraq.[108] Siemens Corporation, a German company, filled in the gaps and provided these goods to various Iraqi hospitals.[109]

This Comment proposes that it may seem troublesome to many Americans to sell anything to Iraq, let alone items capable of aiding in the development of a nuclear launcher considering the instability of the region. But, taking a step back, it becomes clear that these regulations do not harm the targeted countries but rather the U.S. companies who might otherwise export goods to sanctioned nations. Germany, a leading power in the international economic market, seemingly does think the dangers outweigh the benefits with regards to shipping such goods to Iraq; France has equally engaged in this balancing test and deemed it appropriate to shipping like goods to Iraq.[110] In fact, following the U.S.'s successful toppling of Saddam Hussein's regime in Iraq, American forces found a multitude of goods, restricted for sale on the U.S. control list, in Iraq that were supplied by German and French companies in compliance with European export control laws.[111]

These hospitals had valid licenses and end-user agreements[112]; however, because of over-inclusive U.S. export controls that precluded American firms from conducting business with these hospitals, U.S. companies lost business opportunities and, more importantly, global market share. It may seem that with an increased proliferation of such materials, the likelihood of said materials falling into the wrong hands increases. However, what stops German or French companies from simply sending more of these items? What stops German companies from producing a few extra switches a year that might otherwise be supplied by American companies, if the U.S.'s stringent export controls were to be loosened? The threat of proliferation already exists as a result of the actions taken by other companies. Hence, concerning items that

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107 William Safire, Op-Ed., *Selling Our Secrets*, N.Y. TIMES, Sept. 30, 2002, at A6.

108 *Id*.

109 *Id.* at A25. This Comment has not discussed, for the sake of brevity, the idea of whether any other country lists the specific part as controlled.

110 Nathan T.H. Lloyd, Note, *Rebuilding a Broken Regime: Restructuring the Export Administration Act*, 37 VAND. J. TRANSNAT'L L. 299, 305 (2004).

111 *Id.*

112 *Id*.

are less than sinister, these unwieldy regulations on domestic firms necessitate change.

The Secretary of State is permitted to make a discretionary decision to approve all licenses for good that meet licensing requirements[113] where he or she can determine that an export control is ineffective due to the availability of the same item in non-U.S. markets.[114] Additionally, the Secretary may remove the items from the CLL if he or she deems it to be the appropriate action.[115]

It seems, at least intuitively, to be a perfect and foolproof system. If the United States sees other goods being exported by foreign companies in compliance with the host country's requisite export laws, then the U.S. should not fear exporting those items as, theoretically, such controlled items are already available in the world market. It logically follows that these items—controlled, of course, by the WAWA–are relatively safe for exportation,[116],and may be consequentially removed from the export control list. Therefore, any item that remains on the U.S. control list is deemed hazardous and not exported by any other countries.[117] This premise, in theory, seems ideal. The logical question that follows, however, is what is the point of the U.S. having a CCL or a regulatory list of its own at all? Why not just use the Wassenaar List in its entirety?

The "ideal" scenario presented above is far from present in the U.S. control regime. There are numerous specifications on the U.S. control lists not on the Wassenaar List, and thus not on many of the leading exporting countries' lists, either.[118] The U.S. prohibits exports of controlled items to certain countries altogether, regardless of export licenses.[119] This demonstrates that the U.S. export controls are vastly over-inclusive: these regulations encompass any variety of items that are either not controlled or are nominally controlled by a multitude of countries, and hampers the sale of those items abroad. In the end, U.S. small businesses are at the losing end of the over-inclusive regulations—losing market share and profits in the process.

A simple solution to this problem lies in cooperative information sharing and licensing procedures. U.S. companies ought to be allowed to submit requests proving that certain items are uncontrolled by various other countries around the world. The Secretary of State should then respond by having the State Department obtain agreement within a short

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113 Export Administration Act of 1979, 50 U.S.C. §§ 2401-2420(4)(e) (2006).
114 *Id.*
115 *Id.*
116 *Wassenaar Arrangement Control Lists*, *supra* note 49.
117 *Id.*
118 *Commerce Control List*, *supra* note 5.
119 *Id.*

period from the other countries to control the items they are exporting to countries of concern, by removing the item from the CCL, or by creating a special licensing system for these items that is much easier than the normal export license system.

C. ITAR Control Effects

In conjunction with the varying degrees of difficulty that the CCL poses for small businesses desiring to export abroad, ITAR poses an even stronger limitation, sometimes tying up business for months at a time.[120] Once again, the United States is in the minority when it comes to munitions and governmental use controls.[121]

Unlike nearly every other nation, the U.S. imposes a requirement that it approve re-exports of U.S.-origin items.[122] This re-export regulation restricts the sale of ITAR-restricted goods, even after they leave the United States.[123] Most countries implement export protocols that place the onus on the recipient country to control the item once the item has been shipped.[124] In this situation, the United States finds itself, once again, in the minority because ITAR and the U.S. government requires these controlled goods to be under U.S. jurisdiction for the lifetime of any good—termed post-shipment verification.[125] This requirement applies to shipments or re-exports of the item from the recipient country to another and even in-country shipments.[126]

Every time the owner of an American-exported good seeks to move that good across another country's border, he or she must first seek permission from the U.S. Department of State.[127] This regulation can be extremely cumbersome for purchasers who desire to re-export or transfer the product to another destination, as many companies' business model revolves around middle-man type work.

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[120] Export Control Reform, *supra* note 72.

[121] *Id.*; *see also Howard* Loewen, *ITAR Export Control Laws: What Every UAV Member Needs to Know About USML Products and ITAR Regulations*, MicroPilot (Jan. 21, 2014), http://www.micropilot.com/pdf/itar-export-control-laws.pdf.

[122] *Deemed Reexport Guidance*, BUREAU OF INDUSTRY AND SECURITY, http://www.bis.doc.gov/index.php/policy-guidance/deemed-exports/deemed-reexport-guidance (last visited October 27, 2014).

[123] Proliferation of Chemical and Biological Weapons, 15 C.F.R § 742.1(b) (2014).

[124] Report to Senator Jon Kyl, U.S. Senate, *Export Controls Post-Shipment Verification Provides Limited Assurance That Dual-Use Items Are Being Properly Used*, UNITED STATES GENERAL ACCOUNTING OFFICE, *available at* http://www.gao.gov/new.items /d04357.pdf.

[125] *Id*.

[126] *Id*.

[127] *Id*.

The problem is self-evident. Even if a foreign company decides to wait for the lengthy process of U.S. export licensing, it still must comply with various U.S. controls. Every time it desires to sell this product, it must apply for a re-transport license from the U.S. government and inform its future purchaser that it, too, must apply for a license, if he or she wished to resell the item.[128] Rhetorically, with various simpler alternatives at their fingertips, why on earth would a consumer buy a U.S. ITAR-controlled good? Here? Here, small businesses once again lose valuable market share and business profits abroad as a direct result of cumbersome U.S. regulations.

Equally problematic for U.S. businesses with ITAR-controlled goods is the temporal factor. The time it takes[129] to apply for an ITAR-controlled good is vastly more than that of a CCL-controlled good.[130] Similarly, many goods may be simply placed on the ITAR-controlled list because one of the company's customers happens to be the U.S. government.[131] Anytime the U.S. government is a customer of an item, that particular item must be controlled by ITAR.[132] Companies may lobby to remove their goods from ITAR, but the process can take months.[133] Compounded with the inter-agency problems described above, ITAR classifications pose serious financial problems for small businesses exporting abroad.[134]

D. Green Technology Challenges

Alarmingly, another industry that may be harmed by the proliferation of export controls in the United States is that of green technology.[135] Green technology, which has become an emerging and fast growing industry in recent decades, aids countries in the fight against the harmful effects of carbon emissions and global climate change.[136]

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128 *Id*.

129 See *infra* p.13 and note 68.

130 DEPARTMENT OF HOMELAND SECURITY, *Telecon Recap: Export Controls Requirements on Form I-129: A Conversation with the Commerce Department* (last visited Oct. 13, 2014).

131 Arms Export Control Act, Pub. L. 90-629, 90 Stat. 744; *see also* Howard Loewen, *supra* note 122.

132 Arms Export Control Act, *supra* note 132.

133 *Id*.

134 U.S. GAO, *supra* note 19.

135 JENNIFER WATTS & KYLE BAGIN, BUREAU OF INDUS. & SEC., CRITICAL TECHNOLOGY ASSESSMENT: IMPACT OF U.S. EXPORT CONTROLS ON GREEN TECHNOLOGY ITEMS 1 (2010).

136 Jim Norman, *Where There's Never an Oil Shortage*, N.Y. TIMES, May 13, 2007, at J6.

Of the total U.S. exports ($1,300.5 billion) in 2008, 5.8 percent ($75 billion) were green related technologies, and only 0.9 percent ($697.4 million) of these required an export license.[137] The final calculated percentage of total exports represented by licensed green technologies may be nominal (0.05 percent) but this figure constituted 22.5 percent of total licensed exports.[138] These figures demonstrate how regulated green technologies actually are—representing a hair more than one-twentieth of *total* exports but well over a fifth of total *licensed* exports.

Many items used for alternative and green technology require export licenses such as: wind turbines, solar panels, alternative fuel resources for alternatively fueled vehicles, water purification devices, and energy efficiency devices.[139]

What does the above say for small businesses trying to compete in the green technology market? Many businesses are hindered by the vast amount of U.S. export controls on these types of technologies. At the same time, while these businesses are filing for export licenses–especially for ITAR-controlled products categorized as such because of existing governmental contracts for those goods or simply inter-agency administrative hurdles–they are losing out to their foreign counterparts, who are supplying the same products without the hassle of export or re-export licensing procedures.

E. Sanctions

There are three main government entities that focus on the enforcement of U.S. government export controls, including: Directorate of Defense Trade Controls (DDTC), Bureau of Industry and Security (BIS), and the Department of Treasury.[140] The Department of Homeland Security via Customs and Border Protection, and the Coast Guard, also play a large role in the enforcement of export controls by screening processes regarding containers and other modes cross-border shipment.[141] Starting in 2007, the U.S. government drastically increased its civil penalties for export control violations by 500% on corporations and individuals, from $50,000 to an astounding $250,000.[142]

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137 WATTS & BAGIN, *supra* note 136, at 5.

138 *Id.*

139 *Id.* at 6.

140 The Research Foundation for the State University of New York, *Export Control Penalties and Sanctions*, SUNY RF (Dec. 5, 2013), https://portal.rfsuny.org/portal/page/portal/The%20Research%20Foundation%20of%20SUNY/home/export_controls/Export%20Control%20Penalties.

141 *Id*.

142 International Emergency Economic Powers (IEEPA) of 2007, PUB. L. NO. 110-96, 121 STAT. 1011; *see* Jamie A. Joiner & Mark C. Joye, *Complying with U.S. Export*

This Comment contends that the most staggering change is that these penalties may be applied retroactively to incidents that occurred before 2007.[143] Some of the more notable sanctions and penalties include: $680,000 against Cabela's Sporting Goods for shipping rifle scopes in violation of EAR regulations, $4 million against Lockheed Martin for exporting technical data relating to missile defense, and $3 million against Boeing for administrative violations.[144] It can be argued that for a company like Lockheed, which realized 2012 net sales of over $47 billion, this penalty is a drop in the bucket.[145] However, this again highlights the main issues affecting small companies while larger companies, benefitted also by the ability to better understand the licensing process, are also much better financially positioned to handle any potential sanctions or penalties. The effects on small businesses could be drastic considering the monetary compensation that these companies were required to pay.

F. The Cold Hard Facts

In a 2013 comprehensive survey by the National Small Business Association,[146] a large majority of the 500 businesses surveyed can truly be deemed as small businesses: fifty-two percent of respondents employed nine employees or fewer and seventy percent reported spending less than $500,000 on payroll each fiscal year.[147] Further, forty-six percent of the businesses claimed the main barrier to entry to export goods arises in that they "don't know much about it and [are] not sure where to start,"[148] which logically follows from the fact that fifty-four percent of respondents have been exporting for ten or fewer years.

The most telling numbers, however, were on the import fronts. The survey clearly showed that the largest impediments to small businesses are domestic export controls, rather than foreign import controls; fully sixty-nine percent of companies claimed they had no trouble exporting as a result of foreign import regulations.[149]

Controls: Practical Considerations and Guidelines for Businesses, 17 CURRENTS: INT'L TRADE L.J. 59, 64 (2008).

143 *Id*.

144 Joiner, *supra* note 143.

145 Lockheed Martin, Annual Report (Form 10-K) (Feb. 28, 2013).

146 NATIONAL SMALL BUSINESS ASSOCIATION, *supra* note 52, at 2. The National Small Business Association conducted a 2013 survey of over 500 small business owners competing in the export market—evaluating various facets of the current export control regulations and the effects on each business.

147 *Id.* at 3.

148 *Id.* at 5.

149 *Id.* at 9.

Lastly, the survey reports that three-quarters of the responding businesses reported export control complexity issues, another three-quarters reported difficulties with time-consumption regarding navigating these controls, and fifty-three percent described difficulties as a result of dealing with multiple agencies.[150]

G. *Other Considerations*

Some other potentially damaging and unapparent issues include transfers to foreign employees and suppliers' classification.[151] The importance of suppliers' classifications cannot be overstated. Any American company that receives goods from overseas and subsequently ships fully constructed items incorporating those goods can be liable under supplier's classification failures. In order to ship any product, it must be classified on the CCL.[152] However, many foreign companies that supply goods are not familiar with U.S. export controls, and this unfamiliarity may led to grievous errors, such as failure to receive proper classifications of the component parts that a company may desire to re-export.[153]

A second damaging issue involves foreign employees. If a company supplies information (controlled material) to a foreign employee who is a noncitizen or permanent resident of the U.S., that information can be deemed an export and, thus, in violation of export controls.[154] Each business should be familiar with this regulation entitled the "Deemed Export Rule."[155]

H. *Recommendations*

Because of the issues that vendors and buyers may have with regards to classifications, a helpful law could incorporate various export and import requirements on the side of the foreign supplier. Given vendors' tendencies to include liability clauses that exclude liability for export controls, the supplier or vendor should be required to provide export classifications, thus sharing the burden on all the parties involved.[156] This would also aid and protect small businesses that are relatively new to the market and unfamiliar with the vendors' liability limitation practices.

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[150] *Id.* at 13.
[151] Suppliers' classification refers to the selling party's description and designation of the good. *Id.*
[152] NATIONAL SMALL BUSINESS ASSOCIATION, *supra* note 52, at 5.
[153] *Id*.
[154] 15 C.F.R. § 734.2(b)(2)(ii) (2009).
[155] *Id.*
[156] Joiner, *supra* note 143.

This requirement would ensure that suppliers would not only share a portion of the liability, but also a quicker and easier license classification determination because component suppliers are surely more aware of various export controls on their products than final product manufacturers, who have less of a gauge on what specific components of a total product are regulated.

The second proposed regulation deals with the Deemed Export Rule. Through continued global trade, businesses have employees all over the globe. Businesses should not be limited on the information they can provide employees solely because said employee is a non-U.S. citizen. A possible way around these potential export control violations is an employee vetting system. Each company that deals in controlled goods should be allowed to submit a list of foreign employees to whom it would like to afford access to various controlled material. Similar to an export control, the employees could be vetted in a single-streamed process, thus reducing the need for multiple and overlapping export controls every time a company wishes to provide controlled material to a foreign employee.

VIII. TAKEAWAY

So what is the takeaway after looking at all of the daunting tasks that small businesses are facing? Is there any way that businesses can survive in such a regulation-ridden world? The answer is "of course," and those businesses will continue to survive, if not thrive. The key to success, which can make a world of difference, is one of knowing and understanding the new regulations before they take effect, in addition to the old ones currently in place.

The critical point that small businesses need to understand is how each regulation affects their individual business. Trying to understand the overall export control framework may be a challenge, but if a company can understand their niche, they stand a better chance at compliance.

That is not to say, however, that the onus is solely on the part of the small businesses. As discussed above, agency overlap is a huge problem in export control compliance today. Each individual agency should understand the areas it is designated to control. Any overlaps should be defaulted to the Department of Commerce, considering its relatively superior temporal ability in license turnaround with respect to other executive departments. Although this may raise security concerns, goods on which multiple government entities overlap will likely be items the

Department of Defense[157] has no need to control in the first place—as any weapons material and ITAR-controlled items will automatically go to the Defense Department.

The U.S. government should also incorporate more regulations like those implemented on October 15, 2013—using a catch and release subparagraph scheme that businesses can easily understand. Regulation navigation is also a key concern that should be addressed by future legislation. Supplementing the plethora of regulations focused on minor specifications with common goods that use each component could make a huge difference. Further, requiring foreign exporting companies (companies importing components into the United States) to provide licensing information to U.S. re-export companies can further reduce the burden on small business manufacturers that might otherwise be unaware of the particular export restrictions.

The U.S. government also needs to do modify its re-export license requirement for ITAR-controlled goods. This requirement not only creates delays in shipping, but also seriously injures businesses selling items abroad, as the purchaser in many instances is most likely not the end-consumer. The federal government might also reach agreements with various trusted countries and allow these countries to control the re-exportation of certain goods originating from the United States. This would allow the U.S. to continue regulating goods to potentially dangerous, high-risk countries, without requiring every single item to need a re-export license. These agreements with trusted countries would also ensure that the original licensing requirements are not affected.

If each group, small businesses, importers, agencies, and the U.S. government, were to work in tandem and make a concentrated effort to do their individual parts, the U.S. and small domestic businesses will undoubtedly win back their market share on the world-exportation front.

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157 This Comment proposes that the Department of Defense should not be involved in the regulation of certain goods that can be regulated by the Commerce Department because the latter, as evidenced by this comment, usually regulates non-military items, thus not under the munitions list's jurisdiction.