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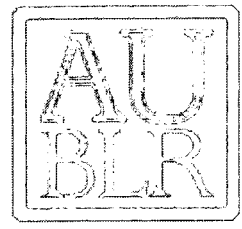
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KEYNOTE

UNITED STATES ASSISTANT ATTORNEY GENERAL FOR NATIONAL SECURITY JOHN P. CARLIN DELIVERS REMARKS AT THE AMERICAN UNIVERSITY BUSINESS LAW REVIEW 2014 SYMPOSIUM

JOHN P. CARLIN*

Thank you for that kind introduction – and for inviting me here today. It's a pleasure to be back at AU, and a privilege to join so many experts, essential partners, and good friends in advancing one of the most important conversations currently facing government and private sector leaders across the country.

At the Justice Department's National Security Division, there is little we do that is more important than working on how the government can partner with private companies to protect our nation and its people better – from terrorism, from cyber-attacks, and from a range of other malicious activities.

This past December, I attended a ceremony marking the twenty-fifth anniversary of the bombing of Pan Am Flight 103 over Lockerbie, Scotland, which claimed the lives of 259 people on the plane and 11 on the ground. 189 were Americans. It was the deadliest act of terror against the United States prior to September 11th.

The families and friends of those who were lost came together that winter day at Arlington National Cemetery to recall the event that changed their lives forever. They spoke movingly of loved ones who had been on

*John P. Carlin, J.D., Harvard University 1999, is the United States Assistant Attorney General for National Security. Confirmed in April 2014, Mr. Carlin oversees nearly 350 federal employees responsible for protecting the United States against terrorism, cyber-threats, and other significant national security threats.

board that plane, many of whom were American college students flying home for the holidays.

On December 21, 1988, instead of reuniting with their companions and loved ones, they heard news reports of a catastrophic explosion and wreckage strewn over miles of the Scottish countryside. Shortly thereafter, they learned, as did the rest of the world, that terrorists were to blame.

There was a call for justice – to find the perpetrators and hold them responsible. And there was also a call for new security measures designed to stop another attack from happening.

At the ceremony last winter, former Secretary of Labor Ann McLaughlin Korologos spoke of her experience leading the seven-member Presidential Commission on Aviation Security and Terrorism that was formed a few months after the attack to investigate what went wrong. Eighteen months after Lockerbie, that Commission issued a report calling for national attention to our aviation security system, and identifying a host of specific proposals intended to harden our nation's airline security and keep all Americans safe – both at airports and in the skies.

Many of these measures did not become reality. Interest faded, attention waned – and so did political and social will. Twelve years later, the horror of 9/11 changed that. It reinvigorated the focus on aviation security – and the 9/11 Commission called for many of the same security measures called for in the wake of Lockerbie. This time, almost all of them were implemented.

Today, national leaders in both government and private industry must apply the lessons we learned from unspeakable tragedies like these, and from decades of effective counterterrorism policy, to business action in cyberspace. It is imperative that we take action promptly, without waiting for a galvanizing tragedy. We can work together to change norms now—not in the wake of an immensely damaging terrorist cyber-attack. In doing so, we will have a much better chance of preventing such an attack from ever taking place.

I grew up in New York City, a place where you can experience the anonymity now enjoyed by so many on the Internet. And when I was a kid, the NYPD sent an officer to our school who told us how to conduct ourselves on the streets of New York.

Our version of Officer Friendly told us to look both ways when we crossed the street. Of course, he told us not to make eye contact with people on the street—which was pretty standard advice back then.

As a kid, that seemed to make total sense. Decades later, New York City is now one of the safest major cities on the planet. And when we look back at that advice, it seems crazy that there was a consensus of blaming the victim for making eye contact. These days, on the internet, we tell our kids

to beware of chatting with individuals they don't know, to avoid certain websites or apps.

When a person's credit card gets stolen, or their credentials for accessing a social media site or their bank are hacked, we tell them, "You should have known better than to go to that website," or, "You shouldn't have used the same 18-character password more than once." Together, hopefully, we can look back in a few short years and think that that those warnings and the victim-blaming is also strange and that we've come a long way with regards to cyber security.

One of the things that's changed in New York over the years is its social norms – like making eye contact. We need to shape social norms in the cyber area, too. Just as it was in a chaotic urban environment, it's tricky to cultivate trust in cyberspace. There were streets in New York where the bad guys and the good guys passed each other shoulder to shoulder. The same thing is true in cyberspace. Legitimate businesses and innocent customers use the same Internet that hackers and terrorists use.

As my former boss at the FBI, Bob Mueller, explained, bad actors – specifically terrorists – are using cyberspace for at least three discrete aspects of terrorist activity: (1) to propagandize and recruit; (2) to plot and plan attacks in the physical world; and (3) to launch attacks in the virtual world itself. It's hard to cultivate trust online amidst such company and to restore a sense of security.□But like change in New York, change in cyberspace will be a community effort. When our Officer Friendly came to visit, he told us about Safe Havens – businesses that opened themselves up just a little bit, to be better members of the community, and to provide a place for people to go if they felt threatened. Back then, there were little yellow Safe Haven signs on the doors of stores in New York, and he told us, "If you're feeling uncomfortable or scared, or are being targeted, don't be afraid to go into one of these stores and seek help. Your safety should be your first priority."

Just as those Safe Havens existed as trusted businesses when I was kid, the government and the corporate community can come together to create safe havens in cyberspace.

We need to work together to prevent terrorists from using networks – using the very websites and apps we use every day – to plot attacks in the physical world. And we need to shore up our security so that devastating attacks cannot be launched in the virtual world. These tasks are not easy, and they are ones we need to undertake with care, to strike a proper balance between security and liberty.

Some businesses, especially those in the communications sectors, may be hesitant to build new partnerships with government – or are drawing back from their current partnerships – because of the national discussion

that has taken place over the last year.[]The President has committed to providing greater transparency about the government's lawful use of data collection authorities. However, as the President has noted, the nature of some unauthorized disclosures have shed more heat than light. And that heat has come onto companies as well, often unfairly. We take their concerns seriously, and we are dedicated to increasing transparency as well as protecting civil liberties. That is why many layers of checks and balances are built into the systems – without question some of the best protections provided by any country in the world. Our authorities are rigorously overseen by Congress, and often scrutinized by the courts and independent government watchdogs. And they are aimed at ensuring the safety of the nation and our allies.

Of course, the private sector should not be punished for complying with the law. We are concerned about this issue, and we are dedicated to working with companies to address misconceptions, correct misinformation, and help to rebuild the public's confidence that our partnerships are conducted under the law. We are working with industry to help them be more transparent about what kinds of information they are required to share with the government, and how very few of their customers are ever impacted by government actions.

Yesterday's announcement by the President of a way forward on the handling of telephony metadata indicates just how committed the Government is to ensuring that the public's concerns are addressed, without the Government sacrificing certain operational needs. As you might have heard, the President announced a proposal that will, with the passage of appropriate legislation, allow the government to end bulk collection of telephony metadata records under Section 215, while ensuring that the government has access to the information it needs to meet its national security requirements.

Getting our legal policies right is one thing. But make no mistake: It will lead to tragedy if the ultimate result of these disclosures is to cause businesses to shy away from working with the government to prevent terrorism. The undeniable truth is that our collaboration, and the protections we have put in place together, make us safer from those who would attempt to do us harm – from terrorists to hostile nation-states seeking to capitalize on our vulnerabilities.

One example that comes to mind is the case of Khalid Aldawsari, a college student from Saudi Arabia who took chemistry classes at Texas Tech in Lubbock, Texas. When he began placing large and unusual orders for chemicals online, the chemical company reported the order to the FBI, as did the shipping company. Ultimately, he was convicted in federal court and sentenced to life in prison for trying to use those chemicals to make a

bomb, potentially to attack a former President. And heading off that threat all began with two companies taking the right step of alerting the FBI to suspicious activity.

Whenever the public faces a threat, whether from terrorists, computer hackers, or pick-pockets on the Metro, people expect the government to protect them. But the government can't do it alone. And that is particularly true in the context of cyber threats, given just how much of our nation's most essential information is found online and, in particular, in the hands of private companies.

You know the threats we face. You've seen them firsthand. Although we often think of the government and our brave men and women serving abroad as a primary focus of terrorist attacks, we must keep in mind that the 9/11 attacks targeted this nation as a whole, and its impact was felt by all of us.

Since then, terrorism is now increasingly diverse and decentralized, from al Qaeda affiliates overseas to homegrown terrorists – such as the Boston Marathon bombers – who may live in the communities they intend to strike. But the cyber threat is growing rapidly, and down the road, may rival or even surpass the threat we face today.

Malicious cyber actors are an increasing risk to our security and prosperity. Last year, BP's CEO stated that his company sees approximately 50,000 attempted cyber intrusions each day. And he is not alone.

As you know, hackers – in many cases working for foreign states or organized criminal syndicates – break into private businesses' servers and steal the key intellectual property that gives us a competitive edge in the global marketplace. And malicious cyber actors sometimes target companies' infrastructure. In 2012, Saudi Arabia's state oil company, Aramco, suffered an attack that destroyed 30,000 of its computers – nearly 75% of its workstations, a devastating loss for any company.

Many of these same hackers exploit vulnerabilities in software, turning home computers or servers into launch pads for malicious denial-of-service attacks against banks, companies, and government agencies – shutting them down and disrupting their ability to do business. It does not take much imagination to see how these same tools could be used by terrorists, resulting in what has been referred to as a potential "cyber 9/11."

When these attacks happen, people ask the same two basic questions many asked after the Lockerbie bombing: "What more could have been done to protect me?" And, "are they going to get these guys?" To answer these questions, we need the private sector and the government to work together.

Intrusions by nation-states have gone on longer than acknowledged.

Why are so many companies waiting to come to the government for help? This situation is not unlike the way that organized crime was able to intimidate small businesses into paying for so-called "insurance" . For each mom and pop store, individually, it made more sense to pay the insurance rather than face retaliation for speaking up or going to the cops. And as a result, the criminal organizations made big profits. They only took a small amount from each business, but the money added up over the dozens or hundreds of businesses they intimidated. It wasn't until the cost of doing business with the mafia got too high – or someone was brave enough to stand up to the mob – that law enforcement was able to break up these organized crime rings.

The calculus that many businesses make today is similar to the decisions that the mom and pop stores had to make several decades ago: Does the cost of paying out – that is, failing to tell the authorities about cyber attacks – outweigh the costs of potential retaliation? When faced with the prospect of taking on a nation-state with all of its powers – not to mention the fear of not being able to do business in that's nation's marketplace – many companies have made the calculation of remaining silent.[ ]But the cost of that silence is increasing. As valuable assets, proprietary information, and research and development investments are repeatedly compromised by increasingly relentless attacks, businesses can no longer afford to stay silent victims. The calculus has changed. Companies are taking action.

Over the last year, we have seen a tipping point. As more and more companies come forward, more and more will feel emboldened. Eventually, these nation-state hackers – just like the mafia – will lose the ability to intimidate victims.[]Public-private partnerships are particularly important because of the key role that businesses play in our society. Unlike some countries, where government maintains control over the telecommunications and energy industries, nearly all critical infrastructure in the United States is owned and managed by private companies. The fiber-optic cables that our communications transit; the servers that direct our Internet traffic; the software that allows us to communicate; and the energy we use to power our daily lives – all of these things, and so many more, are created and operated by private companies.

We thrive as a nation because of private innovation, and the creativity that comes with the freedom to innovate. This has been true throughout our history. But these unique strengths also create opportunities for attacks. When attacked, companies are often in the best position to protect themselves and their customers from cyber aggressors. But they may not always be in the best position to know the precise threats they face, which is where we can help.

Take, for example, the Department's work on cyber threats. On a daily

basis, the FBI is working with companies that have been the victims of hacks – many of whom may not even know they have been victimized, or how to protect themselves. The Washington Post reported earlier this week that federal agents notified more than 2,000 U.S. companies last year that their computer systems were hacked – and, as the article explained, even that considerable figure represents only a fraction of the actual number of cyber intrusions into the private sector.

There are many efforts underway across the government to work with private corporations on strengthening public-private cyber cooperation. The Department of Homeland Security, the Department of Energy, and other departments and agencies routinely work closely with companies to protect critical infrastructure.

In driving this work forward, the FBI has long relied on its InfraGard program, which brings together individuals in law enforcement, government, the private sector, and academia to talk about how to protect our critical infrastructure. InfraGard has more than 85 chapters across the country, with more than 47,000 members.

These are all positive and important efforts, but we have to do more.

As we speak, the Department of Justice is working hard to be a more accessible partner to companies. Over the past two years, the National Security Division established a national program to focus on cyber threats to the national security – those posed by terrorist and nation state actors – and we are continuing to grow. We are still a very new Division, but we are evolving quickly to meet new and emerging threats.

The story of NSD's creation is an interesting one. Although not formally created until 2006, NSD's story begins, like so many others, with calls for reforms that were first spotted years ago. We trace our origin all the way back to 1978, with the passage of the Foreign Intelligence Surveillance Act. FISA was, in part, a response to public and congressional dissatisfaction with a series of intentional abuses of wiretaps and surveillance for political purposes. The Church Committee's report set out those problems and made a case for reform. The report emphasized that the Attorney General, as the nation's chief legal officer, plays an essential role in maintaining the lawfulness of actions by our country's intelligence agencies. NSD was created, and is proud, to execute that mission decades later on his behalf.

So as we tackle the cyber threat, we build upon our roots. We were created so that prosecutors and law enforcement officials could work smoothly and effectively with intelligence attorneys and the Intelligence Community, to ensure that we most effectively defend our nation's security while at the same time protecting our vital civil liberties. And I would be remiss in describing the vital work of our Division if I neglected to acknowledge this week's conviction of Sulaiman Abu Ghayth in New

York. Abu Ghayth, described as a senior spokesman for Osama bin Laden and al Qaeda, was convicted by a federal jury on all counts, including conspiring to kill Americans and other terrorism charges.

So, even as we defend our national security through successful counterterrorism prosecutions in federal court, we also defend our security while protecting our civil liberties in cyberspace. In 2012, we established the National Security Cyber Specialists' Network, with members from across all of our areas of expertise, federal prosecutors from each and every U.S. Attorney's Office, and partners from the Department's Computer Crime and Intellectual Property Section, who have had longstanding and continuing success against organized cyber criminals, hacktivists, criminal fraudsters and other bad actors.

Since then, we have hosted extensive training for these network members and for every member of the National Security Division, to ensure we have the skills we need to tackle the threat. Federal prosecutors across the country are reaching out to companies in their districts to let them know about the network and how we can help.

Here in our nation's capital, we work closely with the FBI's National Cyber Investigative Joint Task Force to assess cyber issues in real time as they arise. We've launched a 24/7 cyber response capacity. We are now a one-stop shop and resource for national security cyber matters across the country.

There are criminal cases to be brought against these actors, but that is just one tool. We are committed to using every tool at our disposal, law enforcement and others, to disrupt adversaries' activities and prevent damage to U.S. national interests – just as we do in other arenas of counterterrorism, counterespionage, and export control.

We are drawing from our expertise in those areas, and building new capabilities to ensure that we can use all available tools to meet a range of constantly-evolving threats.

Employing this comprehensive, "all-tools" approach means we need to be prepared not only to prosecute cyber intrusions, economic espionage, and export control violations, but also to work with our partners to enforce other civil and regulatory laws.

We cannot do this alone. This "all-tools" approach requires trusted collaboration, including with operational and legal experts in the private sector.

It's often said, there are only two types of companies: those that have been hacked and those that will be. Now, that's no longer the case. Today, there is only one category: those that have been hacked, and that will be hacked again.

Going forward, we want to work even more closely with our private

sector partners to be ready for whatever may happen in the near future. Of course, private companies will remain our first line of defense, and their legal teams must be prepared to face difficult questions and complex matters, including how to respond to cyber breaches; how to interpret and comply with the cyber Executive Order and the cybersecurity framework recently released by the Administration; and, how to stay on top of the evolving "standard of care" for cyber security.

All of us – including lawyers and operators in the public and private sectors – will need to cooperate closely to address these and associated threats. We all must act on the premise that success requires reporting from, and close relationships with, victims and potential victims who seek indicators of malicious activity.

My colleagues and I have already met with a number of private entities and received a positive response, and we will continue these meetings to keep the dialogue going.

And as we look toward the future, we must continue establishing channels that regularly communicate cyber threat information between the public and private sectors. Information must move in both directions. It is an approach that works in other contexts, and it will succeed here as well.

We have come a long way in our collective approach to counterterrorism. Together, we have improved airline safety, hardened critical infrastructure, developed new technology that can help first responders, and designed a wide range of protective measures. These measures, of course, don't eliminate the threat of to our national security, which remains very real and very dangerous. But we are safer than we used to be, and better prepared to cope with any potential attack.

We need to achieve this same success in the cyber realm. So the critical question is: What will it take?

We've certainly had plenty of attacks that caused real pain, exposed real weaknesses, and suggested real problems for the future. Yet, despite all of these warnings, we don't seem to have fully turned the corner in addressing this threat. And the reasons for that are understandable.

Confronting cyber threats incurs real economic cost. We appreciate that. But doing nothing will cost us all more in the long run, and may, for some businesses, prove devastating.

The writing is on the wall – our adversaries are getting bolder, more aggressive, and more skilled. They flex their muscle to show us what they can do, but it is only the tip of the iceberg. Without a concerted, collective effort to make the changes needed to protect ourselves in cyberspace, it is only a matter of time before we are really hit – hard. Far better to form partnerships and make the required investments before a large-scale attack takes place.

Indeed, perhaps even more than in the terrorism context, the private sector is critical to our success in the cyber context because of just how much vital information is now held "in corporate trust," so to speak.

While government holds and protects some of what cyber terrorists want to access, the private sector has much, much more. So, whether it's about ensuring that our electric grid is safe from attacks – whether physical or cyber – or making sure you can access your bank account information on your smartphone without getting hacked, we urgently need to form the type of public-private partnerships to keep those vital resources safe. These are the type of partnerships we've created for counterterrorism. We must build on those partnerships to combat cyber threats – not pull away from each other.

This is the challenge now before us – and this is the cause that everyone in this room, and many beyond it, must come together to confront. Each of us has a unique role to play, and distinct responsibilities to fulfill.

Leaders in government can articulate precisely what we have to offer the private sector. Leaders in the private sector can demonstrate what these partnerships have to offer to their customers. And leaders in academia can survey the legal authorities we have – and take stock of what legal authorities we don't have but need – to facilitate cooperative, productive cyber partnerships. We can build these partnerships while respecting civil liberties and do it in a transparent and productive way.

We are committed to meeting regularly with critical partners to get your feedback on how we are doing; to solicit suggestions on how we can do better; and to gain the benefit of your views on how the overall landscape is looking. Please reach out to us so that we can talk more about what NSD does, and how we can work together to keep you safer and our nation safer.

I want to close today by calling upon everyone here to continue the important open dialogue we're holding here at AU today. I urge you to serve as connectors – as bridges – to make private-public partnerships a reality.

We had warnings before 9/11. But we didn't act – at least not enough. The state of security of the Internet today is a rumbling storm in the distance. We need to be smart and work together, now, before a cyber-9/11 – before there's an attack or intrusion or exfiltration so big – and so devastating – we are forever changed. Thank you for participating in this important conversation, and thank you for having me here today.

SYMPOSIUM ARTICLES

HIGH TECHNOLOGY, CONSUMER PRIVACY, AND U.S. NATIONAL SECURITY

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* Professor of Law, Georgetown Law and Director, Center on National Security and the Law, Georgetown Law. Special thanks to David Vladeck for his comments on an earlier draft of this Article, and to Ellen Noble and Morgan Stoddard for their excellent research assistance. This Article draws in part from written testimony prepared for the U.S. House of Representatives Committee on Energy and commerce, Subcommittee on Commerce, Manufacturing, and Trade, for the hearing "Cross Border Data Flows: Could Foreign Protectionism Hurt U.S. Jobs?" Sept. 17, 2014.

INTRODUCTION

Documents released over the past year detailing the National Security Agency's ("NSA") telephony metadata collection program and interception of international content under the Foreign Intelligence Surveillance Act (FISA) implicated U.S. high technology companies in government surveillance.[1] The result was an immediate, and detrimental, impact on U.S. corporations, the economy, and U.S. national security.

The first Snowden documents, printed on June 5, 2013, revealed that the government had served orders on Verizon, directing the company to turn over telephony metadata under Section 215 of the USA PATRIOT Act.[2] The following day, *The Guardian* published classified slides detailing how the NSA had intercepted international content under Section 702 of the FISA Amendments Act.[3] The type of information obtained ranged from E-mail, video and voice chat, videos, photos, and stored data, to Voice over Internet Protocol, file transfers, video conferencing, notifications of target activity, and online social networking.[4] The companies involved read like a who's who of U.S. Internet giants: Microsoft, Yahoo, Google, Facebook, PalTalk, YouTube, Skype, AOL, and Apple.[5]

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1. *See, e.g.*, Glenn Greenwald & Ewen MacAskill, *NSA Prism Program Taps in to User Data of Apple, Google, and Others*, THE GUARDIAN (June 7, 2013, 3:23 PM), http://www.theguardian.com/world/2013/jun/06/us-tech-giants-nsa-data; Barton Gellman and Laura Poitras, *U.S., British Intelligence Mining Data from Nine U.S. Internet Companies in Broad Secret Program*, WASH. POST (June 7, 2013), http://www.washingtonpost.com/investigations/us-intelligence-mining-data-from-nine-us-internet-companies-in-broad-secret-program/2013/06/06/3a0c0da8-cebf-11e2-8845-d970ccb04497_story.html?hpid=z1; Glenn Greenwald, *NSA Collecting Phone Records of Millions of Verizon Customers Daily*, THE GUARDIAN, (June 6, 2013, 8:05 PM), http://www.theguardian.com/world/2013/jun/06/nsa-phone-records-verizon-court-order [herenafter Greenwald, *NSA Collected Verizon Records*]; Glenn Greenwald, *Microsoft Handed the NSA Access to Encrypted Messages*, THE GUARDIAN, (July 12, 2013, 5:04 PM), http://www.theguardian.com/world/2013/jul/11/microsoft-nsa-collaboration-user-data; Barton Gellman & Ashkan Soltani, *NSA Infiltrates Links to Yahoo, Google Data Centers Worldwide, Snowden Documents Say*, WASH. POST (Oct. 30, 2013), http://www.washingtonpost.com/world/national-security/nsa-infiltrates-links-to-yahoo-google-data-centers-worldwide-snowden-documents-say/2013/10/30/e51d661e-4166-11c3-8b74-d89d714ca4dd_story.html. For statutory and constitutional analysis of the telephony metadata program and the interception of international content, *see* Laura K. Donohue, *Bulk Metadata Collection: Statutory and Constitutional Considerations*, 37 HARV. J.L. & PUB. POL'Y 757 (2014) [hereinafter Donohue, *Bulk Metadata Collection*]; Laura K. Donohue, *Section 702 and the Collection of International Telephone and Internet Content*, 38 HARV. J.L. & PUB. POL'Y, (forthcoming 2015) [hereinafter Donohue, *Section 702*).

2. Greenwald, *NSA Collecting Phone Records*, *supra* note 1.

3. Greenwald & MacAskill, *supra* note 1.

4. *Id.*

5. *Id.*

More articles highlighting the extent to which the NSA had become embedded in the U.S. high tech industry followed. In September 2013 *ProPublica* and the *New York Times* revealed that the NSA had enjoyed considerable success in cracking commonly used cryptography.[6] The following month the *Washington Post* reported that the NSA, without the consent of the companies involved, had obtained millions of customers' address book data. In one day alone, some 444,743 email addresses from Yahoo, 105,068 from Hotmail, 82,857 from Facebook, 33,697 from Gmail, and 22,881 from other providers.[7]

The extent of upstream collection stunned the public, as did slides demonstrating how the NSA had bypassed the companies' encryption, intercepting data as it transferred between the public Internet and the Google cloud.[8] Documents further suggested that the NSA had helped to promote encryption standards for which it already held the key or whose vulnerabilities the agency understood but had not taken steps to address.[9]

Beyond this, press reports indicated that the NSA had at times posed as U.S. companies—without their knowledge—in order to gain access to foreign targets. In November 2013 *Der Spiegel* reported that the NSA and the United Kingdom's Government Communications Headquarters ("GCHQ") had created bogus versions of Slashdot and LinkedIn, so that when employees from the telecommunications firm Belgacom tried to access the sites from corporate computers, their requests were diverted to the replica sites that then injected malware into their machines.[10]

As a result of the growing public awareness of these programs, U.S. companies have lost revenues, even as non-U.S. firms have benefited.[11] In

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6. Nicole Perlroth, et al., *N.S.A. Able to Foil Basic Safeguards of Privacy on Web*, N.Y. TIMES, Sept. 5, 2013, http://www.nytimes.com/2013/09/06/us/nsa-foils-much-internet-encryption.html?pagewanted=all&_r=0.

7. Barton Gellman & Ashkan Soltani, *NSA Collects Millions of E-mail Address Books Globally*, WASH. POST, Oct. 14, 2013, http://www.washingtonpost.com/world/national-security/nsa-collects-millions-of-e-mail-address-books-globally/2013/10/14/8e58b5be-34f9-11e3-80c6-7e6dd8d22d8f_story.html.

8. Gellman & Soltani, *supra* note 1.

9. James Ball, et al., *Revealed: How US and UK Spy Agencies Defeat Internet Privacy and Security*, THE GUARDIAN (Sept. 6, 2013, 8:24 PM), http://www.theguardian.com/world/2013/sep/05/nsa-gchq-encryption-codes-security.

10. Steven Levy, *How the NSA Almost Killed the Internet*, WIRED (Jan. 7, 2014, 6:30 AM), http://www.wired.com/2014/01/how-the-us-almost-killed-the-internet/all/.

11. *See, e.g.*, Sam Gustin, *NSA Spying Scandal Could Cost U.S. Tech Giants Billions*, TIME (Dec. 10, 2013), http://business.time.com/2013/12/10/nsa-spying-scandal-could-cost-u-s-tech-giants-billions/ ("The National Security Agency spying scandal could cost the top U.S. tech companies billions of dollars over the next several years, according to industry experts. In addition to consumer Internet companies, hardware and cloud-storage giants like IBM, Hewlett-Packard, and Oracle could suffer billions of dollars in losses."); Ellen Messmer, *U.S. High-Tech Industry Feeling the*

addition, numerous countries, concerned about consumer privacy as well as the penetration of U.S. surveillance efforts in the economic and political spheres, have accelerated data localization initiatives, begun restricting U.S. companies' access to local markets, and introduced new privacy protections, with implications for the future of Internet governance and U.S. economic growth. These effects raise attendant concerns about U.S. national security.

It could be argued that some of these effects, such as data localization initiatives, are merely opportunistic—i.e., other countries are merely using the NSA revelations to advance national commercial and political interests.[12] Even if true, however, the NSA programs provide other countries with an opportunity. They have weakened the U.S. hand in the international arena.

Congress has the ability to redress the current situation. First, and most importantly, reform of the Foreign Intelligence Surveillance Act would provide for greater restrictions on NSA surveillance. Second, new domestic legislation could extend better protections to consumer privacy. These shifts would allow U.S. industry legitimately to claim a change in circumstance, which would help them to gain competitive ground. Third, the integration of economic concerns at a programmatic level within the national security infrastructure would help to ensure that economic matters remain central to national security determinations in the future.

Heat from Edward Snowden Leaks, NETWORKWORLD, (July 19, 2013, 3:44 PM), http://www.networkworld.com/article/2168328/security/u-s—high-tech-industry-feeling-the-heat-from-edward-snowden-leaks.html ("The disclosures about the National Security Agency's massive global surveillance by Edward Snowden, the former information-technology contractor who's now wanted by the U.S. government for treason, is hitting the U.S. high-tech industry hard as it tries to explain its involvement in the NSA data-collection program."); Claire Cain Miller, *Revelations of N.S.A. Spying Cost U.S. Tech Companies*, N.Y. TIMES, Mar. 21, 2014, http://www.nytimes.com/2014/03/22/business/fallout-from-snowden-hurting-bottom-line-of-tech-companies.html ?_r=0 (writing, "Despite the tech companies' assertions that they provide information on their customers only when required under law – and not knowingly through a back door – the perception that they enabled the spying program has lingered."); *Surveillance Costs: The NSA's Impact on the Economy, Internet Freedom & Cybersecurity*, NEW AMERICA'S OPEN TECH. INST. 2 (July 2014), http://oti.newamerica.net/sites/newamerica.net/files/policydocs/Surveilance_Costs_Final.pdf ("American companies have reported declining sales overseas and lost business opportunities, especially as foreign companies turn claims for products that can protect users from NSA spying into a competitive advantage.").

12. *See, e.g.*, Jonah Force Hill, *The Growth of Data Localization Post-Snowden: Analyses and Recommendations for U.S. Policymakers and Industry Leaders*, LAWFARE RESEARCH PAPER SERIES (July 21, 2014) (arguing that protectionism, domestic surveillance and law enforcement, control of information and censorship, and populist politics and anti-globalization, and not the NSA programs, serve as the underlying motivation).

I. ECONOMIC IMPACT OF NSA PROGRAMS

The NSA programs, and public awareness of them, have had an immediate and detrimental impact on the U.S. economy. They have cost U.S. companies billions of dollars in lost sales, even as companies have seen their market shares decline. American multinational corporations have had to develop new products and programs to offset the revelations and to build consumer confidence. At the same time, foreign entities have seen revenues increase. Beyond the immediate impact, the revelation of the programs, and the extent to which the NSA has penetrated foreign data flows, has undermined U.S. trade agreement negotiations. It has spurred data localization efforts around the world, and it has raised the spectre of the future role of the United States in Internet governance. Even if opportunistic, these shifts signal an immediate and long-term impact of the NSA programs, and public knowledge about them, on the U.S. economy.

A. Lost Revenues and Declining Market Share

Billions of dollars are on the line because of worldwide concern that the services provided by U.S. information technology companies are neither secure nor private.[13] Perhaps nowhere is this more apparent than in cloud computing.

Previously, approximately 50% of the worldwide cloud computing revenues derived from the United States.[14] The domestic market thrived: between 2008 and 2014, it more than tripled in value.[15] But within weeks of the Snowden leaks, reports had emerged that U.S. companies such as Dropbox, Amazon Web Services, and Microsoft's Azure were losing business.[16] By December 2013, ten percent of the Cloud Security Alliance had cancelled U.S. cloud services projects as a result of the Snowden information.[17] In January 2014 a survey of Canadian and British

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13. *IT Industries Set to Lose Billions Because of Privacy Concerns*, UNITED PRESS INT'L, (Dec. 17, 2013, 9:20 PM), http://www.upi.com/Business_News/Security-Industry/2013/12/17/IT-industries-set-to-lose-billions-because-of-privacy-concerns/UPI-30251387333206/ ("Information technology companies stand to lose billions of dollars of business because of concerns their services are neither secure nor private.").

14. *Gartner Predict Cloud Computing Spending to Increase by 100% in 2016, Says AppsCare*, PRWEB (July 19, 2012), http://www.prweb.com/releases/2012/7/prweb9711167.htm.

15. *Id.*

16. David Gilbert, *Companies Turn to Switzerland for Cloud Storage Following NSA Spying Revelations*, INT'L BUS. TIMES, (July 4, 2013, 2:33 PM), http://www.ibtimes.co.uk/business-turns-away-dropbox-towards-switzerland-nsa-486613.

17. Mieke Eoyang & Gabriel Horwitz, Op-Ed., *NSA Snooping's Negative Impact on Business Would Have the Founding Fathers 'Aghast*, FORBES (Dec. 20, 2013, 8:00

businesses found that one quarter of the respondents were moving their data outside the United States.[18]

The Information Technology and Innovation Foundation estimates that declining revenues of corporations that focus on cloud computing and data storage alone could reach $35 billion over the next three years.[19] Other commentators, such as Forrester Research analyst James Staten, have put actual losses as high as $180 billion by 2016, unless something is done to restore confidence in data held by U.S. companies.[20]

The monetary impact of the NSA programs extends beyond cloud computing to the high technology industry. Cisco, Qualcomm, IBM, Microsoft, and Hewlett-Packard have all reported declining sales as a direct result of the NSA programs.[21] Servint, a webhosting company based in Virginia, reported in June 2014 that its international clients had dropped by 50% since the leaks began.[22] Also in June, the German government announced that because of Verizon's complicity in the NSA program, it would end its contract with the company, which had previously provided services to a number of government departments.[23] As a senior analyst at the Information Technology and Innovation Foundation explained, "It's clear to every single tech company that this is affecting their bottom line."[24] The European commissioner for digital affairs, Neelie Kroes, predicts that

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AM), http://snewsi.com/id/1342616710/NSA-Snoopings-Negative-Impact-On-Business-Would-Have-The-Founding-Fathers-Aghast.

18. *NSA Scandal: UK and Canadian Business Wary of Storing Data in the US*, PEER 1 HOSTING, (Jan. 8, 2014), http://www.peer1.com/news-update/nsa-scandal-uk-and-canadian-businesses-wary-storing-data-in-us.

19. *Id.; see also* Mary DeRosa, *U.S. Cloud Services Companies Are Paying Dearly for NSA Leaks,* NEXTGOV (Mar. 24, 2014), http://www.nextgov.com/technology-news/tech-insider/2014/03/us-cloud-services-companies-are-paying-dearly-nsa-leaks/81100/ (reporting estimates of losses of $22 billion over the next three years).

20. *IT Industries Set to Lose Billions Because of Privacy Concerns*, *supra* note 13. This number includes domestic customers who may go elsewhere to find greater privacy protections. *See* Gustin, *supra* note 11.

21. Sean Gallagher, *NSA Leaks Blamed for Cisco's Falling Sales Overseas (Updated)*, ARS TECHNICA, (Dec. 11, 2013, 5:05 AM), http://www.arstechnica.com/information-technology/2013/12/nsa-leaks-blamed-for-ciscos-failing-sales-overseas/; Paul Taylor, *Cisco Warns Emerging Market Weakness is no Blip*, FIN. TIMES, (Dec. 13, 2013, 12:07 AM), http:www/ft/com/intl/cms/s/0/fb757c4e-637b-11e3-a87d-00144feabdc0.html#axzz3ILJr30Gr; Spencer E. Ante, *Qualcomm CEO Says NSA Fallout Impacting China Business*, WALL. ST. J., Nov. 22, 2013, http://www.online.wsj.com/articles/SB10001424052702304337404579214353783842062; Miller, *supra* note 11.

22. Julian Hattem, *Tech Takes Hit from NSA*, THE HILL (June 30, 2014, 6:00 AM), http://thehill.com/policy/technology/210880-tech-takes-hit-from-nsa.

23. Andrea Peterson, *German Government to Drop Verizon over NSA Spying Fears*, WASH. POST, June 26, 2014, http://www.washingtonpost.com/blogs/the-switch/wp/2014/06/26/german-government-to-drop-verizon-over-nsa-spying-fears/.

24. *Id.*

the fallout for U.S. businesses in the EU alone will amount to billions of Euros.[25]

Not only are U.S. companies losing customers, but they have been forced to spend billions to add encryption features to their services. IBM has invested more than a billion dollars to build data centers in London, Hong Kong, Sydney, and elsewhere, in an effort to reassure consumers outside the United States that their information is protected from U.S. government surveillance.[26] Salesforce.com made a similar announcement in March 2014.[27] Google moved to encrypt terms entered into its browser.[28] In June 2014 it took the additional step of releasing the source code for End-to-End, its newly-developed browser plugin that allows users to encrypt email prior to it being sent across the Internet.[29] The following month Microsoft announced Transport Layer Security for inbound and outbound email, and Perfect Forward Secrecy encryption for access to OneDrive.[30] Together with the establishment of a Transparency Center, where foreign governments could review source code to assure themselves of the integrity of Microsoft software, the company sought to put an end to both NSA back door surveillance and doubt about the integrity of Microsoft products.[31]

Foreign technology companies, in turn, are seeing revenues increase. Runbox, for instance, an email service based in Norway and a direct competitor to Gmail and Yahoo, almost immediately made it publicly clear that it does not comply with foreign court requests for its customers' personal information.[32] Its customer base increased 34% in the aftermath of the Snowden leaks.[33] Mateo Meier, CEO of Artmotion, Switzerland's

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25. Eoyang & Horwirz, *supra* note 17.

26. Miller, *supra* note 11.

27. *Id.*

28. Danny Sullivan, *Post-PRISM, Google Confirms Quietly Moving to Make All Searches Secure, Except for Ad Clicks*, SEARCH ENGINE LAND (Sept. 23, 2013, 11:53 AM) http://searchengineland.com/post-prism-google-secure-searches-172487.

29. Klint Finley, *Google Renews Battle with the NSA by Open Sourcing Email Encryption Tool*, WIRED (June 3, 2014, 7:41 PM), http://www.wired.com/2014/06/end-to-end/.

30. Matt Thomlinson, *Advancing our Encryption and Transparency Efforts*, MICROSOFT (July 1, 2014), http://blogs.microsoft.com/on-the-issues/2014/07/01/advancing-our-encryption-and-transparency-efforts/; *see also* Carly Page, *Microsoft Installs Tougher Outlook and Onedrive Encryption to Curb NSA Snooping*, THE INQUIRER, (July 1, 2014, 3:36 PM), http://www.theinquirer.net/inquirer/news/2353073/microsoft-installs-better-outlook-and-onedrive-encryption-to-curb-nsa-snooping.

31. Thomlinson, *supra* note 30.

32. Miller, *supra* note 11.

33. *Id.*

biggest offshore data hosting company, reported that within the first month of the leaks, the company saw a 45% rise in revenue.[34] Because Switzerland is not a member of the EU, the only way to access data in a Swiss data center is through an official court order demonstrating guilt or liability; there are no exceptions for the United States.[35] In April 2014, Brazil and the EU, which previously used U.S. firms to supply undersea cables for transoceanic communications, decided to build their own cables between Brazil and Portugal, using Spanish and Brazilian companies in the process.[36] OpenText, Canada's largest software company, now guarantees customers that their data remains outside the United States. Deutsche Telekom, a cloud computing provider, is similarly gaining more customers.[37] Numerous foreign companies are marketing their products as "NSA proof" or "safer alternatives" to those offered by U.S. firms, gaining market share in the process.[38]

B. Trade Agreements

The NSA programs, and media coverage of them, have further impacted bi- and multi-lateral trade negotiations, undermining U.S. economic security. Consider two of the most important talks currently underway: the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP).

TTIP is a trade and investment negotiation that is being conducted between the European Commission and the United States. The purpose of the agreement is to create better trade relations between the two region, enabling companies on both sides of the Atlantic to thrive. The revelations about NSA activities have had a profound impact on the negotiations.

In March 2014 the European Parliament passed a resolution noting "the impact of mass surveillance." It stated, "the revelations based on documents leaked by former NSA contractor Edward Snowden put political leaders under the obligation to address the challenges of overseeing and controlling intelligence agencies in surveillance activities and assessing the impact of their activities on fundamental rights and the rule of law in a democratic society."[39] It recognized that the programs had undermined

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34. Gilbert, *supra* note 16.

35. *Id.*

36. Miller, *supra* note 11.

37. *Id.*

38. Mark Scott, *European Firms Turn Privacy into Sales Pitch*, N.Y. TIMES, June 11, 2014, http://bits.blogs.nytimes.com/2014/06/11/european-firms-turn-privacy-into-sales-pitch/.

39. European Parliament Resolution of Mar. 12, 2014 on the Surveillance Programme, *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&

"trust between the EU and the US as transatlantic partners." Not least were concerns that the information could be used for "economic and industrial espionage"—and not merely for the purpose of heading off potentially violent threats. Parliament strongly emphasized, "given the importance of the digital economy in the relationship and in the cause of rebuilding EU-US trust," that its "consent to the final TTIP agreement could be endangered as long as the blanket mass surveillance activities and the interception of communications in EU institutions and diplomatic representations are not completely abandoned and an adequate solution is found for the data privacy rights of EU citizens." The resolution underscored that any agreement to TTIP would hinge on the protection of the data privacy rights as reflected in the protection of fundamental rights in the EU Charter.[40]

Even if the surveillance programs do not entirely derail TTIP, they have the potential to significantly retard negotiations.[41] Much is at stake. The Center for Economic Policy Research in London, for instance, estimates that a successful TTIP could improve U.S. workers' wages, provide new jobs, and increase the country's GDP by $100 billion per year.[42] Another study, conducted by the Bertelsmann Foundation, suggests that TTIP "could increase GDP per capita in the United States by 13 percent over the long term."[43] To the extent that the programs weaken the U.S. position in the negotiations, the impact could be significant.[44]

Although the United States Trade Representative is trying to counter the political fallout from the NSA debacle by putting local data protection initiatives on the table in the TTIP negotiations, the EU has steadfastly resisted any expansion into this realm.

TPP, in turn, is a trade agreement that the United States is negotiating with 11 countries in the Asia-Pacific region (Australia, Brunei Darussalam,

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language=EN&reference=P7-TA-2014-0230.

40. *Id.*

41. *See, e.g.*, Patrick Donahue and Arne Delfs, *Germany Demands U.S. Honesty on Spying after Expulsion,* BLOOMBERG BUS., July 11, 2014, http://www.bloomberg.com/news/articles/2014-07-10/germany-kicks-out-u-s-spy-as-relations-decline-to-low.

42. William Schomberg and Roberta Rampton, *Credit Markets: EU, U.S. Leaders Launch Free-trade Talks*, REUTERS, (June 17, 2013, 1:52 PM), http://mobile.reuters.com/article/creditMarkets/idUSBRE95G0MD20130617.

43. *Id.; see also* Gabriel Felbermayr, et al., Transatlantic Trade and Investment Partnership (TTIP): Who Benefits from a Free Trade Deal?, Part 1: Macroeconomic Effects, BERTELSMANN STIFTUNG FOUNDATION, *available at* http://www.bfna.org/sites/default/files/TTIP-GED%20study%2017June%202013.pdf.

44. Even if NSA surveillance doesn't derail the TTIP, it could certainly slow it down. The Center for Economic Policy Research in London predicts the TTIP would improve wages, provide new job opportunities, and increase U.S. GDP by $127 billion per year. A study commissioned by Bertelsmann Foundation says the TTIP "could

Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam). TPP (with participation of Japan), accounts for nearly 40% of global GDP, about 1/3 of world trade. Two of the United States' objectives in these negotiations are directly implicated by the Snowden releases: e-commerce / telecommunications, and intellectual property rights.

The NSA programs relate to a number of categories under e-commerce—such as rules preventing discrimination based on the country of origin, and efforts to construct a single, global Internet. Nevertheless, as discussed below, some of the countries involved in TPP have already adopted data localization laws. The NSA programs have thus weakened the United States' negotiation position in these discussions, by making it more difficult to reach agreement in key areas.

In addition to e-commerce considerations, as part of the TPP negotiations, the United States has prioritized intellectual property rights. Some 40 million American jobs are directly or indirectly tied to "IP-intensive" industries. These jobs tend to be high-paying and stimulate approximately 60% of U.S. merchandise exports, as well as a significant portion of services. Efforts to make progress in TPP by developing stronger protections for patents, trademarks copyrights, and trade secrets—including safeguards against cyber theft of trade secrets—is made more perilous by the existence of the NSA programs.

C. Data Localization and Data Protection

Over the past eighteen months, countries around the world have increasingly adopted data localization laws, restricting the storage, analysis, and transfer of digital information to national borders.[45] To some extent, the use of barriers to trade as a means of incubating tech-based industries predated the Snowden releases.[46] In the aftermath of the leaks, the dialogue has gained momentum. The asserted purpose is to protect government data and consumer privacy.

As of the time of writing, China, Greece, Malaysia, Russia, South Korea, Venezuela, Vietnam, Iran, and others have already implemented local data server requirements.[47] Turkey has introduced new privacy regulations

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45. *See* Jonah Force Hill, *The Growth of Data Localization Post-Snowden: Analysis and Recommendations for U.S. Policymakers and Industry Leaders*, 2 LAWFARE RES. PAPER SERIES (2014).

46. *See, e.g.*, Stephen J. Ezell, el al., *Localization Barriers to Trade: Threat to the Global Innovation Economy*, THE INFO. TECH. & INNOVATION FOUND. (Sept. 25, 2013), *available at* http://www2.itif.org/2013-localization-barriers-to-trade-exec-summary.pdf.

47. *Heads Up for Privacy, Data Protection and Cybersecurity in 2014*, SIDLEY AUSTIN LLP (Dec. 30, 2013) http://m.sidley.com/ring-in-the-new-things-to-watch-in-

preventing the transfer of personal data (particularly locational data) overseas.[48] Others, such as Argentina, India, and Indonesia are actively considering new laws, even as Brazilian president, Dilma Rousseff, has been promoting a law that would require citizens' personal data to be stored within domestic bounds.[49] Germany and France are considering a Schengen routing system, retaining as much online data in the European Union as possible.[50]

As a regional matter, the European Union (EU) Commission's Vice President, Viviane Reding, is pushing for Europe to adopt more expansive privacy laws.[51] In March 2014, the European Parliament passed the Data Protection Regulation and Directive, imposing strict limits on the handling of EU citizens' data.[52] Reding announced, "The message the European Parliament is sending is unequivocal: This reform is a necessity, and now it is irreversible. Europe's directly elected parliamentarians have listened to European citizens and European businesses and, with this vote, have made clear that we need a uniform and strong European data protection law, which will. . . strengthen the protection of our citizens."[53] Regardless of where the information is based, those handling the data must obtain the consent of the data subjects to having their personal information processed. They also retain the right to later withdraw consent. Those violating the directive face steep fines, including up to five percent of revenues.[54] Apart

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2014-12-23-2013/; *The National Information Network*, INT'L CAMPAIGN FOR HUM. RTS. IN IRAN, (Nov. 10, 2014), http://www.iranhumanrights.org/2014/11/internet-reportthe-national-information-network-national-internet/.

48. Richard Chirgwin, *USA Opposes 'Schengen Cloud' Eurocentric Routing Plan*, THE REGISTER (Apr. 7, 2014, 12:58 AM), http://www.theregister.co.uk/2014/04/07/keeping_data_away_from_the_us_not_on_ustr/.

49. Levy, *supra* note 10.

50. *See, e.g.*, Jeanette Seiffert, *Weighing a Schengen Zone for Europe's Internet Data*, DEUTSCHE WELLE (Feb. 20, 2014), http://www.dw.de/weighing-a-schengen-zone-for-europes-internet-data/a-17443482 ; Interview by Louisa Schaefer with Philipp Blank, Spokesperson, Deutsche Telekom (Oct. 18, 2013), *available at* http://www.dw.de/deutsche-telekom-internet-data-made-in-germany-should-stay-in-germany/a-17165891.

51. Eoyang & Horwitz, *supra* note 17.

52. European Parliament resolution of 12 Mar., 2014 on the Proposal for a Regulation of the European Parliament and of the Council on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, *available at:* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2014-0212+0+DOC+XML+V0//EN; Press Release, European Commission, Progress on EU Data Protection Reform Now Irreversible Following European Parliament Vote, (Mar. 12, 2014), *available at* http://europa.eu/rapid/press-release_MEMO-14-186_en.htm.

53. Press Release, Progress on EU Data Protection Reform *supra* note 52.

54. *Id.*

from the new directive, the Civil Liberties, Justice, and Home Affairs Committee of the European Parliament passed a resolution calling for the end of the US/EU Safe Harbor agreement.[55] Some 3000 U.S. companies rely on this framework to conduct business with the EU.[56]

In May 2014, the EU Court of Justice ruled that users have a "right to be forgotten" in their use of online search engines.[57] The case derived from a complaint lodged against a Spanish newspaper, as well as Google Spain and Google Inc., claiming that notice of the plaintiff's repossessed home on Google's search engine infringed his right to privacy because the incident had been fully addressed years before. He requested that the newspaper be required to remove or alter the pages in question to excise data related to him, and that Google Spain or Google Inc. be required to remove the information.[58]

The EU court found that even where the physical server of a company processing information is not located in Europe, as long as the company has a branch or subsidiary and is doing business in a Member state, the 1995 Data Protection Directive applies.[59] Because search engines contain personal data, they are subject to such data protection laws. The court recognized that, under certain conditions, individuals have the "right to be forgotten"—i.e., the right to request that search engines remove links containing personal information. Data that is inaccurate, inadequate, irrelevant, or excessive may be removed. Not absolute, the right to be forgotten must be weighed against competing rights, such as freedom of expression and the media.[60]

Various country-specific privacy laws are similarly poised to be

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55. Press Release, European Parliament, NSA Snooping; MEPs Table Proposals to Protect EU Citizens' Privacy (Feb. 12, 2014) *available at* http://www.europarl.europa.eu/news/en/news-room/content/20140210IPR35501/html/NSA-snooping-MEPs-table-proposals-to-protect-EU-citizens'-privacy.

56. Alex Byers, *Tech Safe Harbor Under Fire in Europe*, POLITICO MORNING TECH (Nov. 6, 2013, 10:27 AM), http://www.politico.com/morningtech/1113/morningtech12137.html.

57. Google Spain v. Agencia Española de Protección de Datos, Case C-131/12, ¶ 91-94 (2014), *available at* http://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&text&pageIndex=0&part=1&mode=DOC&docid=152065&occ=first&dir&cid=437838.

58. *See id.*

59. *See id.*; *see also* Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, 1995 O.J. (L 281) 31.

60. *See Google Spain*, Case C-131/12, *available at* http://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&text&pageIndex=0&part=1&mode=DOC&docid=152065&occ=first&dir&cid=437838.

introduced. Their potential economic impact is substantial. The Information Technology and Innovation Fund estimates that data privacy rules could retard the growth of the technology industry by up to four percent, impacting U.S. companies' ability to expand and forcing them out of existing markets.[61]

The current dialogue is merely the latest in a series of growing concerns about the absence of effective privacy protections within the U.S. legal regime. High tech companies appear to see this as a concern. As Representative Justin Amash (MI-R) has explained, "Businesses increasingly recognize that our government's out-of-control surveillance hurts their bottom line and costs American jobs. It violates the privacy of their customers and it erodes American businesses' competitive edge."[62]

It is with the impact of lack of privacy controls in the surveillance sphere on U.S. competitiveness in mind that, in December 2013, some of the largest U.S. Internet companies launched a campaign to pressure the government to reform the NSA programs. Microsoft General Counsel Brad Smith explained: "People won't use technology they don't trust." He added, "Governments have put this trust at risk, and governments need to help restore it."[63] Numerous high technology CEOs supported the initiative, such Google's Larry Page, Yahoo's Marissa Mayer, and Facebook's Mark Zuckerberg.[64] The aim is to limit government authority to collect user data, to institute better oversight and accountability, to ensure greater transparency about what the government is requesting (and obtaining), to increase respect for the free flow of data across borders, and to avoid political clashes on a global scale. Mayer, explained, "Recent revelations about government surveillance activities have shaken the trust of our users, and it is time for the United States government to act to restore the confidence of citizens around the world."[65]

D. Internet Governance

From the inception of the Internet, the U.S.-based Internet Corporation for Assigned Names and Numbers (ICANN) has governed the web. As time has progressed, and the Internet has become part of the global infrastructure, there have been calls from several nations to end U.S.

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61. Michael Hickens, *Spying Fears Abroad Hurt U.S. Tech Firms*, WALL ST. J., Feb. 3, 2014, http://online.wsj.com/articles/SB10001424052702303743604579350611848246016.

62. Gustin, *supra* note 11.

63. Brad Smith, TWITTER (Dec. 8, 2013), https://twitter.com/BradSmi/status/409912923952140289.

64. *Id.*

65. *Id.*

dominance and to have the International Telecommunication Union (ITU), an entity within the UN, become the governing body.[66] The global backlash against the NSA programs raises question about the future of Internet governance. The revelations have not only contributed further to such calls, but they have spurred increased discussion of the need for regional Internet control.[67]

Over the past decade, three main groups have emerged to vie for control of the Internet. The first is centered on states, who consider the question in light of national sovereignty. It is comprised of developing countries as well as large, emerging economies like China, Russia, Brazil, and South Africa.[68] It overlaps significantly with the Group of 77 (consisting of more than 100 countries which emerged from the non-aligned movement in the Cold War). These states are critical of the United States and its dominant role in Internet governance and oppose private sector preeminence, on the grounds that they are pawns of the United States.[69] Emphasis instead is placed on the UN and the ITU as potential repositories of Internet authority. The second group is civil society. The third is the private sector. These groups tend to support what is referred to as a "multistakeholder model:" i.e., native Internet governance institutions that are generally nonprofit entities in the private sector.[70] Membership includes both technical experts (e.g., ICANN and Regional Internet Registries), as well as multinational corporations (e.g., Microsoft, Facebook, and AT&T). Prior to the Snowden releases, Japan, the EU, and the United States found themselves in this camp. Civil society organizations emphasize Internet freedom, consumer privacy, and user rights—often bringing them into conflict with the states who comprise the G77-type group.[71] As one

66. *See* Eric Pfanner, *U.S. Rejects Telecommunications Treaty,* N.Y. TIMES (Dec. 13, 2012), http://www.nytimes.com/2012/12/14/technology/14iht-treaty14.html?pagewanted=1.

67. *See, e.g.*, ICANN, https://www.icann.org/ (last visited Feb. 18, 2015).

68. Milton Mueller & Ben Wagner, *Finding a Formula for Brazil: Representation and Legitimacy in Internet Governance* 3 (2014), (unpublished manuscript) (on file with the University of Pennsylvania Annenberg School Internet Policy Observatory Working Paper Series), *available at* http://www.internetgovernance.org/wordpress/wp-content/uploads/MiltonBenWPdraft_Final.pdf.

69. *See, e.g.*, Amanda Holpuch, *Brazil's Controversial Plan to Extricate the Internet From U.S. Control,* THE GUARDIAN (Sept. 20, 2013), http://www.theguardian.com/world/2013/sep/20/brazil-dilma-rousseff-internet-us-control ("Rousseff proposed a set of ambitious, and controversial, measures that include: constructing submarine cables that do not route through the US, building internet exchange points in Brazil, creating an encrypted email service through the state postal service and having Facebook, Google and other companies store data by Brazilians on servers in Brazil.").

70. *Id.*

71. *Id.*

commentator explains, "This alignment of actors has been in place since the 2003 World Summit on the Information Society (WSIS) meetings. But the Snowden NSA revelations seem to have destabilized this settled political alignment."[72]

In the wake of the Snowden documents, ICANN and Brazil have formed an alliance, condemning U.S. actions. Concern about the latest revelations spurred a major conference in April 2014, the *Global Multistakeholder Conference on the Future of Internet Governance.* The purpose of the meeting, which was held in Sao Paulo, was "to produce universal internet principles and an institutional framework for multi-stakeholder Internet governance."[73]

It is not clear how the newest shifts will be resolved—either temporarily or in the future. But significant questions have been raised: How should the Internet governance be structured to ensure legitimacy and compliance? Who gets to make the decision about what such governance looks like? Which bodies have the authority to establish future rules and procedures? How are such bodies constituted and who selects their membership?

These questions are fundamentally at odds with the decentralization tendencies in the Internet—tendencies that have been exaggerated post-Snowden as a result of regional efforts to expand the local sphere of influence and to protect consumer and state privacy from U.S. surveillance.

The U.S. government's failure to address the situation domestically has undermined the tech industry. Despite calls from the companies for legislative reform to address the breadth of the NSA programs,[74] there has been no significant shift that would allow companies to approach their customers to say, with truth, that the situation has changed. Resultantly, American companies are losing not just customers, but also the opportunity to submit proposals for contracts for which they previously would have been allowed to compete.[75] The future of Internet governance hangs in the balance.

II. ECONOMIC SECURITY AS NATIONAL SECURITY

The NSA programs illustrate lawmakers' failure to recognize the degree to which economic strength is central to national security, as well as the importance of the high technology industry to the U.S. economy.

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72. *Id.*

73. *Id.*

74. *See, e.g.*, Gustin, *supra* note 11 (reporting that the nation's largest Internet companies are calling for Congress and the Administration to reform the secret surveillance programs).

75. Miller, *supra* note 11.

The concept of economic security as national security is not new: the Framers and the generations that followed acknowledged the importance of economic strength as central to national security. Our more recent understandings, however, have gotten away from the concept, in the process cleaving important interests out of the calculations required to accurately understand the implications of government actions. Unintended consequences have resulted. The Snowden leaks, for instance, may have driven bad actors to seek non-U.S. companies for ISP services, creating gaps in insight into their operations. They have also undermined U.S. efforts to call other countries to heel for their exploitation of international communications to gain advantages over U.S. industry. The expansive nature of the programs may well have acted to undermine U.S. national security in myriad ways linked to the country's economic interests.

A. Economic Security from the Founding

Despite its appearance throughout U.S. history, the term "national security" is rarely defined in law.[76] The 1947 National Security Act, for instance, which, *inter alia*, constituted the National Military Establishment (later the Department of Defense), and the National Security Council, refers to "national security" more than 100 times; yet, it does not define the term.[77] The Foreign Intelligence Surveillance Act of 1978 employs the term nearly a dozen times, to ascertain what matters fall within the Foreign Intelligence Surveillance Court's purview, who can certify an application to FISC, and under what conditions *in camera* and *ex parte* proceedings can be held.[78] Where the Attorney General ascertains that a national security threat exists, officials may secretly search and seize property—waiting notice otherwise required under the Fourth Amendment.[79] But no definition is provided in FISA. Nor does the USA PATRIOT Act prove more illuminating—despite referring to national security more than two dozen times.[80]

Definitions of national security that are found in the U.S. Code tend to limit consideration to foreign affairs and matters related to military strength.[81] Under the Classified Information Procedures Act, "national

76. *See* Laura K. Donohue, *The Limits of National Security*, 48 AM. CRIM. L. REV. 1573, 1579 (2011).

77. National Security Act of 1947, Pub. L. No. 80-235, 61 Stat. 495 (current version at 50 U.S.C. § 401 (2012)).

78. 50 U.S.C. §§ 1803(e), 1804(a), 1806(f), and 1845(f) (2012).

79. 50 USC §1825(b) (2012).

80. *See, e.g.*, Uniting and Strengthening America by Providing Appropriate Tools Require to Intercept and Obstruct Terrorism (USA PATRIOT Act) Act of 2001, Pub. L. No. 107-56, §505, 115 Stat. 272, 365–66.

81. *See, e.g.*, 10 U.S.C. § 948a(8) (2012) ("The term 'national security' means the

security" is understood as involving matters related to the "national defense and foreign relations of the United States."[82] Nowhere does the definition reference U.S. economic security.

In the amended National Security Act, while the term could potentially be understood to encompass U.S. economic security, the actual definition does not specify a precise link to economic vitality. Instead, "intelligence related to national security" refers to:

> all intelligence, regardless of the source from which derived and including information gathered within or outside the United States, that
> (A) pertains, as determined consistent with any guidance issued by the President, to more than one United States Government agency; and
> (B) that involves—
> (i) threats to the United States, its people, property, or interests;
> (ii) the development, proliferation, or use of weapons of mass destruction; or
> (iii) any other matter bearing on United States national or homeland security.[83]

The Federal Information Security Management Act of 2002 (providing rules for government-wide information security) similarly fails to consider the economic underpinnings of national security, instead, understanding "national security systems" as any system:

> (i) the function, operation, or use of which
> (I) involves intelligence activities;
> (II) involves cryptologic activities related to national security;
> (III) involves command and control of military forces;
> (IV) involves equipment that is an integral part of a weapon or weapons system; or
> (V) subject to subparagraph (B), is critical to the direct fulfillment of military or intelligence missions; or
> (ii) is protected at all times by procedures established for information that have been specifically authorized under criteria established by an Executive order or an Act of Congress to be kept classified in the interest of national defense or foreign policy.[84]

While there may be room in the definition for economic considerations, they are not front and center.

Executive Branch articulations are similarly unhelpful. President George W. Bush's five-page National Security Presidential Directive 1 referred to

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national defense and foreign relations of the United States.").

82. Classified Information Procedures Act, Pub. L. 96–456, 94 Stat. 2025, (codified at 18 U.S.C. app. § 1(b) (2012)).

83. 50 U.S.C. § 3003(5) (2012).

84. 44 U.S.C. § 3542(b)(2)(A) (2012).

"national security" thirty-three times, without any definition.[85] President Barak Obama's Presidential Policy Directive 1 ("PPD-1"), in turn, addressing the National Security Council, referred to "national security" thirty-three times—without ever defining it.[86] Like the Executive Branch, courts tend to look to the military and diplomatic aspects of national security, instead of their economic concomitant.[87]

Despite the lack of emphasis on economic strength in statutory definitions, the Founders were well aware of the importance of the economy in fostering international independence. The Articles of Confederation failed in significant part because the national government lacked the resources, and the economic strength, to protect the Union. For Alexander Hamilton, absent military might, diplomatic stature, and commercial success, the country would cease to exist.[88]

One of the first expansions of the executive, accordingly, was to include a Secretary of the Treasury, which, along with the Secretary of War and the establishment of the office of the Attorney General, reflected the purposes for which Union had been sought: foreign relations, military strength, economic growth, and the rule of law.[89] In his *Farewell Address*, President George Washington called for U.S. energies to be directed towards strengthening the U.S. economy: "[T]he great rule of conduct for us in regard to foreign nations is in extending our commercial relations, to have with them as little political connection as possible."[90]

The federal government was willing, from a very early date, to act in support of its commercial interests with whatever diplomatic, legal, and military power it could muster.[91]

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85. National Security Presidential Directive on the Organization of the National Security Council System (Feb. 13, 2001), *available at* http://www.fas.org/irp/offdocs/nspd/nspd-1.htm.

86. *See* Presidential Study Directive on Organizing for Homeland Security and Counterterrorism (Feb. 23, 2009), *available at* http://www.fas.org/irp/offdocs/psd/psd-1.pdf ("[C]onceptually and functionally, [national security and homeland security] should be thought of together rather than separately.").

87. *See, e.g.*, N.Y. Times Co. v. United States, 403 U.S. 713, 719 (1971) (Black, J., concurring).

88. FEDERALIST No. 1, (Alexander Hamilton).

89. 19 JOURNALS OF THE CONTINENTAL CONGRESS, 1774-1789, at 125-26 (*available at* http://memory.loc.gov/cgi-bin/ampage?collId=lljc&fileName=019/lljc019.db&recNum=137&itemLink=r%3Fammem%2Fhlaw%3A%40field%28DOCID%2B%40lit%28jc0191%29%29%230190001&linkText=1)

90. President George Washington, Farewell Address (Sept. 19, 1796), *available at* http://avalon.law.yale.edu/18th_century/washing.asp.

91. For a catalog of every military intervention in support of U.S. commercial interests, *see* WILLIAM APPLEMAN WILLIAMS, EMPIRE AS A WAY OF LIFE: AN ESSAY ON THE CAUSES AND CHARACTER OF AMERICA'S PRESENT PREDICAMENT ALONG WITH A FEW THOUGHTS ABOUT AN ALTERNATIVE (1st ed. 1980).

History is telling. The Monroe Doctrine was premised largely on this approach.[92] In 1837, President Martin Van Buren came to office determined to continue Washington's legacy, underscoring the importance of avoiding entangling alliances while pursuing America's economic interests abroad.[93] President Zachary Taylor came to office in 1849 determined to continue the course, emphasizing the importance of bolstering trade as a means of securing the country.[94] The 1850 Clayton-Bulwer Treaty ensured that future canal access through Central America would be open to international trade.[95]

As Millard Fillmore succeeded Taylor, he considered commerce central to U.S. interests abroad—for this reason, the Navy would require further resources to protect trade along the Pacific Coast.[96] Upon taking office, President Franklin Pierce reiterated the same policies: of the complicated European tumults and anxieties, the United States was to be exempt, "But the vast interests of commerce are common to all mankind, and the advantages of trade and international intercourse must always present a noble field for the moral influence of a great people."

The United States went on to emphasize its dealings with Asia and to sign an historic trade agreement with Japan.[97] Expansionism, and the economic benefits it brought, similarly proved central to U.S. national security. "Should [new possessions] be obtained," Pierce asserted during his *Inaugural Address*, "it will be through no grasping spirit, *but with a view to obvious national interest and security*, and in a manner entirely consistent with the strictest observance of national faith." From the 1898 Spanish-American War forward, the country promoted its national interests through formative political, military, and economic engagement in the international arena.

To the extent that the NSA programs, and public knowledge of them, has harmed the U.S. economy, they have harmed U.S. national security. The country's economic strength is part of what enables the United States to

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92. Mark Gilderhus, *The Monroe Doctrine: Meanings and Implications,* 36 PRESIDENTIAL STUD. Q. 5, 5-6 (2006) (describing Monroe Doctrine rhetoric as "a cover for less ennobling purposes connected with the defense of strategic and economic interests").

93. President Martin Van Buren, Inaugural Address (Mar. 4, 1837), *available at* http://www.presidency.ucsb.edu/ws/?pid=25812.

94. President Zachary Taylor, Inaugural Address (Mar. 5, 1849), *available at* http://avalon.law.yale.edu/19th_century/taylor.asp.

95. Clayton-Bulwer Treaty, art. 1, Apr. 19, 1850, 9 Stat. 995.

96. President Millard Fillmore, Message to Congress (Dec. 2, 1850), *available at* http://www.presidency.ucsb.edu/ws/?pid=29491.

97. Treaty of Amity and Commerce, July 29, 1858, 12 Stat. 1051, *available at* http://core.ecu.edu/hist/tuckerjo/harris.html.

respond to external and internal threats. The ability to defend the country against would-be aggressors requires resources—e.g., to build and equip a military force, to move troops, to respond to attacks in whatever form they may materialize. Many of the supplies needed to fend off overreaching by either states or non-state actors derive not from government production, but from the private sector. To the extent that a weak private sector emerges, the government's ability to respond is harmed.

Beyond this, economic security allows the country the freedom to determine its international and domestic policies on the merits, not on need. Where the United States is in a strong economic position, it is less vulnerable in international negotiations, such as those related to trade. It is also in a politically superior position, where it can use its wealth to accomplish the desired ends.

A strong economy also ensures that citizens have their needs met, with sufficient income levels for housing, food, clothing, and education. This, in turn, generates social and political stability, which allows for the development of communities, which creates greater cohesion among citizens. It also contributes to the evolution of democratic deliberations, reinforcing the rule of law.

Economic security allows for growth and innovation, which is fed by education and opportunity. Innovation, in turn, allows the country to continue to adapt to the evolving environment and international context. There are further considerations. But these suffice to illustrate the importance of economic strength to U.S. national security writ large.

High technology is central to the U.S. economy. A recent study by the Bay Area Economic Council Institute sought to ascertain how important the high tech industry is just for the U.S. labor market. It found that not only are high-tech jobs critical for generating employment in other sectors, but that growth in the high-tech sector has increasingly been happening in areas of great economic and geographic diversity, suggesting that the high-tech industry is not limited to one ethic, social, or economic strata.

High-technology has been one of the fastest-growing sectors: between 2004 and 2012, the employment growth in high-tech outpaced private sector growth by a ratio of 3:1. Jobs in Science, Technology, Engineering, and Mathematics (STEM) outpaced job gains across all occupations by a ratio of 27:1.[98] Employment predictions put the demand for high-tech workers to increase 16.2% 2011 to 2020, with STEM employment increasing 13.3% during the same period.[99]

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98. TECHNOLOGY WORKS: HIGH-TECH EMPLOYMENT AND WAGES IN THE UNITED STATES, BAY AREA COUNCIL ECONOMIC INSTITUTE (Dec. 2012), *available at* http://www.bayareaeconomy.org/media/files/pdf/TechReport.pdf.

99. *Id.*

The study found that the generation of jobs in high-technology had far-reaching effects. In addition to the income gains generated by innovation, productivity and a global marketplace, high-technology industrial growth generated other types of jobs. Health care, education, law, restaurants, hotels and personal services, as well as goods-producing construction sectors grew in tandem with high tech, largely because of a local multiplier effect: "For each job created in the local high-tech sector," the study concluded, "approximately 4.3 jobs are created in the local non-tradable sector in the long run."[100]

Even as early as 2002, the National Science Foundation found that the global market for high-technology goods is growing at a swifter rate than for other manufactured goods. More than this, "high-technology industries are driving economic growth around the world."[101]

This study built on one released in 1995 by the National Academies, which had looked carefully at the role and importance of high tech companies in the U.S. economy.[102]

Study after study reflects the importance of high-technology in the U.S. economy. In 2015, a Brookings study found that "advanced industries" (which include high-technology, STEM, and industries, like aerospace, which are heavily dependent on advanced technologies), "represent a sizable economic anchor for the U.S. economy."[103] They led the post-recession recovery. Brookings found that with only 9 percent of the total U.S. employment, advanced industries produce some $2.7 trillion per year—around 17% of the country's GDP. Further, about 60 percent of U.S. exports are tied to this sector, with 2.2 jobs being created domestically for every new advanced industry job. In sum, "Directly and indirectly. . . the sector supports almost 39 million jobs—nearly one-fourth of all U.S. employment."[104]

What these numbers mean is that hits to high technology directly impact the U.S. economy. The country's strength relies, in part, on wealth and resources—particularly the production and consumption of goods and services. With the economy so central to U.S. national security, one might

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100. *Id.*

101. *Industry, Technology, and the Global Marketplace*, SCI. & ENGINEERING (2002), http://www.nsf.gov/statistics/seind02/c6/c6s1.htm#c6s111.

102. NATIONAL ACADEMY OF ENGINEERS, RISK AND INNOVATION: THE ROLE AND IMPORTANCE OF SMALL, HIGH-TECH COMPANIES IN THE U.S. ECONOMY (1995).

103. Mark Muro, et al., *America's Advanced Industries: What They Are, Where They Are, and Why They Matter*, BROOKINGS INST., 3 (Feb. 2015), http://www.brookings.edu/~/media/Research/Files/Reports/2015/02/03%20advanced%20industries/final/AdvancedIndustry_FinalFeb2lores.pdf.

104. *Id.*; *see also id.* at 10.

be forgiven for assuming that economic interests—particularly those that affect significant sectors—are well-represented in the institutional structure that governs national security. Unfortunately, they are not.

B. National Security Infrastructure

The National Security Council ("NSC") is "the principal forum for consideration of national security policy issues requiring Presidential determination." [105] The President looks to the forum for advice and assistance in matters ranging from domestic, foreign and military, to intelligence and economic.[106]

It is thus surprising that the 1947 National Security Act includes neither the Secretary of the Treasury, nor the Secretary of Commerce, as permanent (statutory) members of the NSC. Instead, the entity is chaired by the President, with formal membership extended to the Vice President, the Secretary of State, and the Secretary of Defense.[107] The Chair of the Joint Chiefs of Staff acts as the statutory military advisor, the Director of National Intelligence as the statutory intelligence advisor, and the Director of National Drug Control Policy as the statutory drug control policy advisor.[108]

Under PDD-1, the NSC includes the Secretary of Treasury, and "[w]hen international economic issues are on the agenda of the NSC, the NSC's regular attendees will include the Secretary of Commerce, the United States Trade Representative, the Assistant to the President for Economic Policy, and the Chair of the Council of Economic Advisers."[109]

When the emphasis is not international economic issues, the structure does not cement economic concerns into the discussion. Nor does it contemplate the inclusion of Treasury or Commerce as an operational matter—i.e., when the intelligence community is deciding whether to develop a surveillance program. Such issues are not brought directly to the NSC.[110]

To the extent that the failure to include these members at the most basic level reflects a perspective that potentially sidelines economic concerns, the continued failure to build in strong representation at a programmatic level underscores the concern. Economic issues may be treated with seriousness,

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105. Presidential Policy Directive on the Organization of the National Security Council System (Feb. 13, 2009), *available at* http://fas.org/irp/offdocs/ppd/ppd-1.pdf.

106. *Id.*

107. 50 U.S.C. § 3021 (2012).

108. *Id.*

109. President Policy Directive, *supra* note 86.

110. DeRosa, *supra* note 19.

but they are not meaningfully integrated into the national security infrastructure.

C. Unintended Harmful Consequences

There are various ways in which the NSA's apparent failure to take account of the potential impact of public knowledge of the programs on U.S. industry may have acted to undermine U.S. security beyond weakening the economy. The backlash risks shielding foreign government actions from public scrutiny. It potentially undermines the ability of the United States to develop international norms against ubiquitous surveillance, which can be used for political or economic espionage. And it raises the possibility that the country will lose digital sight of active threats against the United States.

As was previously noted, the data localization movement, given momentum by the NSA revelations, risks the creation of distinct, parallel Internets, which would stifle the free flow of information that connects not just economies, but cultures and people, with potential rollbacks for an increasingly globalized world. This would affect the country's interest in democratic engagement and it would harm the United States' international reach. The creation of national search engines, national email systems, and national social networks, moreover, means that foreign governments will have direct control over electronic communication networks, facilitating censorship and domestic surveillance and limiting outside view of the extent to which such steps are being taken.

When Turkish Prime Minister Recep Erdoğan, for instance, recently tried to shut down Twitter, the international community was immediately put on notice.[111] #TwitterisblockedinTurkey #dictatorerdogan, and #occupytwitter quickly moved to popular trending topics internationally.[112] The United States, EU, and others formally objected to the action through diplomatic channels. Had Turkey been an isolated network, it may have secretly censored the politically damaging information (in this case, leaks alleging corruption in the Erdoğan government), without generating such immediate, international attention.

Along the same lines, in July 2014 President Vladimir Putin signed a new law requiring Internet companies to store all Russian users' data within domestic borders. Russia's media and parliament members have

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111. Kevin Rawlinson, *Turkey Blocks Use of Twitter after Prime Minister Attacks Social Media Site*, THE GUARDIAN, (Mar. 20, 2014), http://www.theguardian.com/world/2014/mar/21/turkey-blocks-twitter-prime-minister.

112. *Id;* Sebnem Arsu and Dan Bilefsky, *In Turkey, Twitter Roars after Effort to Block It*, N.Y. TIMES, Mar. 21, 2014, http://www.nytimes.com/2014/03/22/world/europe/turks-seek-to-challenge-twitter-ban.html?_r=2.

used Edward Snowden's leaks about NSA spying to rally support for the new law.[113] The legislation serves to intensify Putin's control over Internet companies.[114] With internal data centers, it will be easier for the Russian president to enforce censorship policies and to collect information about members of the political opposition. The law could also give Putin an excuse to shut down major social media networks if they fail to comply with the new regulations.

The NSA revelations also have undermined U.S. credibility in challenging other countries' efforts to obtain trade secrets and other information through state surveillance. China provides one of the strongest examples. Because of the NSA programs, U.S. objections to China selling surveillance technology to oppressive regimes look rather weak. Post-Snowden, Chinese efforts have become even more public and devastating to U.S. interests.

Since 2005, when President Mahmoud Ahmadinejad first took office, Iran has stated its plan to develop a national Internet network.[115] In the intervening decade, the country has been unable to do so. But in 2014 Iran's Ministry of Communications and Information Technology announced that China would officially be collaborating with them on the creation of the National Information Network.[116] Part of Iran's aim has been to develop a system that allows the country to turn off the international components of the Internet, in a way that will enable the government and domestic banking industry to continue to operate. With more than half the population under age 35, Iran has a tech-savvy citizenry, which has, to date, found various ways around government efforts to block

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113. Yasha Levine, *Putin Ramps Up Internet Censorship, citing Google and Snowden to Ensure Public Support*, PANDODAILY (Mar. 20, 2014) http://pando.com/2014/03/20/putin-ramps-up-internet-censorship-citing-google-and-snowden-to-ensure-public-support/.

114. Sarah Gray, *Putin Tightens Grip on Internet: Signs New Law Requiring Mass Storage of Russians' Data*, SALON (Jul. 23, 2014), http://www.salon.com/2014/07/23/putin_tightens_grip_on_internet_signs_new_law_requiring_mass_storage_of_russians_data/.

115. Behrang Tajdin, *Will Iran's National Internet Mean No World Wide Web?*, BBC NEWS (Apr. 27, 2013), http://www.bbc.com/news/world-middle-east-22281336.

116. Engineer Jahangard, in his meeting with China's "Committee of Information", announced that the countries will exchange their experiences in the field of ICT (Internet Communication Technology), Ministry of I.C.T., Feb. 10, 2015, available at https://www.ict.gov.ir/fa/news/10162. *See also* Jessica McKenzie, *When it Comes to Internet Censorship, China and Iran Are All in This Together*, TECHPRESIDENT (Jan. 22, 2014), http://techpresident.com/news/wegov/24693/when-it-comes-internet-censorship-china-iran-are-all-together; *China to Help Iran Implement Its Closed National Internet, International Campaign for Human Rights in Iran*, IRAN HUMAN RIGHTS (Jan. 21, 2014), http://www.iranhumanrights.org/2014/01/china-iran-internet/.na.

social media and other international sources. It is not clear whether Iran will be able to completely divest itself of access to the world wide web. What is clear is that in a post-Snowden era, their efforts to do so are being facilitated by countries with interests diametrically opposed to the United States.

Online warfare between China and the United States simmered in the background, until in early 2013 the Obama Administration began to make it center stage. In January 2013, the *New York Times* reported that Chinese hackers had infiltrated its computers following a threat that if the paper insisted on publishing a story about its prime minister, consequences would follow.[117] The following month, a security firm, Mandiant, revealed that the Chinese military unit 61398 had stolen data from U.S. companies and agencies.[118] In March 2013 President Obama's National Security Advisor publicly urged China to reduce its surveillance efforts—after which classified documents leaked to the public demonstrated the extent to which China had infiltrated U.S. government servers.[119] Two months later, the National Security Advisor flew to China to lay the groundwork for a summit, in which cyber surveillance would prove center stage.[120] Two days before the Obama-Xi meeting was scheduled to take place, *The Guardian* ran the first story on the NSA programs.[121] On June 7, when Obama raised the question of Chinese espionage, Xi responded by quoting *The Guardian* and suggesting that the U.S. should not be lecturing the Chinese about surveillance.[122] Although differences may mark the two countries' approaches (e.g., in one case for economic advantage, in the other for political or security advantage), the broader translation for the global community has been one in which the United States has lost the high ground to try to restrict cyber-surveillance.

A final point is worth noting in this context. To the extent that non-U.S. companies are picking up customers and business overseas, the United States' ability to conduct surveillance may be further harmed—thus going directly to the country's national security interests. In other words, it may be in the country's best interests to keep traffic routed through U.S. companies, which would allow the national security infrastructure, with appropriate legal process, to access the information in question. The

117. Kurt Eichenwald, *How Edward Snowden Escalated Cyber War*, NEWSWEEK (Oct. 31, 2013, 7:22 PM), http://www.newsweek.com/2013/11/01/how-edward-snowden-escalated-cyber-war-243886.html.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

apparent overreach of the NSA, however, may end up driving much of the traffic elsewhere, making it harder for the United States to obtain the information needed to protect the country against foreign threats.

III. STEPS REQUIRED TO REDRESS THE CURRENT SITUATION

Numerous steps could be taken by Congress to address the situation in which U.S. industry currently finds itself. The most effective and influential decision that legislators could take would be to curb the NSA's authorities under the Foreign Intelligence Surveillance Act. This action has two components: first, ending the telephony metadata collection program and, second, restricting the use of to/from, or about collection under upstream interceptions. Both programs would further benefit from greater transparency, to make it clear that their aim is to prevent foreign aggression and to prevent threats to U.S. national security—not to engage in the interception of trade secrets or to build dossiers on other countries' populations.

The second most effective change that could be undertaken would be to introduce stricter privacy controls on U.S. companies, in the process bringing the United States into closer line with the principles that dominate in the EU. The two entities are not as far apart as the dialogue might lead one to assume, and so changes required in this sphere would be minimal. Together, these two alterations—curbing the NSA surveillance programs and providing increased consumer protections for privacy—would allow U.S. industry to argue changed circumstances to allow companies to again become competitive for contracts and markets to which they seek access.

A third alteration that would make a substantial difference over the longer term relates to the national security infrastructure. The current failure of the United States to integrate economic concerns creates a vulnerability for the country in terms of the breadth and depth of programs subsequently adopted. New thought needs to be given on how to take on board—and to mitigate—potentially devastating economic consequences of government surveillance efforts.

A. FISA Alterations

In addition to its economic impact, the NSA program relating to telephony metadata runs contrary to Congressional intent in introducing the FISA, contradicts the statutory language, and violates the Fourth Amendment.[123] In 2014, the Privacy and Civil Liberties Oversight Board came to a similar conclusion,[124] as did the President's own appointed

123. Donohue, *Bulk Metadata Collection*, *supra* note 1.

124. PRIVACY AND CIVIL LIBERTIES OVERSIGHT BD., REPORT ON THE TELEPHONE

Review Group, charged with considering the telephony metadata collection program, in 2013.[125]

Accordingly, the President announced on January 17, 2014 that he was "ordering a transition that will end the Section 215 bulk metadata program as it currently exists, and establish a mechanism that preserves the capabilities we need without the government holding this bulk metadata."[126] The alternative approach was to be developed by March 28, 2014. Nine months later, on September 13, 2014, the FISC approved the Department of Justices's ("DOJ") request to extend the program for another 90 days—without any transition program in place. More than a year after the announcement, a new program has yet to be put into place.

The President issued a new presidential directive for U.S. signals intelligence activities, both at home and abroad. The classified nature of parts of the document, international skepticism about the Administration's commitment to privacy, and the failure of the Administration to make good on its promise of transition to a new program meant that the global community, with good reason, has questioned whether anything has really changed.

As a matter of Section 702 and the interception of international content, PRISM and Upstream collection present global concerns. Neither program has yet to be addressed through any legislative change. The existence of these programs, while perhaps statutorily consistent with the FISA Amendments Act, as well as constitutionally sufficient with regard to the interception of non-U.S. persons communications, where the individual is reasonably believed to be located outside the United States, goes some way towards undermining international confidence in U.S. companies.

The Fourth Amendment does not reach non-U.S. persons based overseas who lack a substantial connection to the United States.[127] Writing for the Court in *United States v. Verdugo-Urquidez*, Chief Justice Rehnquist concluded that "the people" referred to in the Fourth Amendment indicate a particular group—not merely people *qua* people.[128] His reading stems from a deeply Aristotelian approach: i.e., one that emphasizes membership in the

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RECORDS PROGRAM CONDUCTED UNDER SECTION 215 OF THE USA PATRIOT ACT AND ON THE OPERATIONS OF THE FOREIGN INTELLIGENCE SURVEILLANCE COURT (2014), *available at* https://www.eff.org/files/2014/01/23/final_report_1-23-14.pdf.

125. PRESIDENT'S REVIEW GRP. ON INTELLIGENCE & COMMC'NS TECHS., LIBERTY AND SECURITY IN A CHANGING WORLD, (2013), *available at* http://apps.washingtonpost.com/g/page/world/nsa-review-boards-report/674/.

126. Remarks on United States Signals Intelligence and Electronic Surveillance, 2014 DAILY COMP. Pres. Doc. 30 (Jan. 17, 2014).

127. Donohue, *Section 702*, *supra* note 1.

128. United States v. Verdugo-Urquidez, 494 U.S. 259, 265 (1990) (per curiam).

political community as a concomitant of forming a structure of government.[129] As members of the polis, U.S. persons, both distributively and collectively, obtain the protections of the Constitution.

Viewed in this regard, the Constitution itself embodies the collective organization of "the people" into one entity. "U.S. persons" and "the people" are, therefore, one and the same. The "right of the people" thus refers to a collective group of individuals "who are part of a national community or who have otherwise developed sufficient connection with this country to be considered part of that community."[130]

Very few cases address precisely what constitutes sufficient contact with the United States to satisfy the "substantial connections" aspect of the majority's decision. Those that do point in seemingly different directions.[131] At a minimum, however, it would be extraordinary to assume that simply because an individual uses a U.S. company, he or she thereby gains the protections of the Fourth Amendment. This was the basic argument underlying the "modernization" of FISA in the first place, to take account of bad actors, communicating overseas, who would suddenly fall within the more protective FISA regime merely because their communications happened to come within U.S. territory by nature of the carrier in question.

Even recognizing, however, that few constitutional barriers may apply to the programmatic use of Section 702 insofar as it is applied to non-U.S. persons (leaving aside the questions that accompany the incidental collection of massive amounts of U.S. persons' information, including entirely domestic conversations), as a matter of policy, both PRISM and the use of to/from or about Upstream collection has dramatically undermined U.S. industry. As a matter of policy, therefore, greater restrictions, more transparency, and more effective oversight of the international collection of content may help to alter the situation with regard to the skepticism expressed towards U.S. companies.

The Obama Administration has begun to take steps to acknowledge the importance of data privacy for European citizens, but its actions have thus far been limited to law enforcement, excluding surveillance conducted for national security purposes. In June 2014, Attorney General Eric Holder announced that, as part of the EU-U.S. Data Protection and Privacy Agreement, the Administration would work with Congress to provide EU citizens the ability to seek redress in U.S. courts where personal data,

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129. ARISTOTLE, POLITICS, bk. I (Benjamin Jowett trans.) (c. 350 B.C.E.), *available at* http://classics.mit.edu/Aristotle/politics.1.one.html.

130. *Verdugo-Urquidez*, 494 U.S. at 265.

131. Orin Kerr, *The Fourth Amendment and the Global Internet*, 67 STAN. L. REV. 285, 308 (2015).

shared with the United States by European countries for law enforcement purposes is subsequently intentionally or willfully disclosed.[132] The Office of the Director of National Intelligence claims this action as part of the privacy-protective measures implemented in the wake of the Snowden disclosures.[133] The agreement, however, is limited to information provided by European countries, making it somewhat beside the point. More relevantly, the Administration supported the USA FREEDOM Act, which would have prohibited the bulk collection of telephony metadata under Section 215 of the USA PATRIOT Act (as well as the Pen Registers and Trap and Trace provisions of FISA and National Security Letters, which appear in five parts of the U.S. Code). Congress, however, failed to pass the USA FREDOM Act. Actions taken with regard to Section 702 have been minimal and generally focused on U.S. persons.

B. Privacy Law Harmonization

Much ink has been spilled on the cultural and practical differences between the United States and the EU with regard to data protection and privacy law. These differences have been over-blown.

There are myriad ways in which the two regions reflect a similar approach. Just as the United States' Fourth Amendment protects the right to privacy, for instance, Article 8 of the European Convention for the Protection of Human Rights and Fundamental Freedoms embraces the same.[134]These documents constitutionally ground two fundamental liberty interests in their respective regions' governing frameworks: (a) the right to

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132. *Attorney General Holder Pledges Support for Legislation to Provide E.U. Citizens with Judicial Redress in Cases of Wrongful Disclosure of Their Personal Data Transferred to the U.S. for Law Enforcement Purposes*, DEPT. OF JUSTICE June 25, 2014, http://www.justice.gov/opa/pr/attorney-general-holder-pledges-support-legislation-provide-eu-citizens-judicial-redress.

133. *Signals Intelligence Reform 2015 Anniversary Report*, Office of the Director of National Intelligence, IC ON THE RECORD, *available at* http://icontherecord.tumblr.com/ppd-28/2015/privacy-civil-liberties ("In furtherance of its commitment to protecting privacy in the law enforcement context, the Administration is working with Members of Congress on legislation to give citizens of designated countries to the right to seek judicial redress for intentional or willful disclosures of protected information, and for refusal to grant access or to rectify any errors in that information.")

134. *Compare* U.S. CONST., amend. IV ("The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized."), *with* Convention for the Protection of Human Rights and Fundamental Freedoms art. 8, Nov. 4, 1950, 213 U.N.T.S. 221, *available at* http://coventions.coe.int/Treaty/en/treaties/html/005.htm ("Everyone has the right to respect for his private and family life, his home and his correspondence.").

privacy, and (b) freedom from arbitrary invasion of one's private sphere.[135] In the European Union, these liberties are supported by EU-wide directives, such as the 1995 European Data Protection Directive and the EU Internet Privacy Law of 2002.[136] Further, in both the EU and the U.S. such liberty interests are protected through national legislation, in which a judicial remedy is provided for a breach of the right to privacy.[137] The manner in which these rights are treated is similarly consistent. In both spheres, these rights are offset against the obligations owed by the data holder to the individual to whom the information relates.[138]

As a substantive matter, the two regions have adopted similar provisions. In the EU and the U.S., for instance, heightened protections are provided

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135. *Compare* U.S. CONST., amend. IV ("The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized. *"), with* Convention for the Protection of Human Rights and Fundamental Freedoms art. 8, Nov. 4, 1950, 213 U.N.T.S. 221, *available at* http://coventions.coe.int/Treaty/en/treaties/html/005.htm ("Everyone has the right to respect for his private and family life, his home and his correspondence.").

136. Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, 1995 O.J. (L 281) 31; Directive 2002/58/EC of the European Parliament and of the Council of 12 July 2002 concerning the processing of personal data and the protection of privacy in the electronic communications sector, 2002 O.J. (L 201) 37.

137. *Compare* Directive 95/46, of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data, Recitation 55, 1995 O.J. (L 281) 31, 36, *with* U.S. statutory provisions related to privacy (including, *inter alia*: the Americans with Disabilities Act, 42 U.S.C. §§ 12101-12213 (2012); Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779 (codified as amended in scattered sections of 47 U.S.C.) (2012), Children's Internet Protection Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 20 and 47 U.S.C.) (2012), Children's Online Privacy Protection Act of 1998, 15 U.S.C. §§ 6501-6506 (2012), Fair Credit Reporting Act 15 U.S.C. §§ 1681-1681x (2012), Driver's Privacy Protection Act of 1994, 18 U.S.C. §§ 2721-2725 (2012), Electronic Communications Privacy Act of 1986, Pub. L. No. 99-508, 100 Stat. 1848 (codified as amended in scattered sections of 18 U.S.C.) (2012), Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of the U.S.C.) (2012), Privacy Act of 1974, 5 U.S.C. § 552a (2012), Privacy Protection Act of 1980, 42 U.S.C. §§ 2000aa-2000aa-12 (2012), Right to Financial Privacy Act of 1978, 12 U.S.C. §§ 3401-3422 (2012), Telephone Consumer Protection Act of 1991, Pub. L. No. 102-243, 105 Stat. 2394 (codified as amended in scattered sections of 47 U.S.C.) (2012), Video Privacy Protection Act of 1988 18 U.S.C. § 2710 (2012), and the Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, 110 Stat. (codified as amended in scattered sections of the U.S.C.) (2012).

138. *Compare* Recitation No. 25, 1995 O.J. (L281) 31,*33 with* Greenwald & MacAskill, *supra* note 1.

for what is known as personally-identifiable information.[139] A series of exceptions to the dominant structure is provided in two central areas: security (including, e.g., criminal law, public security, defense, and national security) and freedom of expression (such as with regard to journalism, literary pursuits, artistic expression, and political opinions).[140] To ensure that the substantive measures reflect the underlying constitutional principles, both regions insist on minimization—i.e., that the information collected on individuals be limited to what is strictly necessary for the purposes delineated by statute.[141]

Both the U.S. and the EU have established a set of substantive requirements related to individuals' knowledge that data about them is being collected, stored, and possibly shared with others. Consent, for instance, is central to both systems.[142]

Much has been made in regard to the distinction between the opt-in (European approach) versus the opt-out (American approach).[143] What has been lost, however, is that both approaches rely on the consent of the subject (subject to specific exceptions, above), in order to proceed with data gathering, analysis, and distribution. To facilitate this structure, both regions also require that notice be provided to targets and that individuals have the right to access information that is held about them.[144] Individuals, in both systems, have the right to object to particular information, and in both systems, the data holder has a duty to ensure that the information is accurate and kept up to date.[145]

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139. *Compare, e.g.*, Recitation No. 26, 1995 O.J. (L 281) 31,*33 with* 5 U.S.C. § 552a.

140. *Compare, e.g.*, Recitation Nos. 16 (national security), 17 (written and artistic expressions), and 36 (political opinions), 1995 O.J. (L 281) 31, 32 *with* Foreign Intelligence Surveillance Act of 1978, Pub. L. No. 95-511, 92 Stat. 1783 (codified as amended in scattered sections of the U.S.C.) (2012) (national security exceptions and singling out of otherwise protected First Amendment activity). *See also* Council Directive 2006/24 and Amending Directive 2002/58/EC, 2006 O.J. (L. 105) 54 (creating exceptions for criminal law).

141. *Compare* Recitation No. 28, 1995 O.J. (L 281) 31, *34 with* 92 Stat. 1783 (codified as amended in scattered sections of the U.S.C.).

142. *Compare* Recitation No. 30, 1995 O.J. (L 281) 31, 34 *with* Greenwalk & McAskill, *supra* note 1.

143. *See, e.g.*, Gerhard Steinke, *Data Privacy Approaches from U.S. and EU perspectives,* 19 TELEMATICS AND INFORMATICS 193, 196 (2002) (explaining the EU Data Protection Directive requires consumers to opt -in before sensitive information is disclosed to third parties); Tim Worstall, *The EU Warns Tech Firms: Opt Out Is No Longer Good Enough,* FORBES (Jan. 10, 2013), http://www.forbes.com/sites/timworstall/2013/01/10/the-eu-warns-tech-firms-opt-out-is-no-longer-good-enough/.

144. *Compare, e.g.*, Recitation Nos. 38 (notice) and 41 (right of access), 1995 O.J. (L 281) 31, 35 *with* Greenwalk & McAskill, *supra* note 1.

145. *Compare, e.g.*, 1995 O.J. (L 281) 31, 40, 43, (referring specifically to article 14

Keeping in mind the consistencies between the two systems, and the benefits to be gained for U.S. industry from emphasizing harmony, there are two areas where the regions differ that could be addressed through legislative reform: recognition of residual rights in third party data, and the creation of a comprehensive, privacy-protective regime, as opposed to the piecemeal approach that currently marks U.S. law.

1. Residual Rights in Third Party Data

One central question that divides the United States from numerous other countries and regions—including the European Union—centers on who owns an individual's data. In the United States, since *Smith v. Maryland* (addressing pen registers and trap and trace devices), and *U.S. v. Miller* (focusing on financial records), all three branches have treated information held by third parties as lacking an individual right to privacy.[146]

In contrast, the EU considers that the individual who has provided data to a third party to still have a privacy interest in the information.[147] The recent European Court decision, recognizing the right to anonymity, necessarily presupposes a continued interest in data, even once it is obtained by a third party.[148]

The difference between the approaches is central to understanding how new technologies, such as social network analysis, cloud computing, and data mining, have deepened the privacy interests implicated in third party handling of data. New technologies allow information to be generated about which, even those to whom the data relates are unaware. To say that individuals do not have a reasonable expectation of privacy in this information rather flies in the face of common sense.

The Supreme Court appears to be coming to this conclusion as well. In *United States v. Jones*, the Court considered a case involving 28-day surveillance involving the placement of a GPS chip on a vehicle.[149] Although ultimately decided on grounds of trespass, a shadow majority expressed strong concern about the implications of long-term surveillance. Justice Alito, joined by Justice Ginsburg, Justice Breyer, and Justice Kagan,

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(right to object) and article. 6 (accurate data)) *with* Greenwald & McAskill, *supra* note 1.

146. Smith v. Maryland, 442 U.S. 735 (1979); United States v. Miller, 425 U.S. 435 (1976).

147. *See, e.g.*, Recitation No. 47, 1995 O.J. (L 281) 31, 36.

148. *See* Google Spain v. Agencia Española de Protección de Datos, Case C-131/12, (2014), *available at* http://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&text&pageIndex=0&part=1&mode=DOC&docid=152065&occ=first&dir&cid=437838.

149. United States v. Jones, 132 S. Ct. 945 (2012).

suggested that in most criminal investigations, long-term monitoring "impinges on expectations of privacy."[150] The nature of new technologies mattered:

Recent years have seen the emergence of many new devices that permit the monitoring of a person's movements. In some locales, closed-circuit television video monitoring is becoming ubiquitous. On toll roads, automatic toll collection systems create a precise record of the movements of motorists who choose to make use of their convenience. Many motorists purchase cars that are equipped with devices that permit a central station to ascertain the car's location at any time so that roadside assistance may be provided if needed and the car may be found if it is stolen.[151]

Justice Sotomayor went one step further, calling into question the entire basis for the third party doctrine. Specifically, in light of the level of intrusiveness represented by modern technology, "it may be necessary to reconsider the premise that an individual has no reasonable expectation of privacy in information voluntarily disclosed to third parties."[152] Sotomayor pointed out:

This approach is ill suited to the digital age, in which people reveal a great deal of information about themselves to third parties in the course of carrying out mundane tasks. People disclose the phone numbers that they dial or text to the cellular providers; the URLs that they visit and the e-mail addresses with which they correspond to their Internet service providers; and the books, groceries, and medications they purchase to online retailers.[153]

She continued, "I would not assume that all information voluntarily disclosed to some member of the public for a limited purpose is, for that reason alone, disentitled to Fourth Amendment protection."[154]

Congress has an opportunity to take the lead by recognizing the right to privacy still held by data holders when information is collected by third parties. It can then craft statutes accordingly, ensuring that U.S. companies offer greater protections for consumers, in the process allowing industry to offset the claims of its overseas competitors.

2. Legal Framework

Thus far, U.S. high technology companies have been subject to a very different statutory and regulatory structure than that which prevails in the

150. *Id.* at 964 (Alito, J., concurring).
151. *Id.* at 963 (Alito, J., concurring).
152. *Id.* at 957 (Sotomayor, J., concurring).
153. *Id.*
154. *Id.*

EU. In the United States, privacy rights have largely been protected via a series of vertical statutes dealing with specific areas, such as children using the Internet, driver-related information, and medical data.[155]

In the EU, in contrast, privacy has been protected by a more omnibus-type approach, which horizontally reaches across a number of areas. This approach is reflected in the 1995 Directive as well as the national legislation implementing the directive on a country-by-country basis.[156]

The vertical statutory scheme has been successful in addressing particular, discreet areas where privacy interests reside. However, outside of these narrow exceptions, in the interests of encouraging innovation, the high technology sector has been left largely unregulated by federal statute. The assumption has been that market forces would adjust to protect privacy interests.

The advantage of this approach has been to give high tech companies a significant amount of flexibility, allowing them to independently gauge the appropriate level of privacy protections to give to consumers.

The drawback has been that privacy itself has become commoditized, with companies actually making money off of selling consumers' privacy interests. Consider Google and its email service, Gmail, for instance. The company reads and analyzes all of its customers' emails, it watches what people read, it looks at web sites people visit, and it records what people purchase. The company then sells access to customers' private lives to

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155. Children's Online Privacy Protection Act of 1998 (COPPA), Pub. L. 105-277, 112 Stat. 2681 (1998) (codified at 15 U.S.C. §§ 6501-6506 (2012)); Driver's Privacy Protection Act of 1994, Pub. L. 103-322, 108 Stat. 2099 (1994) (codified at 18 U.S.C. §§ 2721-2725 (2012)); Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, 110 Stat. 1936 (1996) (codified at 42 U.S.C. §§ 300gg, 1320d *et seq.* (2012) & 29 U.S.C. § 1181 *et seq* (2012)).

156. *See, e.g.*, Data Protection Act of 1998, c. 29 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/1998/29/contents; Bundesdatenchutzgesetz [BDSG] [Federal Data Protection Act], May 18, 2001, BGBL, I at 904 (Ger.), *available at* http://www.iuscomp.org/gla/statutes/BDSG.htm; Loi 78-17 du 6 janvier 1978 relative à l'informatique aux fichiers et aux libertés [Law 78-17 of Jan. 6, 1978 Relating to Data Files and Liberties]. JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANCAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Jan. 7, 1978, p. 227 (revised in 2004), *available at* http://www,cnil.fr/documentation/textes-fondateurs/loi78-17/;, Act on the Amendment of the Personal Data Act (986/2000) (Fin.), *available at* http://www.finlex.fi/pdf/saadkaan/; Act on Processing of Personal Data, Act No. 429, May 2000 (Den.), *available at* http://www.datatilsynet.dk/english/the-act-on-processing-of-personal-data/read-the-act-on-processing-of-personal-data/compiled-version-of-the-act-on-processing-of-personal-data/; Nomos (1997:2472) Prostasia ton Fysikon Prosopon Enanti tis Epexergasias Dedomenon Prosopikou Charaktira [Protection of Individuals with Regard to the Processing of Personal Data], Ephemeris tes Kyverneseos tes Hellenikes Demokratias [E.K.E.D.] 1997 (Greece), *available at* http://www.freedominfo.org/regions/europe/greece/.

companies who want to advertise.[157] Thus, the mother who sends an email to her son raising concern about depression may receive an ad within hours for psychiatric services, even as a pregnant woman merely looking at cribs, may within days receive mail through the U.S. post, advertising sales at Babies R'Us.

In September 2013, Google lost an effort in the 9th Circuit Court of Appeals for judicial review of a lower court's refusal to dismiss multiple class action lawsuits accusing Google of violating the Wiretap Act.[158] United States District Judge Lucy Koh determined that the case was too far along to suffer delays.[159] Koh's interpretation of the Electronic Communications Privacy Act limits the "ordinary course of business" exception—not least because Google's practice violates its own policies.[160] The lawsuits, filed in California, Florida, Illinois, Maryland, and Pennsylvania, at great expense, are ongoing.

Capitalizing on private data represents a significant breach of the right to privacy. Instead of protecting privacy, the market has exploited it for monetary gain. In the United States and overseas, individuals are concerned about the lack of protections afforded. Congressional legislation could fix this problem by bringing high technology within the broader statutory framework and thus closing a gap in the existing law.

3. Safe Harbor Considerations

In the wake of the Snowden revelations, the EU Commission issued a report recommending the retention of Safe Harbor, but recommending significant changes, including required disclosure of cloud computing and other service provider contracts used by Safe Harbor members.[161]

The Safe Harbor provisions, developed from 1999 to 2000 by the U.S. Commerce Department, the Article 31 Committee on Data Privacy, and the European Union, created a narrow bridge between the United States and EU. At the time, the European Parliament, which did not bind the European Commission, *rejected* the Safe Harbor provisions by a vote of 279 to 259, with twenty-two abstentions. Chief amongst European

157. Dan Gillmor, *As We Sweat Government Surveillance, Companies Like Google Collect Our Data,* THE GUARDIAN (Apr. 18, 2014), http://www.theguardian.com/commentisfree/2014/apr/18/corporations-google-should-not-sell-customer-data.

158. Joffe v. Google, Inc., 746 F.3d 920 (9th Cir. 2013).

159. In re Google Inc., No. 5:13-md-02430, 2013 WL 5423918 (N.D. Cal. Sept. 26, 2013).

160. *Id.*

161. *Communication from the Commission to the European Parliament and the Council,* EUROPEAN COMM'N (Nov. 27, 2013), http://ec.europa.eu/justice/data-protection/files/com_2013_847_en.pdf.

concerns was the failure of the agreement to provide adequate protections.

In light of the massive data breaches over the past five years in the United States, the practices of a largely unregulated high technology industry, and the ubiquitous nature of NSA surveillance, Europeans are now even less supportive of the Safe Harbor provisions.[162] They amount to a self-regulated scheme in which the U.S. Federal Trade Commission looks at whether a company, which has voluntarily opted-in to the program, fails to do what it has stated it will do, within the bounds of its own privacy policy.[163] Stronger measures are necessary to restore European confidence in U.S. high technology companies.

C. Establishing Economic Security as National Security

Economic strength as national security, as was previously discussed, is not a new concept. The Founding itself was premised, in part, on the importance of economic security as being vital to U.S. national interests. In 1787, the Articles of Confederation were written out of existence in part because of concern about building a stronger economy to allow the government to fulfill its domestic obligations, and to reassure the international community that the United States was a viable trading partner.[164] Since that time, the United States has at times had to remind itself of the importance of the economy to U.S. national interests. We are once again at such a moment.

High technology is a vital part of the U.S. economy. It is a symbolic and actual manifestation of the country's commitment to innovation in every sphere of life. It plays to the United States' strengths as a nation. It has the potential to change regimes, to alter political relationships, and to shape the daily lives of people around the globe. And it deserves special attention. The danger is that U.S. industry will become less competitive and that the U.S. will lose its dominance in the Internet sphere.

To some extent, we do, structurally, pay some attention to the importance of the economy for U.S. national security. But many consequential decisions are not aired in full light of the possible implications for U.S. economic interests.[165] One way Congress could

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162. *See* European Parliament Resolution *supra* note 39 ("Takes the view that, as under the current circumstances the Safe Harbour principles do not provide adequate protection for EU citizens").

163. *See Safe Harbor Privacy Principles,* U.S. DEPT. OF COMMERCE (July 21, 2000), *available at* http://www.export.gov/safeharbor/eu/eg_main_018475.asp.

164. *See* FEDERALIST NO. 11 (Alexander Hamilton) ("The speculative trader will at once perceive the force of these observations, and will acknowledge that the aggregate balance of the commerce of the United States would bid fair to be much more favorable than that of the thirteen States without union or with partial unions.").

165. *See* In re Google Inc., No. 5:13-md-02430, 2013 WL 5423918 (N.D. Cal. Sept.

rectify this would be to take a look at how to integrate economic concerns, as an institutional matter, into the national security infrastructure—and not just at the highest levels, but at a programmatic level, where key decisions about programs are being made.

CONCLUSION

The Snowden documents revealed not just the extent to which high technology companies had been coopted or compromised, but also that the targets of NSA surveillance include allied and non-allied countries.[166] The impact of this information has meant that U.S. companies have lost revenues and experienced declining market share. Simultaneously, the United States' position in international trade negotiations has been weakened. Public awareness of the NSA programs spurred international efforts to implement data localization. Jurisdictional questions and national borders previously marked the worldwide Internet discussions.[167] But countries began using the NSA programs to justify restricting data storage to national borders, making it more difficult for the United States to gain access.[168] The backlash has led some commentators to raise concern that "the Internet will never be the same."[169] At risk is the balkanization of the Internet, undermining its traditional culture of open access, and increasing the cost of doing business.[170]

By undermining high technology companies, U.S. economic security—which is central to U.S. national security—is at risk. Part of the problem

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26, 2013).

166. *See, e.g.*, Laura Poitras, et al., *NSA Spied on European Union Offices*, DER SPIEGEL, (June 29, 2013, 11:21 PM), http://www.spiegel.de/international/europe/nsa-spied-on-european-union-offices-a-908590.html; Laura Poitras, et al., *Codename 'Apalachee': How America Spies on Europe and the UN*, DER SPEIGEL (Aug. 26, 2013, 11:58 AM), http://www.spiegel.de/international/world/secret-nsa-documents-show-how-the-us-spies-on-europe-and-the-un-a-918625.html; Lana Lam & Stephen Chen, *EXCUSIVE: US spies on Chinese Mobile Phone Companies, Steals SMS Data: Edward Snowden*, S. CHINA MORNING POST (June 23, 2013), http://www.scmp.com/news/china/article/1266821/us-hacks-chinese-mobile-phone-companies-steals-sms-data-edward-snowden; Lana Lam, *US Hacked Pacnet, Asia Pacific Fibre-Optic Network Operator, in 2009*, S. CHINA MORNING POST (June 23, 2013), http://www.scmp.com/news/hong-kong/article/1266875/exclusive-us-hacked-pacnet-asia-pacific-fibre-optic-network-operator; Ewen MacAskill & Julian Borger, *New NSA Leaks Show How U.S. is Bugging its European Allies*, THE GUARDIAN (July 1, 2013, 6:28 AM), http://www.theguardian.com/world/2013/jun/30/nsa-leaks-us-bugging-european-allies.

167. *See, e.g.*, Kristina Irion, *Government Cloud Computing and National Data Sovereignty*, 4 POL'Y & INTERNET 40 (2012).

168. Levy, *supra* note 10.

169. Levy, *supra* note 10.

170. *Id.*

appears to be that the national security institutional structure has failed to adequately reflect the importance of economic concerns. Beyond this, there have been a number of unintended consequences even within spheres traditionally understood as within a national security realm.

To redress the negative effects that have followed from public awareness of the NSA programs conducted under Section 215 of the USA PATRIOT Act and Section 702 of the FISA Amendments Act, the most important step that Congress could take would be to reign in the surveillance authorities themselves, in the process providing greater transparency and oversight. An alteration in U.S. privacy law would also help to reassure U.S. customers and individuals located outside domestic bounds that consumer privacy is protected, allowing industry accurately to claim that the circumstances have changed. Consideration of how to integrate economic concerns into the national security infrastructure would further help to emphasize the importance of taking account of the impact of new initiatives on the United States.

DATA RETENTION REQUIREMENTS AND OUTSOURCED ANALYSIS: SHOULD PRIVATE ENTITIES BECOME GOVERNMENT SURROGATES IN THE COLLECTION OF INTELLIGENCE?

MICHAEL J. WOODS*

INTRODUCTION

June 5, 2013 marked the beginning of an extraordinary, though not unprecedented, period in the history of the American intelligence community. Following extensive (and unauthorized) revelations of U.S. "bulk collection" programs targeting telephone metadata, both the Executive Branch and Congress have embarked on a more or less comprehensive review of intelligence activities and the intricate regulatory structure that is meant to restrain these activities within Constitutional parameters. In many aspects, the present experience is similar to the experience in 1974-1978, when aggressive investigative journalism brought to light the extent to which U.S. intelligence agencies were engaging in questionable activities, including largely unsupervised domestic surveillance operations. In the 1970s, these disclosures led to extensive Congressional investigations, the promulgation of Executive Orders governing the conduct of all intelligence activities, and the creation of a statutory framework to govern intelligence surveillance activities

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conducted within the United States.

The present instance of this reflective process, however, also introduces some significant new themes. In the 1970s, the clear impulse in response to the revealed abuses was to directly regulate government activity.[1] Though the intelligence reforms of the mid-1970s occurred when the reputations of Executive Branch institutions were at a historically low ebb, there appeared to be a consensus that those government institutions, fitted out with proper oversight, could safely conduct intelligence activities. In the post-Snowden reform discussions, this consensus is much less in evidence. It may be that the perceived inadequacies of the 1970s-era oversight structure in the face of post 9/11 pressures fatally undermined the belief that some combination of regulatory, judicial, and Congressional oversight can be sufficient to control intelligence agencies. In any case, reform discussions now include the consistent theme that the collection, searching, and perhaps even analysis of potentially relevant data is best done by the private holders of that data not the government.

My intention here is to briefly examine whether private entities should ever serve as government surrogates in the collection or analysis of data. Mindful of the limitations of writing while this topic is in "mid-discussion," I will first examine the current proposals, and the assumptions underlying those proposals. Then, I will explore some of the issues that, in my view, militate against the surrogacy and note trends in communications technology that ought to be addressed in any reform discussions.

I. THE PRESIDENT'S DATA RETENTION PROPOSAL

Within weeks of the first Snowden disclosures, President Obama commissioned a special review group to examine the issues surrounding "bulk collection" of data and to make policy recommendations to him.[2] Shortly thereafter, Congress requested that the pre-existing Privacy and Civil Liberties Oversight Board ("PCLOB") conduct an inquiry into the newly disclosed surveillance activities.[3] Both bodies consulted widely with

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1. For a thorough description of the reform process, *see* DAVID S. KRIS & J. DOUGLAS WILSON, NATIONAL SECURITY INVESTIGATIONS AND PROSECUTIONS at Chapter 2 (regulation of intelligence activities) and Chapter 3 (regulation of intelligence surveillance and searches, specifically). (2d ed. 2012).

2. *See* Memorandum Reviewing Our Global Signals Intelligence Collection and Communications Technologies, 2013 DAILY COMP. PRES. DOC. 567 (Aug. 12, 2013) *available at* http://www.gpo.gov/fdsys/pkg/DCPD-201300567/pdf/DCPD-20130056 7.pdf.

3. For the initial Congressional request, *see* Letter from Tom Udall et al., U.S. Senators, to the Privacy and Civil Liberties Oversight Board (June 12, 2013), *available at* http://www.pclob.gov/Library/Letter-Senate_letter_to_PCLOB-Jun2013.pdf. Additional members of Congress joined the request in subsequent days.

intelligence agencies, outside interest groups, academics, policymakers, and representatives of industry.

The Presidential review group, known formally as the Review Group on Intelligence and Communications Technologies, released its report on December 12, 2013.[4] The report contained numerous recommendations, but one that garnered particular attention was that bulk collection of telephony metadata might be replaced by a "system in which such metadata is held instead either by private providers or by a private third party."[5] Less than a month later, on January 14, 2014, President Obama announced his proposals to reform U.S. intelligence collection operations.[6] He issued a Presidential Decision Directive that made changes to the operational rules affecting intelligence collection.[7] He then announced, conditionally, the end of bulk collection of telephony metadata pursuant to Section 215 of the USA PATRIOT Act and appeared to endorse (though noted certain difficulties) the Review Group's recommendation on non-government entities holding the metadata.[8] The condition was important: his Administration, together with Congress, would work to come up with a solution that enabled the intelligence community to obtain the information it requires while leaving the metadata in the hands of the telephone companies.[9] The bulk collection program was to continue until the solution, which had an original due date of March 28, 2014, was fully in place.[10] The March 28 deadline passed, and the Administration announced that the

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4. *See* THE PRESIDENT'S REVIEW GRP. ON INTELLIGENCE & COMMC'NS TECHS., LIBERTY AND SECURITY IN A CHANGING WORLD (2013), *available at* http://www.whitehouse.gov/sites/default/files/docs/2013-12-12_rg_final_report.pdf.

5. *Id.* at 25 (focusing on Recommendation number five).

6. Remarks on United States Signals Intelligence and Electronic Surveillance Programs, 2014 DAILY COMP. PRES. DOC. 30 (Jan. 17, 2014), *available at* http://www.gpo.gov/fdsys/pkg/DCPD-201400030/pdf/DCPD-201400030.pdf.

7. Press Release, The White House Office of the Press Sec'y, Presidential Policy Directive – Signals Intelligence Activities (Jan. 17, 2014), *available at* http://www.whitehouse.gov/the-press-office/2014/01/17/presidential-policy-directive-signals-intelligence-activities.

8. The collection in bulk of telephone metadata had been authorized under the "business records" section of the Foreign Intelligence Surveillance Act of 1978 ("FISA"), which is codified at 50 U.S.C. § 1861. This application of section 1861 was enabled by the expansion of the business records authority by section 215 of the USA PATRIOT Act. *See* Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, Pub. L. No. 107-56, § 215, 115 Stat. 272 (2001). For this reason, the FISA business records provision is commonly known as "Section 215."

9. *See* Remarks on United States Signals Intelligence and Electronic Surveillance Programs, *supra* note 6, at 7.

10. *Id.*

bulk collection program would continue until the solution was enacted.[11] The PCLOB issued an extensive report on January 23, 2014, and, though consultation with the PCLOB was noted in the President's statement, it does not appear that the PCLOB findings were as closely linked to the Administration's policy as those of the Review Group.[12]

As of October 2014, the Administration has yet to release a detailed proposal for "solving" the bulk collection problem or any particular details regarding how the "data retention by provider" concept might be implemented. The implementation details are important, since there is no guarantee that the telephone companies will retain, or continue to maintain, metadata for a long enough period of time to satisfy the needs of the intelligence community. In the present system of bulk collection (at least as it has become publicly known) the government compels the major telephone carriers to turn over "call detail records" in bulk, perhaps on a daily basis.[13] The intelligence community then retains these records for a period of five years, and queries them as needed.[14] If this system transitions to one in which the telephone companies did not hand over records in bulk to the government, but rather, executed individualized queries against the stock of records that the company holds in the ordinary course of business, then the length of time that the company holds its own records becomes particularly relevant. [15] If, for example, the intelligence agency requires that records be searched five years into the past and the telephone companies only retain such records for twelve months, then

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11. *See* Presidential Statement on the National Security Agency's Section 215 Bulk Telephony Metadata Program, 2014 DAILY COMP. PRES. DOC. 213 (Mar. 27, 2014), *available at* http://www.gpo.gov/fdsys/pkg/DCPD-201400213/pdf/DCPD-201400213.pdf (commenting that data "should remain at the telephone companies for the length of time that it currently does today.").

12. PRIVACY & CIVIL LIBERTIES OVERSIGHT BD., REPORT ON THE TELEPHONE RECORDS PROGRAM CONDUCTED UNDER SECTION 215 OF THE USA PATRIOT ACT AND ON THE OPERATIONS OF THE FOREIGN INTELLIGENCE SURVEILLANCE COURT 168 (2014), *available at* http://www.pclob.gov/library/215-Report_on_the_Telephone_Records_Program.pdf. Interestingly, the PCLOB explicitly rejected the idea of data retention by providers.

13. Declassified versions of the "primary order" issued by the Foreign Intelligence Surveillance Court ("FISC") indicate that two companies are compelled to produce records. *See* Primary Order, BR-14-01 (FISC January 3, 2014) at 3-4. Redacted version of order *available at*, http://www.fisc.uscourts.gov/sites/default/files/BR%2014-02%20Order-2.pdf.

14. *See* PRIVACY & CIVIL LIBERTIES OVERSIGHT BD., *supra* note 12, at 21–37.

15. *See, e.g., United and Strengthening America by Fulfilling Rights and Ending Eavesdropping, Dragnet-collection and Online Monitoring Act:* ("USA FREEDOM Act"): *Hearing on H.R. 3361 Before the S. Select Comm. on Intelligence*, 113th Cong. (2014) (statement of Sen. Dianne Feinstein, Chairman, S. Select Comm. on Intelligence), *available at*, http://www.feinstein.senate.gov/public/index.cfm/press-releases?ID=a6cbcb99-b19d-41a4-be93-ae4b98410dab.

either the agency will have to forego the ability to search beyond twelve months or the company will have to be compelled to retain its records for a longer period of time. This reasoning assumes, of course, that the intelligence agencies actually need access to historical records, and this is far from a settled question. Many, most notably the PCLOB, have questioned the examples cited as justification for the bulk telephony program.[16] The amount of time that metadata retains a demonstrable intelligence value appears to be a "soft" number at present, but there will need to be a consensus value for any solution to proceed.

The intelligence value question opens a very complex debate, even when that debate is restricted to just traditional telephony. Telephone companies retain call detail records as "business records," that is, records that are generated in the ordinary course of business and are retained for as long as needed in the conduct of the company's business.[17] The business need for call detail records has evolved over time. In the past, they were an essential component of the telephone billing systems relevant to most customers. As the billing function has transitioned, CDRs remain important for other business functions like traffic management and load balancing in the telephone networks, calculation of inter-company transactions between telephone providers, and fraud investigations. However, the retention periods associated with each of these functions may vary from one company to the next, and even between components of a single company (i.e. wireless networks vs. landline networks; international vs. domestic).[18]

How the President's proposal will craft a workable solution is likely to depend heavily on Congress. The current FISA statute contains no explicit provision at all for data retention, and thus, it is unlikely that the creation of such requirements is within the existing authority of the Foreign Intelligence Surveillance Court ("FISC"). The solution, therefore, will certainly require legislative action. There is no shortage of legislative proposals, but none so far have addressed the specific challenge of data retention. In general, the legislative proposals fall into three categories: (1)

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16. *See* PRIVACY & CIVIL LIBERTIES OVERSIGHT BD., *supra* note 12, at 145–155.

17. Some have suggested that the Federal Communications Commission regulations require telephone companies to retain call detail records for eighteen months. *See* 47 C.F.R. § 42.6 (2000). In fact, the FCC requirement is to retain certain customer billing records—which increasingly do not incorporate call detail records at all.

18. A generic description of these business uses is often included in the privacy policy statements of telephone companies. *Compare Privacy Policy Summary*, VERIZON WIRELESS, https://www.verizon.com/about/privacy/ (last updated Nov. 2013) *with AT&T Privacy Policy*, AT&T, http://www.att.com/gen/privacy-policy?pid=2506 (last visited Feb. 22, 2014).

those that focus on enhanced oversight of intelligence agency activity without substantially altering Section 215;[19] (2) those that simply abolish the ability to conduct bulk collection pursuant to Section 215;[20] and (3) those that abolish bulk collection, but provide a targeted alternative means for the intelligence community to obtain data from private entities.[21] Whether any of these develop into an option that meets the twin goals of the stated Administration policy (meeting intelligence needs but providers retaining the data), or whether the Administration's view prevails at all remains unknown. As the discussion intensifies, the data retention question likely will come back into focus, and the possibility of requiring companies to retain, or even analyze, data on the government's behalf will need serious examination.

II. TELEPHONE PROVIDERS AS GOVERNMENT SURROGATES

Lacking a specific proposal to critique, the next stage of my inquiry is to broadly examine the issues in a proposal that would require telephone companies to retain call detail records (or equivalent telephony metadata) for a period defined without reference to the use of those records in ordinary business. The companies would then be required to produce records in response to targeted queries authorized by the FISC Those queries could require the simple delivery of information, and might also require the provision of information prospectively or the production of records found to be associated with the queried numbers. Thus, the notional solution would require the telephone company both to retain data, and to produce the data in a specified format (perhaps entailing some rudimentary analysis of the data on the part of the company).

The foundational question here is whether or not such a data retention scheme better serves to protect Constitutional interests. There is a lively debate in the courts as to the Constitutional significance of the telephony metadata at issue in the bulk collection program.[22] Although difficult to

19. *See, e.g.*, FISA Improvements Act of 2013, S. 1631, 113th Cong. (as reported by S. Comm. on Intelligence, Oct. 31, 2013) (enhances oversight and reporting requirements but retains ability to conduct bulk collection under Section 215).

20. *See, e.g.*, USA FREEDOM Act, H.R. 3361, 113th Cong. (as passed by House, May 22, 2014) (explicitly revokes the authority for bulk collection).

21. *See, e.g.*, FISA Transparency and Modernization Act, H.R. 4291, 113th Cong. (as referred to Comm., Mar. 25, 2014) (revokes authority for bulk collection but creates new mechanism for expanded queries of telephone metadata). A similar approach is taken in a new Senate version of the USA FREEDOM Act introduced in the summer of 2014 by Sen. Leahy. *See* USA FREEDOM Act of 2014, S. 2685, 113th Cong (as voted against on a cloture motion to proceed on Nov. 11, 2014).

22. *See* Klayman v. Obama, 957 F. Supp. 2d 1, 41 (D.D.C. 2013); Am. Civil Liberties Union v. Clapper, 959 F. Supp. 2d 724, 752 (S.D.N.Y. 2013).

predict, it seems the courts may be evolving toward a more nuanced approach than that taken in *United States v. Miller*[23] and *Smith v. Maryland*.[24] The ease with which metadata can now be aggregated and analyzed, along with the steady enhancement of the metadata itself, seems to be chipping away at the traditional precedent that transactional data in the hands of third parties does not have any Constitutional protection. If the data has some greater or lesser degree of Constitutional significance, then the examination of that data by the government is an especially sensitive operation. If that is the case, why would whatever Constitutionally protected interests exist be more secure if the operation were outsourced to private corporations? I think the answer lies in the belief that, because the Constitution principally protects individuals from government activity, keeping more data out of the hands of the government effects a de facto enhancement of personal liberty.

This belief, however, does not take into account the effect that the data retention mandate has on the very nature of the private entity. Telecommunications companies are in the business of moving data in forms such as voice, video, text, and internet traffic efficiently from one point to another. As discussed above, metadata generated by the communications process is held only if, and only for as long as, there is a business purpose in doing so.[25] Outside of limited internal business operations like fraud detection and cybersecurity, there typically is no need for companies to retain metadata for extended periods of time.[26] If the company is required to retain data for the use of intelligence agencies, it is no longer acting pursuant to a business purpose. Rather, it is serving the government's purpose; the company has become an agent or surrogate of the government in this context. The Constitutional benefit of having the data held by private entities is lost when, by the very act of compelling retention of that data for non-business purposes, the private entity becomes a functional surrogate of the government. Put another way, people initially may be comforted by the thought of their data remaining in the hands of telephone companies, but only to the extent that they believe the companies are truly independent of the government. When the companies are seen as

23. 425 U.S. 435, 443 (1976) (finding no Fourth Amendment protections for business records created through voluntary interactions with third parties).

24. 442 U.S. 735, 743–46 (1979) (applied *Miller* to find no Fourth Amendment protection for telephone call detail records).

25. Telephone providers typically note this principle in their user agreements or privacy policies. *See, e.g.*, *Verizon Privacy Policy Summary & AT&T Privacy Policy supra* note 18.

26. Telecom companies are allowed to access statutorily protected information for "rights and property" protection and for functions incidental to the delivery of the service. *See* 18 U.S.C. §§ 2072(b)(2), (5), 2511(2)(a)(i) (2012).

surrogates for or with the intelligence agencies, surely that comfort will dissipate.

The use of surrogates is not unfamiliar territory for the government. In fact, the government performs many of its functions through the vast infrastructure of federal contracting. Federal acquisition principles, which govern how federal agencies purchase goods or services from contractors, have always recognized that there are some functions so inherently governmental that they should never be outsourced.[27] Inherently governmental functions include activity "significantly affecting the life, liberty, or property of private persons"[28] and specifically include the "direction and control of intelligence and counter-intelligence operations."[29] Some aspects of the data retention concept may approach, if not exceed, this limit. While one might argue that the government still retains the "direction and control" of the collection operation, it is also true that the day-to-day decisions of how to retain the data, and what specifically to retain, will occur beyond the government's view, in very large and complex technical environments that are imperfectly understood outside the circle of those that actually operate them. The government may well have to rely on the companies' understanding and implementation of the retention requirements in the rapidly evolving and often proprietary environments that the companies control. This concern becomes more acute when the companies are also required to perform some form of analysis on the data before handing it to the government.

The current proposal is hardly the first time that the government has pushed the envelope on the "inherently governmental function" limit. The use of security contractors to perform quasi-military functions during the wars in Iraq and Afghanistan raised concerns about whether the government could maintain sufficient "direction and control" to ensure the proper behavior of its surrogates.[30] The investigations prompted by the often unsatisfactory and occasionally tragic results of that endeavor revealed the inherent difficulties in establishing effective oversight within a

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27. *See* Memorandum from the Office of the Press Sec'y on Government Contracting to the Heads of Exec. Dep'ts and Agencies (March 4, 2009) *available at* http://www.whitehouse.gov/the_press_office/Memorandum-for-the-Heads-of-Executive-Departments-and-Agencies-Subject-Government/.

28. *See Circular No. A-76 Revised: Performance of Commercial Activities*, OFFICE OF MGMT. & BUDGET (May 29, 2003) at Attachment A, Section B(1)(a)(3), *available at* http://www.whitehouse.gov/omb/circulars_a076_a76_incl_tech_correction/.

29. *See* 48 C.F.R. § 7.503(c)(8) (2010).

30. *See, e.g.*, James Risen, *Before Shooting in Iraq, a Warning on Blackwater,* N.Y. TIMES, at A1, June 29, 2014, *available at* http://www.nytimes.com/2014/06/30/us/before-shooting-in-iraq-warning-on-blackwater.html?_r=0.

private entity.[31] It is noteworthy that the private security entities involved eagerly sought this role (as a surrogate) and were businesses constructed entirely for the purpose of providing these kinds of services to the government. By contrast, telecommunications providers are likely to resist any suggestion of data retention requirements, and operate businesses substantially unfocused on the collection of intelligence. The government's history with military contractors suggests that the benefits of outsourcing a difficult function can be lost

Effective oversight would be absolutely critical to any potential outsourcing of intelligence collection or analysis to private entities. One of the legacies of intelligence reform in the 1970s was a multi-layered oversight system designed to bring external review of intelligence agency activities while not compromising security. In the Executive Branch, oversight took the form of the President's Intelligence Oversight Board, which oversees the regulation of intelligence activities under Executive Order 12,333 and the various agency-specific implementations of that order.[32] Inspectors General within the Executive Branch are also involved in the oversight of intelligence activities, as is the PCLOB.[33] Intelligence agencies are subject to Congressional oversight, most directly through the Senate Select Committee on Intelligence and the House Permanent Select Committee on Intelligence. Congress has imposed myriad reporting requirements in the National Security Act, the FISA and many of the periodic Intelligence Authorization Acts.[34] Finally, the Courts exercise supervision of surveillance activities within the United States (and those targeting U.S. persons outside the United States) pursuant to FISA. As recently declassified opinions have confirmed, the FISC not only scrutinizes applications for surveillance authority but also is significantly involved in the "minimization" process applied to the collected information.[35]

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31. *See* JENNIFER K. ELSEA, CONG. RESEARCH SERV., R40991, PRIVATE SECURITY CONTRACTORS IN IRAQ AND AFGHANISTAN: LEGAL ISSUES (2010) at 1-2 *available at* https://www.fas.org/sgp/crs/natsec/R40991.pdf.

32. *See* Exec. Order 12,333, 3 C.F.R. § 200 (1981), *reprinted as amended in* 50 U.S.C. § 401 app. at 16–30 (2012).

33. *See, e.g.*, 50 U.S.C. §§ 403q (CIA Inspector General), 3033(3)-(5)(A), (Inspector General of the Intelligence Community), 3602 (NSA Director of Compliance) (2012); *see also* 42 U.S.C. § 2000ee(c)-(d) (2006 & Supp. V 2012) (PCLOB enabling statute).

34. *See* 50 U.S.C. §§ 1808, 1826, 1846, 1862, 1871(a), 1881f (2012) (Congressional reporting requirements for various FISA operational authorities).

35. *See, e.g.*, Memorandum Opinion, In re Application of the Federal Government for an Order Requiring Production of Tangible Things from [Redacted], [Redacted], at 79–81 (FISA Ct., Oct. 3, 2011) [hereinafter Memorandum Opinion], *available at* http://www.lawfareblog.com/wp-content/uploads/2013/08/162016974-FISA-court-

Aside from the possible involvement of the FISC, none of these oversight mechanisms relate to private entities. All of the government facing oversight mechanisms derived from the Fourth Amendment restraints on government action[36] Oversight mechanisms in the private sector do not share that pedigree. Private companies conduct internal oversight to ensure that their employees comply with company policy; company policy, in turn, requires compliance with all relevant fiduciary, statutory, regulatory, and contractual requirements.[37] As in the case of data retention practices, corporate policy and oversight mechanisms are specifically tailored to the business. In telecommunications companies, customer privacy is the subject of oversight—but that oversight arises mostly from a contractual obligation. The common practice in the industry is to publish a privacy policy that explains what information the company collects, how it will use the information, and with whom it will share the information.[38] These policies may implement regulatory requirements, but also may exceed the protections required by regulation. Corporate oversight focuses on putting safeguards in place to implement the privacy policies, detecting violations of the privacy policy, assessing the need to issue notices or seek customer consent, and remediating improper disclosures of private data.

So, if data retention and analytical requirements make some telecom employees surrogates for government intelligence agencies, will existing oversight mechanisms be sufficient? I think that the answer is clearly no. Without substantial changes, the government facing mechanisms cannot be brought to bear on the telecom employees. Similarly, the in-house oversight structures do not contemplate governmental activity occurring within the private company. In order to establish the requisite direction and control, every company that is compelled to enter this new relationship with the intelligence agency will have to construct appropriate oversight mechanisms. To achieve uniform protection, these new mechanisms would have to be consistent in each company. Who would enforce such

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opinion-with-exemptions.pdf; Primary Order, In re Application from the Federal Government for an Order Requiring that Production of Tangible Things from [Redacted], BR 08-13, at 17–20 (FISA Ct. Mar. 2, 2009) [hereinafter Primary Order], *available at* http://www.dni.gov/files/documents/section/pub_March%202%202009%20Order%20from%20FISC.pdf.

36. U.S. CONST. amend. IV.

37. *See, e.g., Verizon Code of Conduct*, VERIZON, *available at* http://www.verizon.com/about/sites/default/files/Verizon-Code-of-Conduct.pdf. Verizon's code details requirements for employees to comply with various legal obligations and describes internal enforcement of the same. For example, the Code requires the customer information. *See id. at sec. 4.1.1.*

38. *See Verizon Privacy Policy Summary*, *supra* note 18; *AT&T Privacy Policy*, *supra* note 18.

consistency and monitor the operation of these new structures? Most likely those tasks would fall to the same institutions that now oversee government activities (Congress, the courts, and Executive Branch agencies). In light of recent events, all of these institutions have been criticized for failing to question the development of the bulk collection program, and their critics portray them as sclerotic and self-referential. If any of this criticism is valid, then these institutions need substantial refurbishment before they can take on the creation of a new layer of oversight within private companies. But if such rejuvenation is possible, then wouldn't it be more efficient to bring enhanced oversight to bear in the government space, and leave the current collection paradigm intact?

The proposed outsourcing certainly does not offer any promise of efficiency. Under current conditions, the government would have to oversee the construction of collection and oversight mechanisms in several telecommunications companies just to maintain access to the stores of telephony metadata that appears to have been involved in the bulk collection program. Current conditions, however, are never persistent in technology. Already, telecommunications networks are evolving beyond traditional switched telephony. Voice over Internet Protocol ("VoIP") technologies handle voice traffic over the Internet (as opposed to the telephony networks) and already account for a substantial portion of voice traffic.[39] Even more dramatic has been the rise of "over the top" ("OTT") applications that use peer to peer or other technologies to establish direct connections between users over the Internet. In 2012, one such application (Skype) accounted for 34% of all international voice calling minutes (more than any other single provider).[40] VoIP and over the top applications may traverse IP networks operated by a large telecommunications company (most of which are also Tier 1 Internet Service Providers), but they do so as Internet traffic (not telephony) and thus the equivalent of call detail records reside with the VoIP or OTT provider, and not with the telecommunications company (which is simply the conduit for the IP traffic).[41] If the U.S. intelligence agencies were to commit to the outsourced

39. For a simplified technical explanation of VoIP, *see Understanding VoIP*, PACKETIZER, http://www.packetizer.com/ipmc/papers/understanding_voip/.

40. Phil Goldstein, *Report: Skype Makes Up One-Third of All International Phone Traffic*, FIERCE WIRELESS (Feb. 15, 2013), http://www.fiercewireless.com/story/report-skype-makes-one-third-all-international-phone-traffic/2013-02-15 (providing statistics for VoIP and Skype).

41. For example, a company like Verizon might carry a Skype call, but that call would simply be in the form of individual packets traversing Verizon's network. Only the provider (Skype) would re-assemble those packets on either end of the communication and thus know the identity of the user on either end of the call. *See* Goldstein, *supra* note 40.

solution to obtain telephony metadata, they would need to approach each successive VoIP or OTT application owner to establish access equivalent to the CDRs they obtain under the existing program. The technical difficulties multiply if the intelligence agencies were to eventually seek the same sort of access to IP metadata from Internet Service Providers.

Finally, the commercial effect on U.S. companies of outsourcing collection ought to be considered. No telecommunications company will be eager to undertake the increased responsibility, scrutiny, and liability entailed by having its employees become surrogates for the government in the collection of intelligence. More troubling for large U.S. telephone companies (all of which have extensive operations outside of the U.S.) is the effect in the international market of overt association with a U.S. intelligence agency.[42] There is a negative effect even when that relationship is compelled. The effect of an ongoing and official surrogacy relationship would doubtless be far more lasting and substantial. U.S. companies would become routinely subject to the same suspicions that, prior to the Snowden disclosure, some in the U.S. government had leveled at certain foreign corporations.[43]

CONCLUSION

All of the foregoing reasons, in my view, argue for maintaining the current structure under which intelligence agencies retain and analyze data that has been obtained from telecommunications companies in an "arm's length" transaction compelled by a FISA order. I think the proposal to outsource this work to surrogates in the private sector is a futile attempt to sidestep the difficult work that needs to be done to restore public confidence in intelligence agencies. I think that the best path forward is to focus on the repair and enhancement of existing oversight mechanisms, as well as on adjustments to the scope of FISA authorities. This last point alone will require a careful re-balancing of privacy and security interests—a process that took several years when it last occurred in the 1970s.[44] The

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42. *See* Eamon Javers, *Is a Snowden Effect Stalking U.S. Telecom Sales?*, CNBC (Nov. 15, 2013, 12:16 PM), http://www.cnbc.com/id/101202361; *see also,* Anton Troianoski & Danny Yadron, *German Government Ends Verizon Contract*, WALL ST. J. (June 26, 2014 2:54 PM), http://online.wsj.com/articles/german-government-ends-verizon-contract-1403802226.

43. *See, e.g.*, MIKE RODGERS & DUTCH RUPPERSBERGER, HOUSE OF REPRESENTATIVE PERMANENT SELECT COMM. ON INTELLIGENCE, INVESTIGATIVE REPORT ON U.S. NATIONAL SECURITY ISSUES POSED BY CHINESE TELECOMMUNICATIONS COMPANIES HUAWEI AND ZTE (2012), *available at* https://intelligence.house.gov/sites/intelligence.house.gov/files/documents/Huawei-ZTE%20Investigative%20Report%20%28FINAL%29.pdf.

44. The reform period in Congress ran from the establishment of the Church Committee on January 27, 1975 through the passage of FISA in 1978. *See* KRIS &

adjustments to intelligence authorities made in the immediate aftermath of 9/11 should not persist or vanish[45] by default simply because we cannot bring ourselves to undertake deliberate reform.

WILSON, *supra* note 1 at Chapter 2, sec. 2.3, Chapter 3, sec. 3.7. In the Executive Branch, active reform continued until the issuance of Executive Order 12,333 in 1981. *See id.* At Chapter 2, sec. 2.7.

45. Under current law, Section 215 of the USA PATRIOT Act sunsets on June 1, 2015. *See* USA PATRIOT Improvement and Reauthorization Act of 2005, Pub. L. No. 109-177, § 102(b), 120 Stat. 192 (2006).

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COMMENTS

STARE INDECISIS: THE FEDERAL CIRCUIT'S EN BANC BATTLE AGAINST ITSELF AND BUSINESS IN *LIGHTING BALLAST CONTROL, LLC V. PHILIPS ELECTRONICS NORTH AMERICA CORP.*

RONNY VALDES*

In 1998, the Federal Circuit ruled in Cybor Corp. v. FAS Technologies, Inc., an en banc decision, that the standard of review for patent claim construction cases would be de novo. From 1998 until this year, neither Congress nor the Supreme Court had intervened to confirm, or change the standard. The standard was challenged in an en banc case at the United States Court of Appeal for the Federal Circuit, Lighting Ballast Control, LLC. v. Philips Electronics North America Corp. *A key question is whether the Federal Circuit should reconsider or overrule its en banc decisions with another en banc decision absent intervention from the Supreme Court or Congress under the foundational legal principle of stare decisis. Focusing on this key question, this Comment examines four primary points: (1) the unknown nature of the reach and limitations of the Federal Circuit in reconsidering or overruling its en banc standards with another en banc decision under stare decisis; (2) the* Lighting Ballast *case as a means of testing the Federal Circuit's perceived reach in overruling previous en banc decisions en banc; (3) uniformity concerns if the Federal Circuit can overrule its own en banc decisions with other en banc decisions absent intervention; and (4) the negative effect a lack of uniformity in the patent law can have on businesses. This Comment suggests that the Federal Circuit believes it can continually established precedents. Stare decisis seeks intervention to define the scope of*

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review in patent claim construction standard, thereby eliminating the present threat of the Federal Circuit acting contrary to the principles of stare decisis.

INTRODUCTION

Mark Twain wrote "a country without a patent office and good patent laws is just a crab and [cannot] travel any way but sideways and backwards."[1] Patents today play a vital role for businesses by giving a right to exclude others from making, using, or selling an invention.[2] Historically, courts exclusively construed the

1. MARK TWAIN, A CONNECTICUT YANKEE IN KING ARTHUR'S COURT 107 (1889).

2. *See* 35 U.S.C. § 271(a) (2012) (classifying any party who makes, uses, or sells a patented invention as an infringer).

meaning of patent claims as a matter of law.[3] The United States Court of Appeals for the Federal Circuit has jurisdiction over all appeals from district courts on patent claim construction cases.[4] In *Cybor Corp. v. FAS Technologies*, an en banc decision, the Federal Circuit held that when it reviews a patent claim construction case, the standard of review is de novo.[5] This standard of review was controversial since its establishment; however, until this year, neither Congress nor the Supreme Court had intervened to confirm or challenge the standard.[6]

Momentum eventually built to the point where in 2013 a new en banc case challenged the Federal Circuit's de novo standard.[7] This challenge was significant because it presented the first opportunity for the en banc Federal Circuit to reconsider the de novo standard since declining to do so in the 2005 *Phillips v. AWH Corp.* case.[8] The opportunity for en banc review of an established en banc standard without prior intervention is unique to the Federal Circuit as the Supreme Court has historically played a "hands-off" role with the Federal Circuit regarding patent cases.[9] However, this opportunity for reconsideration posed a problem because it clashes with the fundamental legal principle of stare decisis.[10] Stare decisis instructs courts to respect previous decisions absent intervention from a higher authority

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3. *See* Markman v. Westview Instruments, Inc. (*Markman II*), 517 U.S. 370, 372, 377, 391 (1996) (holding that the "mongrel practice" of construing patents does not violate the 7th Amendment jury guarantee and should be left up to the judge).

4. *See* 28 U.S.C. § 1295(a)(1) (2012) (granting the Federal Circuit jurisdiction for appeals on all final decisions from district courts on patent matters).

5. *See* Cybor Corp. v. FAS Techs., Inc., 138 F.3d 1448, 1454–56 (Fed. Cir. 1998) (en banc) (holding that the Supreme Court affirmation of the Federal Circuit's decision in *Markman v. Westview Instruments* endorsed de novo review in patent claim construction cases).

6. *See, e.g.*, Phillips v. AWH Corp., 415 F.3d 1303, 1330 (Fed. Cir. 2005) (en banc) (Mayer J., dissenting) ("[A]ny attempt to fashion a coherent standard under this regime is pointless, as illustrated by our many failed attempts to do so, I dissent.").

7. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 500 Fed. App'x 951, 951–52 (Fed. Cir. 2013) (stating three questions on en banc review: (1) if *Cybor* should be overruled; (2) if deference should be afforded to any part of the district court's claim construction; and (3) if so what deference).

8. *See* Tamlin H. Bason, *Federal Circuit Hears Arguments En Banc on De Novo Review of Claim Construction*, BNA (Sept. 16 2013), http://www.bna.com/federal-circuit-hears-n17179877141/ (noting that the last attempt for en banc review of the de novo standard in *Retractable Technologies, Inc. v. Becton, Dickinson & Co.*, failed because the judges lacked the requisite six votes).

9. *See* Timothy B. Dyk, *Does the Supreme Court Still Matter?*, 57 AM. U. L. REV. 763, 765 (2008) (asserting that the Supreme Court hears about one percent of patent cases from the Federal Circuit).

10. *See generally* Nat'l Org. of Veterans' Advocates, Inc. v. Sec'y of Veterans Affairs, 260 F.3d 1365, 1373 (Fed. Cir. 2001) ("[S]tare decisis is a doctrine that binds courts to follow their own earlier decisions or the decisions of a superior tribunal."); Mendenhall v. Cedarapids, Inc., 5 F.3d 1557, 1570 (Fed. Cir. 1993), (asserting that stare decisis creates statements of law binding in future cases before the same court or an inferior court).

thereby ensuring uniformity in the law.[11]

This Comment argues that by taking the *Lighting Ballast* case en banc to reconsider the established *Cybor* en banc standard, the Federal Circuit is acting contrary to the principles of stare decisis because the panel decision already affirmed the validity of *Cybor* by applying it.[12] While stare decisis is not black letter law for the courts, the Federal Circuit was specifically created with the purpose of ensuring uniformity in patent law.[13] Therefore, the risk of uncertainty for patent law as a whole exists when the Federal Circuit is not acting in a manner that promotes uniformity, which, in turn, negatively affects business interests.[14]

Part I of this Comment discusses the basics of patent litigation, patent claim construction, and the history of the standard of review through *Lighting Ballast* as well as the influence of stare decisis and uniformity in patent cases.

Part II of this Comment analyzes stare decisis in *Lighting Ballast.* Furthermore, it analyzes the proper interplay between the Supreme Court and the Federal Circuit and the reliance on the expertise of the Federal Circuit in patent law.

Part III recommends that the Supreme Court intervene to eliminate debate by determining when the Federal Circuit can review en banc cases with other en banc decisions.

This Comment concludes that the Federal Circuit is in a unique situation with the claim construction standard of review because it lacked guidance from a higher authority for over fifteen years, but that stare decisis must weigh heavily on a court created to promote consistency.

I. DECONSTRUCTING THE INFLUENCE OF STARE DECISIS, PATENT CLAIM CONSTRUCTION, AND THE COSTS OF PATENT LITIGATION.

Stare decisis has a long and rich history in the American legal system. Patent litigation can often carry a value of millions and even billions of dollars. Patent claim construction is a fundamental concept in patent law that is necessary in any patent litigation. Understanding each of these concepts in basic terms is the key to

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11. *See Nat'l Org. of Veterans' Advocates*, 260 F.3d at 1373 (citing Restatement (Second) Judgments § 28 cmt. b, at 275–76 to show the utility of stare decisis in protecting parties and courts when determining the scope of statutes or rules).

12. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 498 F. App'x 986, 989 (Fed. Cir. 2013) (applying de novo review on a matter of a claim construction).

13. *See* S. REP. NO. 97-275 at 2 (1981) (emphasizing that consistency and uniformity in the patent law would serve the patent and business communities positively).

14. *See* John F. Duffy, *Harmony and Diversity in Global Patent Law*, 17 BERKELEY TECH. L.J. 685, 686 (2002) ("Uniformity of law has an undeniable intellectual appeal."). *But See,* RICHARD A. POSNER, THE FEDERAL COURTS: CRISIS AND REFORM 163 (1985) ("If uniformity is desirable (as it is), so are diversity and competition.").

understanding the disconnect between the Federal Circuit and its Constitutional role.

A. To Stand by Things Decided: The Role of Stare Decisis in the American Legal System.

Stare decisis, also known as the doctrine of precedent, is intended to bind courts to previous decisions absent intervention from a higher authority.[15] The general rule is that when a court has decided an issue and established a principle of law, it will adhere to and apply that principle in all future cases with similar facts to create stability and predictability in the court system.[16] Stare decisis is considered especially strong in cases of a statutory nature like patent cases.[17] Two types of stare decisis exist: vertical stare decisis and horizontal stare decisis.[18]

Vertical stare decisis is when higher authorities review the principles established by lower authorities and the lower authorities adhere to the higher authority's decision.[19] Examples include when a court of appeals panel reviews a district court and when the Supreme Court reviews a court of appeals decision. In each instance, the lower court is bound by the higher court precedent.[20] Horizontal stare decisis is when later courts review the principles established by a court at the same level and are bound to follow them absent a compelling reason to overturn.[21] An example is when a court of appeals hears a case en banc challenging a previous en banc precedent decided by the same court. Absent unworkability or a directive from the Supreme Court, under stare decisis the en banc court should adhere to the previous

15. *See* BLACK'S LAW DICTIONARY 1537 (9th ed. 2009) (separating stare decisis into different categories that include vertical and horizontal stare decisis).

16. *See* Payne v. Tennessee, 501 U.S. 808, 827 (1991) (citing Vasquez v. Hillery, 474 U.S. 254, 265–66 (1986)) (noting that stare decisis is the preferred course to maintain predictability and stability); *see also* Martin v. Franklin Capital Corp., 546 U.S. 132, 139 (2005) (stating that the basic principle of justice is that similar cases should be decided similarly).

17. *See* Neal v. United States, 516 U.S. 284, 295 (1996) (adding that stare decisis is more important in statutory cases because "Congress is free to change this Court's interpretation of its legislation"); *see also* Thomas R. Lee, *Stare Decisis in Historical Perspective: From the Founding Era to the Rehnquist Court*, 52 VAND. L. REV. 645, 703–04 (1999) (clarifying that stare decisis is at its strongest in statutory cases).

18. *See* Amy Coney Barrett, *Stare Decisis and Due Process*, 74 U. COLO. L. REV. 1011, 1016 n.17 (2003) (distinguishing the two types of stare decisis where one involves a court following its own precedent and the other where the court follows higher authority precedent).

19. *See* BLACK'S LAW DICTIONARY 1537 (9th Ed. 2009) (defining vertical stare decisis).

20. *Cf.* Barrett, *supra* note 18, at 1016 n.17 (using the example of higher authority precedent binding a lower authority).

21. *See* BLACK'S LAW DICTIONARY 1537 (9th Ed. 2009) (defining horizontal stare decisis).

decision of the same court en banc.[22] Notably, stare decisis is not black letter law, but rather, "a principle of policy."[23] Historically, however, the role of stare decisis as a foundational legal principle in the American system has increased its stature to a point where courts consider it the wisest path unless a compelling reason demands reversal.[24] The value of stare decisis is that it provides valuable consistency in the law.[25]

The Supreme Court is the highest court in the United States with ultimate authority over all courts, including the Federal Circuit.[26] The Court has criticized "lower courts" that deviate from established precedents for causing a disruption in the expected results from the legal community.[27] The Court has said that until it considers a specific legal point, the point is not settled regardless of accepted practices from the lower courts.[28] The Court warns that "lower courts" should be cautious when creating new rules that differ from established precedent.[29] The Court prefers preserving uniformity in the law, especially in patent law.[30]

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22. *Cf.* Barrett, *supra* note 18, at 1016 n.17 (illustrating the precedent decided by the old court binding the new court absent some determination of unworkability or another factor).

23. *See* Payne v. Tennessee, 501 U.S. 808, 828 (1991) (quoting Helvering v. Hallock, 309 U.S. 106, 119 (1940)).

24. *See* Lee, *supra* note 17, at 652–54 (comparing the policy considerations when choosing to apply stare decisis).

25. *See, e.g.*, *Payne*, 501 U.S. at 827 ("Stare decisis is the preferred course because it promotes the evenhanded, predictable, and consistent development of legal principles, fosters reliance on judicial decisions, and contributes to the actual and perceived integrity of the judicial process.").

26. *Cf.* U.S. CONST. art. III (establishing the Supreme Court as the only federal court required by the Constitution).

27. *See* Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co., 535 U.S. 722, 739 (2002) (chastising the Federal Circuit for ignoring the guidance of *Warner-Jenkinson Co. v. Hilton Davis Chemical Co.* because it would "disrupt the settled expectations of the inventing community").

28. *See, e.g.*, Andrews v. Hovey, 124 U.S. 694, 716 (1888) ("A question arising in regard to the construction of a statute of the United States concerning patents for inventions cannot be regarded as judicially settled when it has not been so settled by the highest judicial authority which can pass upon the question.").

29. *See, e.g.*, Warner-Jenkinson Co. v. Hilton Davis Chem. Co., 520 U.S. 17, 29, (1997) (noting that application of established doctrines should not be given latitude to be changed at will or eliminated); *see also* Ariad Pharms., Inc. v. Eli Lilly & Co., 598 F.3d 1336, 1347 (Fed. Cir. 2010) (en banc) (recognizing that as a federal court, the statements made by the Supreme Court cannot be easily thrown away as dicta but are in fact binding).

30. *See* Bonito Boats, Inc. v. Thunder Craft Boats, Inc., 489 U.S. 141, 162 (1989) (referencing the importance of uniformity and the patent law and Congress' recognition of that importance in establishing the Federal Circuit); *see also* THE FEDERALIST NO. 43 at 309 (B. Wright Ed. 1961) (emphasizing that the purpose behind the Patent and Copyright Clauses of Constitution was to unify the intellectual property law at the federal level).

Stare decisis is also important for businesses because it provides a consistent standard for the business community to rely upon.[31] Given that patent law is a commercially based field, courts relying on prior decisions and standards absent higher intervention create certainty for businesses.[32] Uniformity concerns go hand-in-hand with consistency and must be applied in specific courts, like the Federal Circuit that was granted exclusive jurisdiction over patent law appeals, in order to promote uniformity.[33]

B. Flexing the Monopolistic Muscle: Patent Value, Infringement Suits, and Claim Construction.

The three primary parts of a patent are the specification, the drawings, and the claims.[34] Arguably, the most important part of a patent is the set of claims at the end of the specification, which delineate the subject matter of the invention and serve as the metes and bounds of the rights granted.[35] Once a patent has been issued, it carries a presumption of validity until proven otherwise through a judicial determination.[36]

In today's economy, patents of all kinds have become increasingly valuable for businesses.[37] Businesses can use patents in many ways. Licensing opportunities can create consistent revenue streams for a business, and building strong patent portfolios can increase a business' market power.[38] However, some of the businesses that fall under the subset known as non-practicing entitites ("NPEs") focus less on using

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31. *See* Pamela J. Stephens, *The New Retroactivity Doctrine: Equality, Reliance, and Stare Decisis*, 48 SYRACUSE L. REV. 1515, 1565 (1998) ("[U]nderlying the doctrine of stare decisis is the principle of protecting justifiable reliance upon established law.").

32. *See, e.g.*, Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (offering the example of certainty in sales and use taxes as a settled expectation for businesses and encouraging investment).

33. *See, e.g.*, 28 U.S.C. § 1295 (2012) (demonstrating the unique situation of the Federal Circuit which has jurisdiction by subject matter rather than geography making it the only specialized court of appeals).

34. *See* ROBERT A. MATTHEWS, 1 ANNOTATED PATENT DIGEST (MATTHEWS) sec. 1:21 (2013) (showing the components in a patent application).

35. *See id.* (noting that victory in infringement cases can depend wholly on the interpretation of the claims).

36. *See* 35 U.S.C. § 282(a) (2012) (noting that each claim of the patent is presumed valid despite dependence on other claims).

37. *See, e.g.*, Paul S. Hunter, *The Importance of Patents*, LABORATORYNEWS (July 1, 2005), http://www.labnews.co.uk/features/the-importance-of-patents/ (noting that patents can provide freedom of movement in particular fields and licensing opportunities).

38. *See* Joe Hadzima, *The Importance of Patents: It Pays to Know Patent Regulations*, MIT ENTER. FORUM, http://www.mitef.org/s/1314/interior-2-col.aspx?sid=1314&gid=5&pgid=5784 (declaring that many companies see strong patent portfolios as a key to success even if their focus is not on enforcement but instead on cross-licensing).

patents and more on enforcing and litigating the patents for money.[39] The current economic trends indicate that the role of patents in business will continue to grow moving forward.[40]

Following issuance of the patent, the patent owner ("patentee") may bring a patent infringement claim against any party he believes is violating the exclusive rights given when the patent issued.[41] The grant of a patent gives the patentee the right to exclude any party from making, using, selling, or offering to sell the invention without the permission of the patentee.[42] Accused infringers are required to plead non-infringement and invalidity of the patent as defenses.[43] Accused infringers pleading invalidity generally seek to render one or all of the claims of the patent invalid under one of the patentability standards, which precludes infringement.[44] Relief for a patentee can come in two forms: equitable relief, which includes temporary or permanent injunctions, and compensatory money damages.[45] In order to prove whether the patent is invalid or whether relief for the patentee is proper, the court must construe the meaning of the claims in the patent to determine what the patent covers.[46] This process is called claim construction.

In patent claim construction, judicial entities determine the scope and meaning of the words in the claims to a person with ordinary skill in the art.[47] Patent claim

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39. *See* Ghyo Sun Park & Seong Don Hwang, *The Rise of the NPE*, MANAGING INTELLECTUAL PROP. (Dec. 1, 2010), http://www.managingip.com/Article/2740039/The-rise-of-the-NPE.html (defining NPE as "a company that acquires patents or patent rights and that generates revenue by monetising those patents without manufacturing or using the patented invention(s)").

40. *See* THE CHANGING FACE OF US PATENT LAW AND ITS IMPACT ON BUSINESS STRATEGY 2 (Daniel R. Cahoy & Lynda J. Oswald eds., 2012) (asserting there is reason to believe the role of the patent system in relation to business will increase in the future based on the strong rise of issued patents since 2011).

41. *See* MATTHEWS, *supra* note 34, at sec. 9:1 (mentioning that most patent infringement litigation arises when the invention has great commercial value).

42. *See* 35 U.S.C. § 271(a)-(c) (2012) (expanding the basic definition of infringer from subsection (a) in subsections (b) and (c) where it discusses inducement of infringement and contributory infringement).

43. *See* 35 U.S.C. § 282(b)(1)-(3) (2012) (stating that invalidity defenses apply for patentability standards like novelty and specific section 112 standards like written description).

44. *See* Optivus Tech., Inc. v. Ion Beam Applications S.A., 469 F.3d 978, 991 (Fed. Cir. 2006) (holding the issue of infringement is moot if a patent is declared invalid).

45. *See* 35 U.S.C. §§ 283-284 (2012) (establishing that courts apply injunctions for a time they deem reasonable and that the court will assess damages if the jury does not).

46. *See* Markman v. Westview Instruments (*Markman I*), 52 F.3d 967, 979 (Fed. Cir. 1995) (en banc) (determining that for the purposes of claim construction, the written description can serve as a dictionary for terms appearing in the claims).

47. *See* Pall Corp. v. Hemasure, Inc., 181 F.3d 1305, 1308–09 (Fed. Cir. 1999) (accepting that technical terms will be accorded the ordinary meaning they have in their field of invention); *see also* Networld LLC v. Centraal Corp., 242 F.3d 1347, 1352

construction typically occurs as an initial step in patent infringement suits.[48] The Supreme Court held in *Markman II* that claim construction was a matter of law to be performed by the courts, not the jury, affirming the decision of the Federal Circuit.[49] Claim construction begins with the district court holding a pre-trial evidentiary hearing called a "*Markman* hearing", where patent documents are reviewed, experts testify, and parties make arguments regarding the scope of the claim.[50] Courts use two types of evidence to construe claims: intrinsic evidence and extrinsic evidence.[51] Intrinsic evidence consists of "the claims, the specification, and the prosecution history".[52] Extrinsic evidence consists of all forms of evidence unrelated to the patent document including, technical treatises, dictionaries, and expert testimony.[53]

Many courts prefer to use intrinsic evidence as the primary tool of analysis because it is the evidence best suited to provide context into the meaning of terms in the claims.[54] Some patent judges disagree as to whether all forms of intrinsic evidence should be considered, or if only the claims should be considered.[55] Judges consider extrinsic evidence when the intrinsic evidence does not clearly and unambiguously give meaning to the disputed terms in the patent claims.[56] Courts will generally allow reliance on extrinsic evidence to understand how a technology

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(Fed. Cir. 2001) (noting the intention of claim construction is not to broaden or narrow claims but to define them).

48. *See* Abbot Labs. v. Sandoz, Inc., 544 F.3d 1341, 1358 (Fed. Cir. 2008) (explaining that the preliminary claim construction is reviewed at the injunction stage for correctness).

49. *See* Markman v. Westview Instruments (*Markman II*), 517 U.S. 370, 378, 390–91 (1996) (characterizing claim construction as a "mongrel practice" that required special training possessed by the judge not the jury).

50. *Cf.* EMI Grp. N. Am., Inc. v. Intel Corp., 157 F.3d 887, 891–92 (Fed. Cir. 1998) (explaining that many difficult infringement cases are resolved during *Markman* hearings).

51. *See Markman I*, 52 F.3d at 979–80 (citing precedent describing intrinsic and extrinsic evidence).

52. *See* Unique Concepts, Inc. v. Brown, 939 F.2d 1558, 1561 (Fed. Cir. 1991) (citing Locite Corp. v. Ultraseal, Ltd., 781 F.2d 861, 867 (Fed. Cir. 1985)).

53. *See Markman I*, 52 F.3d at 980 (describing the utility of extrinsic evidence in claim construction analyses).

54. *See* Nazomi Commc'ns, Inc. v. Arm Holdings, P.L.C., 403 F.3d 1364, 1368 (Fed. Cir. 2005) (citing Vitronics Corp. v. Conceptronic, Inc., 90 F.3d 1576, 1582 (Fed. Cir. 1996)).

55. *See, e.g.*, Jakub Michna, *Is the Scope of a Patent's Coverage Determined by its Claims, or by its Specification? Top Patent Judges Disagree*, SUNSTEIN, KANN, MURPHY & TIMBERS LLP, http://www.sunsteinlaw.com/is-the-scope-of-a-patents-coverage-determined-by-its-claims-or-by-its-specification-top-patent-judges-disagree/ (discussing Judge Lourie's dissent in *Arlington Industries, Inc. v. Bridgeport Fittings, Inc.* as an example of Federal Circuit judge disagreement on the role of the specification in claim construction).

56. *See* Vitronics Corp. v. Conceptronic, Inc., 90 F.3d 1576, 1585 (Fed. Cir. 1996) (determining that the district court unnecessarily relied on extrinsic evidence when the specification clearly defined the terms in the claims).

works.[57] Some courts view expert testimony during claim construction with skepticism and generally prefer to rely on dictionaries or legal treatises when needed.[58]

Both patent litigation and the claim construction process have great economic costs on businesses.[59] Businesses spend large amounts of money combating NPEs who can block a business' production and sale of products with a single patent over a small component and a patent infringement lawsuit.[60] Businesses tend to settle cases and agree to pay licensing fees to NPEs because the enormous cost of litigating dissuades businesses from pursuing litigation.[61] Additionally, for businesses that own patents, an adverse construction of claims in litigation can lead to patents being rendered invalid thereby eliminating all claims of infringement from a competitor.[62] Factored together, litigation and claim construction can be disastrous to business and have led some to classify the patent system as a burden on business.[63]

C. *Declining Deference: De Novo Review at the Federal Circuit*

Patent claim construction was historically subject to de novo review at the Federal Circuit, meaning that the Federal Circuit was not required to offer any deference to the claim construction determinations made by the district court.[64] The roots of de

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57. *See, e.g., id.* (stating the district court could use extrinsic evidence to understand how the technology worked).

58. *See, e.g., id.* (expressing that testimony on construction of claims is acceptable only if the patent documents are insufficient to allow a court to make a determination of meaning for a disputed term in the claims).

59. *See, e.g.*, David Thier, *More Than $20 Billion Spent on Patent Litigation In Two Years*, FORBES (Oct. 8, 2012, 11:50 AM), http://www.forbes.com/sites/davidthier/2012/10/08/in-two-years-the-smartphone-industry-has-spent-more-than-20-billion-spent-on-patent-litigation/ (quoting a New York Times article which states that $20 billion was spent by the smartphone industry on patent litigation between 2010 and 2012).

60. *See* Charles E. Schumer, *A Strategy for Combating Patent Trolls*, WALL ST. J. (June 12, 2013, 6:59 PM), http://www.online.wsj.com/news/articles/SB10001424127887323844804578531021238656366 (voicing concern because in 2011 U.S. companies paid $29 billion in litigation costs and settlements to NPEs).

61. *See id.* (comparing patent litigation to a highway with two exits both of which carry a heavy toll).

62. *See, e.g.*, Optivus Tech., Inc. v. Ion Beam Applications S.A., 469 F.3d 978, 991 (Fed. Cir. 2006) (holding one of the patents at issue invalid thereby eliminating infringement claims).

63. *See* THE CHANGING FACE OF US PATENT LAW AND ITS IMPACT ON BUSINESS STRATEGY 4 (Daniel R. Cahoy & Lynda J. Oswald eds., 2012) (offering a critique from Judge Richard Posner who claims most industries would be fine without patent protection).

64. *See* Cybor Corp. v. FAS Techs., Inc., 138 F.3d 1448, 1455 (Fed. Cir. 1998) (en banc) (concluding that the de novo standard of review from the Federal Circuit's decision in *Markman I* was still good law because the Supreme Court affirmed the decision).

novo review at the Federal Circuit are found in the Supreme Court's *Markman II* decision.[65] The focus of this case was whether patent claim construction was a matter of law for judges to decide or a matter of fact subject to the Seventh Amendment jury guarantee.[66] The Court decided that infringement determinations were for the jury as a matter of fact but that claim construction was for the judge as a matter of law.[67] The Court stressed that uniformity in patent law was important, and that judges were better suited to make determinations regarding the meaning of terms in a legal document.[68] Prior to the Supreme Court decision, the Federal Circuit had ruled that the proper appellate standard of review for patent claim construction cases was de novo.[69] The Supreme Court affirmed the Federal Circuit's decision but made no mention of what the proper standard of review for patent claim construction should be.[70]

The Federal Circuit firmly established de novo review as the standard for patent claim construction appeals in *Cybor Corp. v. FAS Technologies*.[71] Prior to the decision in *Cybor*, some Federal Circuit panels had already been applying the de novo standard of review in claim construction appeals using the Federal Circuit's determination in *Markman I*.[72] However, other panels had applied a clear error standard to findings considered factual in nature and incident to the construction of patents.[73] Instead of allowing a panel ruling, the Federal Circuit decided *sua sponte* to hear *Cybor* en banc in order to clarify the standard of review question.[74] The en

65. 517 U.S. 370 (1996).

66. *See* U.S. CONST. amend. VII (guaranteeing a jury trial for all suits at common law with a value exceeding twenty dollars); *Markman II*, 517 U.S. at 376 (summarizing that both lower courts held that claim construction was within the realm of the court).

67. *See Markman II*, 517 U.S. at 377, 390 (recognizing the importance of the 7th Amendment jury guarantee, but refusing to extend that protection to patent claim construction). *See generally* Pullman-Standard v. Swint, 456 U.S. 273, 288 (1982) (claiming the line between questions of law and fact as vexing).

68. *See Markman II*, 517 U.S. at 381–82. 388–89 (recounting the history of 18th century English judges making determinations on patents and holding that judges through training are more likely to give the correct interpretation).

69. *See* Markman v. Westview Instruments, 52 F.3d 967, 974–75, 979 (Fed. Cir. 1995) (en banc) (establishing that because claim construction is a matter of law, the review of the claim construction by the appellate court must be de novo).

70. *See Markman II*, 517 U.S. at 391 (demonstrating silence on the proper standard of review despite affirming the Federal Circuit's opinion).

71. 138 F.3d 1448 (Fed. Cir. 1998) (en banc).

72. *See, e.g.*, Serrano v. Telular Corp., 111 F.3d 1578, 1582 (Fed. Cir. 1997) (applying the de novo standard to a claim construction case).

73. *See, e.g.*, Eastman Kodak Co. v. Goodyear Tire & Rubber Co., 114 F.3d 1547, 1555–56 (Fed. Cir. 1997) (applying a limited clear error standard as to the use of extrinsic evidence in claim construction), *abrogated by* Cybor Corp v. FAS Techs., Inc., 138 F.3d 1448 (Fed. Cir. 1998).

74. *See Cybor*, 138 F.3d at 1450 (noting that the panel assigned to the case heard oral argument, however, the court decided to hear the case en banc, prior to the opinion issuing).

banc Federal Circuit held that the Supreme Court's decision in *Markman II* served as an endorsement of the Federal Circuit's assertion in *Markman I*: that the proper standard of review for all aspects of claim construction was de novo.[75] Judge Mayer dissented stating that the Supreme Court intended to affirm that claim construction itself was a matter of law for the judge, not to adopt any standard of review.[76]

Following *Cybor*, the Federal Circuit routinely applied the de novo standard of review and a challenge to the standard was not accepted en banc until 2005 in *Phillips v. AWH Corp.*[77] The Federal Circuit asked the parties to brief seven questions, the final of which was whether it was appropriate for the court to give any deference to the district court claim construction under both *Markman* cases and *Cybor*.[78] After much fanfare, the en banc court in *Phillips* decided not to address the issue of de novo review at the time and left the standard established by *Cybor* untouched.[79] Judge Mayer again dissented stating his belief that the de novo standard for claim construction at the Federal Circuit was absurd.[80] Following *Phillips*, there was no Supreme Court intervention on the matter, as certiorari was denied.[81] Later attempts challenging the *Cybor* standard of review were denied en banc rehearings by the Federal Circuit.[82] In a dissent to the denial of rehearing en banc in *Retractable Technologies*, Judge Moore asserted that claim construction is the most important part of patent litigation and that the Federal Circuit's de novo standard is confusing and unworkable.[83]

The de novo standard of review has been characterized as substituting uniformity for procedural efficiency of the courts.[84] Furthermore, businesses have criticized the

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75. *See id.* at 1455–56 (claiming that *Markman II* implied that the totality of claim construction is a matter of law including the standard of review).

76. *See id.* at 1464 (Mayer, J., dissenting) (asserting that *Markman II* only decided that claim construction was a matter of law as a matter of policy).

77. 415 F.3d 1303 (Fed. Cir. 2005) (en banc).

78. *See* Phillips v. AWH Corp., 376 F.3d 1382, 1382–83 (Fed. Cir. 2004) (granting rehearing en banc).

79. *See Phillips*, 415 F.3d at 1328 ("After consideration of the matter, we have decided not to address that issue at this time. We therefore leave undisturbed our prior en banc decision in *Cybor*.").

80. *See id.* at 1330 (Mayer, J., dissenting) ("Now more than ever I am convinced of the futility . . . in adhering to the falsehood that claim construction is a matter of law devoid of any factual component.").

81. *See* AWH Corp. v. Phillips, 546 U.S. 1170, 1170 (2006) (denying certiorari without explanation).

82. *See, e.g.*, Retractable Techs., Inc. v. Becton, Dickinson and Co., 659 F.3d 1369, 1370 (Fed. Cir. 2011) (per curiam) (denying rehearing en banc).

83. *See id.* at 1370 (Moore J., dissenting) ("Despite the crucial role that claim construction plays in patent litigation, our rules are still ill-defined and inconsistently applied, even by us.").

84. *See* John F. Duffy, *On Improving the Legal Process of Claim Interpretation: Administrative Alternatives*, 2 WASH. U. J.L. & POL'Y 109, 124 (2000) (claiming this trade-off makes it unlikely the matter will be definitively solved).

de novo standard because they claim it increases litigation costs, as the possibility of appellate review and reversal followed by a remand is greater because no deference is offered to the claim construction of the district court.[85] The general sentiment from businesses is that allowing the de novo standard of review creates uncertainty in patent litigation, which, in turn, creates higher costs for businesses due to increased litigation and less inclination to settle.[86]

The potential for change in the standard of review arose again in 2013 when the Federal Circuit granted rehearing en banc in *Lighting Ballast Control v. Philips Electronics*.[87] This case represented the first opportunity to revisit the *Cybor* standard of review en banc since the *Phillips* case and the denial of rehearing in *Retractable Technologies*.[88]

D. Light at the End of the Tunnel?: Lighting Ballast History and Issues

The origins of the en banc rehearing of *Lighting Ballast* trace back to a dispute between the parties over infringement, the scope of a "control means" claim limitation, the meaning of the term "connected to" in the patent, and validity of the patent overall.[89] Lighting Ballast Control's (LBC) patent covers "a lighting ballast that powers fluorescent lamps with heatable filaments."[90] The district court went through the claim construction analysis looking at intrinsic and extrinsic evidence to ascertain the meaning of "connected to" and other claim limitations.[91] As required by statute, Universal Lighting Technologies (ULT), the true defendant despite the case being named for Philips Electronics, brought up an invalidity defense claiming

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85. *See* Paul R. Michel, *The Court of Appeals for the Federal Circuit Must Evolve to Meet the Challenges Ahead*, 48 AM. U. L. REV. 1177, 1193 (1999) (explaining that in patent cases the appeal rate hovered around fifty percent compared to ten percent of other civil judgments). *But See* J. Jonas Anderson & Peter S. Menell, *Informal Deference: A Historical, Empirical, and Normative Analysis of Patent Claim Construction*, 108 NW U. L. REV. 1, 42–43 (2014) (explaining that the rate of reversal in claim construction cases today is closer to the rate of reversal in other patent issues).

86. *See* Anderson & Menell, *supra* note 85, at 70 (citing multiple precedents that suggest the de novo standard encourages appeals and multiplies proceedings); *see also* James F. Holderman, *The Patent Litigation Predicament in the United States*, 2007 U. ILL. J.L. TECH & POL'Y 1, 11 (2007) (identifying the de novo standard as one factor that create uncertainty in patent litigation).

87. Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 500 F. App'x 951, 951 (Fed. Cir. 2013) (granting rehearing en banc).

88. *See Retractable Techs.*, 659 F.3d at 1370 (denying rehearing en banc).

89. *See* Lighting Ballast Control, LLC. v. Philips Elecs. N. Am. Corp., 814 F. Supp. 2d 665, 671 (N.D. Tex. 2011), *rev'd*, 498 F. App'x 968 (Fed. Cir. 2013) (listing the seven grounds under which ULT moved for judgment as a matter of law).

90. *Id.* at 670 (quoting U.S. Patent No. 5,436,529 (filed Apr. 22, 1993)).

91. *See id.* at 675–83 (analyzing the claims, specification, prosecution history, and expert testimony from the "connected to" limitation and the "control means limitation").

LBC's patent was invalidated by prior art.[92] The district court held, after construing the claims, that the patent was valid and therefore, the subsequent jury verdict on infringement would stand.[93] The jury decided that ULT did infringe and awarded damages to LBC.[94]

ULT appealed the case to the Federal Circuit where a three-judge panel reversed the district court, holding the patent was invalid because it was indefinite.[95] The panel made a point to mention that matters of claim construction are matters of law, which required it to offer no deference to the determinations of the district court.[96] The panel focused on an entirely different part of the patent than the district court in deciding the appeal, rendering the claim construction by the district court essentially useless.[97]

Following the reversal, LBC appealed for a rehearing of the case en banc arguing that the *Cybor* standard of review should be overturned.[98] The Federal Circuit granted the rehearing en banc and heard oral argument on the case on September 13, 2013, with a good portion of the argument focusing on whether and why the *Cybor* standard should be overturned.[99] LBC argued that the de novo standard should be abandoned entirely and a clear error standard should be implemented.[100] ULT

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92. *See id.* at 686–87 (claiming that the '529 patent is invalid because a large amount of uncontested evidence exists and on the contested evidence the arguments from LBC conflict with the claim language and even LBC's own infringement claims).

93. *See id.* at 689–90 (holding that the '529 patent is not invalidated by either the Japanese '997 patent or '799 patent).

94. *See id.* at 670–71, 691, 693 (allowing the jury's award of $3,000,000 in damages to stand and granting the amount as a lump sum payment in exchange for a license for ULT to use the '529 from the date judgment is entered until the patent expires).

95. *See* Lighting Ballast Control LLC. v. Philips Elecs. N. Am. Corp., 498 F. App'x 986, 987 (Fed. Cir. 2013) (providing an example of the Federal Circuit overruling a district court holding on a matter entirely different than what the district court considered essential to the decision).

96. *See id.* at 989 (citing the *Cybor* case which allows the de novo standard to apply to questions of law, requiring no deference).

97. *See id.* at 989–91 (focusing on the means-plus-function limitation in the claim 1 term "voltage source means").

98. *See* Petition for Rehearing En Banc at 6–11, Lighting Ballast Control LLC. v. Philips Elecs. N. Am. Corp., 500 F. App'x 951 (2013) (Nos. 2012-1014, 2012-1015) (applying the facts of *Lighting Ballast* at the district court level to argue that *Cybor* forces Federal Circuit panels to re-review factual conclusions).

99. *See* Lighting Ballast Control, LLC. v. Philips Elecs. N. America Corp., 500 F. App'x 951, 951 (Fed. Cir. 2013) (granting rehearing en banc); *see also* J. Jonas Anderson, *Oral Argument Recap: Lighting Ballast Control v. Philips*, PATENTLYO (Sept. 13, 2013), http://www.patentlyo.com/patent/2013/09/oral-argument-recap-lighting-ballast-control-v-philips.html (noting that at oral argument both parties initially agreed de novo was not the proper standard of review with the parties differing on the necessary scope of deference).

100. *See* Anderson, *supra* note 99 (detailing LBC's desire for deference on all aspects of patent claim construction).

initially argued that the de novo standard could change but only to offer deference on issues of historical fact.[101] The argument explored three primary issues: national uniformity concerns, line-drawing between issues of fact and issues of law, and interestingly, the impact of stare decisis.[102] Judge Taranto made a point to ask ULT and the Patent Office Solicitor whether the Federal Circuit is able to revisit an established en banc precedent through another en banc decision absent statutory intervention from Congress or judicial intervention from the Supreme Court.[103] Neither the ULT attorney nor the Solicitor arguing before the Federal Circuit appeared to have an answer to this question, suggesting it was up to the court to make that determination.[104] The question from Judge Taranto was deliberate because precedent, or stare decisis, is a foundational legal principle in the American system.[105]

E. Harmony in the Law and the Courts: The Influence of Uniformity on the Federal Circuit

When Congress established the United States Court of Appeals for the Federal Circuit in 1982, one of its primary reasons was to create uniformity in patent law.[106] Before 1982, every federal court of appeal had jurisdiction over patent appeals from district courts in their territory.[107] Wide ranging jurisdiction also created many instances of forum shopping, which Congress wanted to eradicate.[108] Furthermore, prior to the Federal Circuit's establishment, only the Supreme Court was able to

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101. *See id.* (demonstrating ULT's desire for a narrow application of deference).

102. *See id.* (explaining that the stare decisis issue seemingly took the arguing attorneys by surprise).

103. *See* Oral Argument at 21:54, 55:53, Lighting Ballast Control LLC v. Philips Elecs. N. Am. Corp., 744 F.3d 1272 (Fed. Cir. 2014) (en banc), *available at* http://oralarguments.cafc.uscourts.gov/default.aspx?fl=2012-1014_9132013.mp3 (manifesting Judge Taranto's hesitation at overruling established en banc precedents under stare decisis).

104. *See id.* at 22:24, 56:10 (demonstrating the two attorneys' surprise at the question of stare decisis implications inherent to the decision of the case).

105. *See* THE FEDERALIST NO. 78, at 471 (Alexander Hamilton) (Clinton Rossiter ed., 1961) ("To avoid an arbitrary discretion in the courts, it is indispensable that they should be bound down by strict rules and precedents, which serve to define and point out their duty in every particular case that comes before them.").

106. *See* S. REP. NO. 97-275 at 2 (1981) (recognizing two other purposes in creating the Federal Circuit: to improve the administration of patent law); *see also* H.R. REP. NO. 97-312 at 20-23 (1981) (explaining that forum shopping was also a problem that created wide inconsistencies in the patent law).

107. *Cf.* 28 U.S.C. § 1338 (1976) (granting jurisdiction to district courts over patent cases which at the time could then be appealed to the regional federal courts of appeal).

108. *See* S. REP. NO. 97-275 at 5 (1981) (discussing how a court of appeals dedicated to patent law will reduce forum shopping which was common in patent litigation).

render binding decisions on national law issues like patent law.[109] Concerns arose that the appellate courts were overburdened by patent cases because their nature was technical, and required extensive amounts of time.[110]

Uniformity in patent law is necessary for the same reason adherence to stare decisis is promoted at the Federal Circuit, namely, the powerful role of the Federal Circuit as the exclusive holder of patent appellate jurisdiction.[111] This key factor distinguishes the Federal Circuit from the other courts of appeal because its jurisdiction was purposely defined by subject matter instead of geography.[112] The Supreme Court initially was hands-off and allowed the Federal Circuit to make the major pronouncements on patent law without frequent challenges.[113] In recent years, the Court's role has increased and some Federal Court judges like Judge Dyk believe the role of the Court will continue to increase going forward.[114]

Congress greatly considered the needs of businesses in establishing the Federal Circuit by asserting that uniformity in patent law created by the Federal Circuit would be an improvement for businesses over the old system.[115] Congress recognized the important nature of patents as a driving force of innovation where significant investment was placed in research, development, and distribution of products.[116] Congress' aim was to reduce uncertainty in order to promote investment.[117] Judge Dyk notes that, in the 1970s, experts estimated the breakdown of assets in American corporations was twenty percent intellectual property and

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109. *See id.* (emphasizing the need for the Federal Circuit to address the inability to provide "quick and definitive answers to legal questions of nationwide significance").

110. *See* Ellen F. Sward & Rodney F. Page, *The Federal Court Improvement Act: A Practitioner's Perspective*, 33 AM. U. L. REV. 385, 388–89 (1984) (concluding that the centralization of patent case jurisdiction in the Federal Circuit would lead to the beneficial effect of lightening other circuits' case load).

111. *Cf.* Matthew F. Weil & William C. Rooklidge, *Stare Un-Decisis: The Sometimes Rough Treatment of Precedent in Federal Circuit Decision-Making*, 80 J. PAT. & TRADEMARK OFF. SOC'Y 791, 805 (1998) (presenting the idea that in many patent cases, the Federal Circuit can serve as the court of last resort since the Supreme Court often denies certiorari in patent cases).

112. *See* 28 U.S.C. § 1295 (2012) (enumerating the Federal Circuit's unique status as having nationwide jurisdiction of patent appeals from Article III courts).

113. *See* Dyk, *supra* note 9, at 764 (noting that in the first ten years of the Federal Circuit's existence, the Supreme Court only reviewed three patent decisions).

114. *See id.* at 764–65 (explaining the recent increase in Supreme Court cases reviewing patent cases from the Federal Circuit).

115. *See* S. REP. NO. 97-275 at 6 (1981) (noting that uniformity will make business planning easier and more stable, as predictable law becomes the norm).

116. *See id.* (quoting the general patent counsel of GE, "Patents, in my judgment, are a stimulus to the innovative process, which includes not only investment in research and development but also a far greater investment in facilities for producing and distributing the goods").

117. *See id.* (quoting the general patent counsel of GE, "Certainly it is important to those who must make these investment decisions that we decrease unnecessary uncertainties in the patent system").

eighty percent hard assets.[118] Today, those same experts assert that the proportions have been reversed with intellectual property playing a greater role in the corporate community.[119] Businesses plan around consistent applications of law, and with the strong economic impact patent litigation can have, uniformity in the law is critical.[120] However, all of this could be threatened by a potential overreach by the Federal Circuit if it is allowed to reconsider established en banc standards at will with new en banc cases.

II. THE FEDERAL CIRCUIT'S ADHERENCE TO STARE INDECISIS: RECONSIDERING EN BANC STANDARDS EN BANC AND THE NEGATIVE RESULT ON BUSINESS LITIGATION STRATEGIES

Throughout its history, the Federal Circuit has valued its role as a pseudo-court of last resort for patent claims. However, the very purposes for creating the Federal Circuit preclude allowing the court to constantly review its own established en banc standards without input from the Supreme Court or Congress. For a specialized court that values uniformity in law, stare decisis must play a greater role.

A. Slipping Down the Slope: Reconsidering Established En Banc Standards Absent Judicial or Statutory Intervention.

The principle of stare decisis guides a court like the Federal Circuit more than other courts because of the importance of uniformity and consistency concerns and the statutory nature of patent law interpretation.[121] While stare decisis is not black letter law, the Federal Circuit has purposefully ignored this important principle by twice reconsidering the en banc *Cybor* standard prior to any judicial or statutory intervention from a higher authority.[122] The Federal Circuit's rejection of stare decisis by giving itself the opportunity to reconsider established en banc standards at will with other en banc cases ironically creates a dangerous precedent.[123]

Other federal courts of appeal typically do not face a problem of reconsidering

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118. *See* Dyk, *supra* note 9, at 766 (citing Ocean Tomo 300 Patent Index, http://www.oceantomo.com/productsandservices/investments/indexes/ot300 (last visited Feb. 23, 2014)) (delineating visually the percentages of tangible versus intangible assets from 1975 to 2010).

119. *See id.*

120. *See* Thier, *supra* note 59 (noting that many times small companies with fewer resources can be shut out of the patent community through attrition).

121. *See* Neal v. United States, 516 U.S. 284, 295 (1996) (emphasizing that compelling reasons such as irreconcilability with other doctrines is needed to overturn prior precedent).

122. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 500 F. App'x 951, 951 (Fed. Cir. 2013) (granting rehearing en banc); *accord* Phillips v. AWH Corp., 376 F.3d 1382, 1382-83 (Fed. Cir. 2004) (granting rehearing en banc).

123. *Cf.* Akamai Techs., Inc. v. Limelight Networks, Inc., 692 F.3d 1301, 1336 (Fed. Cir. 2012) (demonstrating an en banc court overruling a panel precedent as is the normal course of action).

their own en banc precedents twice in a fifteen-year period because intervention from a higher authority will resolve the issue.[124] The Supreme Court can and often does resolve circuit splits in all areas of the law because circuit splits are one of the three primary considerations for the Court when deciding which cases to hear.[125] However, with intra-circuit splits, which are splits between multiple panels of an appeals court, the split is typically resolved by an appeals court hearing the case en banc.[126] The Supreme Court may choose to and has rendered many decisions on appeals from en banc decisions in cases where the issue of law is particularly relevant.[127]

Patent law appears to receive different treatment from the Supreme Court because in the past, the Court has not taken many patent cases.[128] Numbers do show that the Court's interest in patent cases is growing as the percentage of Supreme Court patent cases in the last seven years has increased.[129] For example in 2014 the Supreme Court granted certiorari to at least six patent cases.[130] Yet, when the issue of the patent claim construction de novo standard of review arose, the Court balked and the jurisprudence is littered with denials of certiorari.[131] The Federal Circuit claimed multiple times that the Supreme Court clearly supported the de novo standard because it affirmed the Federal Circuit's decision in *Markman I*; however, the reality

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124. *See, e.g.*, Joe Mullin, *Supreme Court Upends Top Patent Court's "Burden of Proof" Rule*, ARS TECHNICA (Jan. 22, 2014 4:19 PM), http://arstechnica.com/tech-policy/2014/01/supreme-court-upends-top-patent-courts-burden-of-proof-rule/ (providing an example of the Supreme Court intervening to resolve an issue); Lee Smith, *Congress Passes Legislation to Overturn the Federal Circuit's GPX Decision*, KING & SPALDING (Apr. 2012), http://www.kslaw.com/library/newsletters/TradeManufacturing Alert/2012/April/article2.html (providing an example of Congress intervening to resolve an issue).

125. SUP. CT. R. 10 (2010) (stating that the two other primary considerations are if a state court of last resort has decided a federal question that conflicts with another state court of last resort or if a state court of last resort has decided a question of federal law that should be settled by the Supreme Court).

126. *Cf.* Michael Duvall, *Resolving Intra-Circuit Splits in the Federal Courts of Appeal*, 3 FED. CTS. L. REV. 17, 18 (2009) (establishing that subsequent panels cannot overrule prior panels' decisions; only the en banc court has that ability).

127. *See, e.g.*, Kappos v. Hyatt, 132 S. Ct. 1690 (2012) (serving as an example of the Supreme Court considering the limits on introduction of evidence as a relevant issues of federal law).

128. *See* Dyk, *supra* note 9, at 765 (using an example from 2006 to show that the Supreme Court only hears as much as one percent of patent cases that come out of the Federal Circuit).

129. *See id.* (stating that in 2007, the term prior to the article, the Supreme Court had three patent cases, which constituted four and a half percent of the cases decided by the Court).

130. *See Patent Law and the Supreme Court: Certiorari Petitions Granted*, WILMERHALE LLP (Jan. 2015), https://www.wilmerhale.com/pages/publications andnewsdetail.aspx?NewsPubId=10737419833.

131. *See, e.g.*, Retractable Techs., Inc. v. Becton, Dickinson and Co., 133 S. Ct. 833 (2013) (denying certiorari).

is that prior to *Teva Pharmaceuticals v. Sandoz* in 2014, the Supreme Court never directly addressed the patent claim construction standard of review.[132] The issue is further complicated because the Federal Circuit has exclusive jurisdiction over patent appeals and without intervention from the Court, the Federal Circuit's decisions are the controlling law making it a pseudo-court of last resort.[133]

The hands-off approach on the issue of claim construction by the Supreme Court has allowed the Federal Circuit to operate independently and create tension on the issue of claim construction among the different judges.[134] This same tension has arisen in other subject areas like patentable subject matter and software patents.[135] Notably, absent was any intervention from the Supreme Court on the claim construction standard of review issue.[136] This absence of intervention on this specific issue changed when the Supreme Court granted certiorari in *Teva Pharmaceuticals v. Sandoz*.[137] But, the entire problem at issue here finds its roots from a subjective interpretation of a Supreme Court decision.[138]

In *Cybor*, the Federal Circuit interpreted the Supreme Court's silence as an indication that the Court approved of the de novo standard announced by the Federal Circuit's *Markman* decision.[139] However, the Supreme Court had not yet weighed in on the issue, and an issue is not fully decided until the Court has decided what the

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132. *See* Markman v. Westview Instruments, 517 U.S. 370, 391 (1996) (offering neither support nor rejection of the Federal Circuit's de novo standard of review but merely offering silence).

133. *See* Michael Paul Chu, Note, *An Antitrust Solution to the New Wave of Predatory Patent Infringement Litigation*, 33 WM. & MARY L. REV. 1341, 1351 (1992) ("The Federal Circuit is effectively the court of last resort for patent appeals because very few patents reach the Supreme Court.").

134. *See* Anderson & Menell, *supra* note 85, at 6 (proffering that a lack of agreement among the judges on whether *Markman* implied that claim construction has factual determinations has created more confusion and uncertainty in the patent system).

135. *See, e.g.*, Alice Corp. v. CLS Bank Int'l, 134 S. Ct. 2347, 2353–54 (2014) (presenting a case where the Court addressed software patents en banc and multiple judges wrote opinions); Ass'n for Molecular Pathology v. Myriad Genetics, 133 S. Ct. 2107, 2114–15 (2012) (presenting a case where the Court addressed patentable subject matter and all three judges on the panel wrote opinions); Bilski v. Kappos, 130 S. Ct. 3218 (2010) (presenting a case where the Court addressed software patents).

136. *See* Retractable Techs., Inc. v. Becton, Dickinson and Co., 133 S. Ct. 833 (2013) (denying certiorari); AWH Corp. v. Phillips, 546 U.S. 1170 (2006) (denying certiorari) (demonstrating the inference that Supreme Court lacked interest thus far in resolving the standard of review issue).

137. Teva Pharms. USA, Inc. v. Sandoz, Inc., 134 S. Ct. 1761 (2014) (serving as the first case where the Supreme Court has agreed to consider the proper claim construction standard of review at the Federal Circuit).

138. *See* Cybor Corp. v. FAS Techs., Inc., 138 F.3d 1448, 1451 (Fed. Cir. 1998) (en banc) (assuming that the affirmation of the Federal Circuit's decision in *Markman I* means the Supreme Court endorsed the de novo standard of review).

139. *See id.* (implying that the unanimous nature of the Supreme Court's vote in *Markman II* played a role in deciding *Cybor*).

law really means. Therefore, there was room for debate.[140] The Supreme Court's *Markman II* decision made no references to the proper standard of review and instead, classified claim construction as a "mongrel practice" that is neither purely factual nor purely legal.[141] In the wake of that decision and before *Cybor*, some Federal Circuit panels still applied clear error implying that *Markman II* did not elucidate a clear standard of review.[142] Often, different entities will extoll the virtues of one standard over another, but the more important issue is that the Supreme Court has failed the intra-circuit split at the Federal Circuit, created by the dissents in en banc cases, and allowed it to reconsider its established en banc standards at will.[143]

The issue of the correct standard of review was resolved by the Supreme Court in *Teva*, but it only serves a minimal purpose because it leaves unanswered the stare decisis questions presented here.[144] *Teva* was decided at the Federal Circuit with no references to stare decisis.[145] At the Supreme Court, neither at oral argument nor in its opinion was stare decisis mentioned.[146] The scope of the Federal Circuit's ability to constantly reconsider established en banc standards would be ripe for review in *Lighting Ballast* because the decision was based on a stare decisis determination.[147] It is important for the Supreme Court to consider why the Federal Circuit, a court founded on uniformity principles, believes it has the unquestionable right to

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140. *See* Andrews v. Hovey, 124 U.S. 694, 716 (1888) ("A question arising . . . cannot be regarded as judicially settled when it has not been so settled by the highest judicial authority which can pass upon the question.").

141. *See* Markman v. Westview Instruments, 517 U.S. 370, 378, 386 (1996) (referring to claim construction as a mixed question of law and fact where judges tell juries which law governs the reasoning).

142. *See* Eastman Kodak Co. v. Goodyear Tire & Rubber Co., 114 F.3d 1547, 1558 (Fed. Cir. 1997) (stating a district court determination may not be overruled unless there is an erroneous interpretation of law or erroneous facts), *abrogated by* Cybor Corp v. FAS Techs., Inc., 138 F.3d 1448 (Fed. Cir. 1998).

143. Ryan Stephenson, Note, *Federal Circuit Case Selection at the Supreme Court: An Empirical Analysis*, 102 GEO. L.J. 272, 286-87 (2013) (stating that Federal Circuit dissents can serve as intra-circuit splits to create the catalyst for Court review).

144. *See* Teva Pharms. USA, Inc. v. Sandoz, Inc., 135 S. Ct. 831, 842 (2015) (holding that for underlying questions of fact the standard of review is clearly erroneous not de novo).

145. *See* Teva Pharms. USA, Inc. v. Sandoz, Inc., 723 F.3d 1363, 1375–76 (Fed. Cir. 2013) (deciding the case solely using invalidity and infringement determinations).

146. *See* Oral Argument Transcript, Teva Pharms. USA, Inc. v. Sandoz, Inc., No. 13-854 (U.S. argued Oct. 15, 2014), *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-854_p86b.pdf; Teva Pharms. USA, Inc. v. Sandoz, Inc., 135 S. Ct. 831, 832–844 (2015) (demonstrating that the words "stare decisis" were not mentioned at all in the opinion and the references to "precedent" were regarding Rule 52 of the Fed. R. Civ. P. not the scope of the Federal Circuit's review of its own precedent).

147. *See generally* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 744 F.3d 1272 (Fed. Cir. 2014) (deciding the case by applying stare decisis and citing *Cybor* as the precedent).

reconsider established precedent without Supreme Court input. However, the Supreme Court merely granted, vacated, and remanded *Lighting Ballast* to the Federal Circuit in light of the decision in *Teva*.[148]

The Federal Circuit justified de novo review by stating that uniformity cannot be served if the Federal Circuit must offer deference to trial judge's factual determinations.[149] However, a key component of claim construction is considering extrinsic evidence, which is surely a fact-finding task as the Court found in *Teva*.[150] The difference in opinion between the silent Supreme Court precedent in *Markman II* and the Federal Circuit's interpretation in *Cybor* should have served as evidence of a split and an impetus for Supreme Court review; however, the parties in *Cybor* did not petition for certiorari.[151] The intra-circuit split is further highlighted by the multiple dissents from Federal Circuit judges who believe some deference should be offered to the fact-finding done by the district courts.[152] The Federal Circuit is the only appeals court that hears patent cases, so the circuit split must come from within.[153] Multiple Federal Circuit judges calling for review of an established standard should have served as a cue to the Supreme Court that the issue is ripe for review.[154]

The Supreme Court could have granted certiorari to address the important precedent issue: whether the Federal Circuit should reconsider its en banc *Cybor* standard with another en banc decision considering the stare decisis implications.[155] The Federal Circuit is in a unique position where it is able to review its own en banc decision with another en banc decision because of the previous lack of intervention

148. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., No. 13-1356, 2015 WL 303220 at *1 (U.S. Jan. 26, 2015).

149. *See Cybor*, 138 F.3d at 1455 (addressing its belief that the Supreme Court did not intended a "silent, third option – that claim construction may involve subsidiary or underlying questions of fact").

150. *See* Paul R. Gugliuzza, *The Federal Circuit as a Federal Court*, 54 WM. & MARY L. REV. 1791, 1832 (2013) (emphasizing that the evaluation of extrinsic evidence appears to be a fact-finding task, though the Federal Circuit rejected the premise); *see also Teva Pharmaceuticals*, 135 S. Ct. at 840.

151. *See* SUP. CT. R. 10(c) (2010) (stating that certiorari should be granted if courts of appeal misinterpret previous Supreme Court precedent).

152. *See, e.g.*, Retractable Techs., Inc. v. Becton, Dickinson & Co., 659 F.3d 1369, 1373 (Fed. Cir. 2011) (Moore, J., dissenting from denial of rehearing en banc); Amgen, Inc. v. Hoechst Marion Roussel, Inc., 469 F.3d 1039, 1040 (Fed. Cir. 2006) (Michel, C.J., dissenting from denial of rehearing en banc); Phillips v. AWH Corp., 415 F.3d 1303, 1330 (Mayer, J., dissenting).

153. *See* 28 U.S.C. § 1295(a)(1) (2012) (giving the Federal Circuit exclusive jurisdiction over patent cases).

154. *See* SUP. CT. R. 10(a) (2010) (naming circuit splits as a compelling reason for a certiorari grant from the Court).

155. *See* SUP. CT. R. 10(c) (2010) (mentioning again that the Supreme Court can grant certiorari to decide questions of federal law not yet settled by the Court).

from the Supreme Court in the preceding fifteen years.[156] The principle of stare decisis clearly states that courts are bound by their previous decisions absent intervention from a higher authority, and in this case, that intervention did not exist at the time *Lighting Ballast* was decided.[157] The Federal Circuit's purpose requires it to adhere to this principle because of the court's foundation as a bastion of uniformity in patent law and the fact that statutory decisions are given greater weight under stare decisis.[158] Since the Federal Circuit has made clear that the standard of review is de novo, it appears that continual review of the standard by the Federal Circuit in subsequent en banc decisions is directly contrary to the principles of horizontal stare decisis because it questions a clearly established precedent.[159] If the Federal Circuit is allowed to reconsider an en banc decision with another en banc decision absent Supreme Court intervention, the Federal Circuit will exceed the traditional confines of stare decisis, which in the case of a specialized court like the Federal Circuit, is contrary to the great weight given to precedent.[160] The *Teva* case has eliminated the lack of intervention by the Supreme Court, however, the risk for the Federal Circuit to continually review established en banc standards with new en banc cases continues and can merely move to a new area of patent law.

The need for review from the Supreme Court is paramount. Especially in light of the new cases that will work their way up to the Federal Circuit based on the AIA. The intention of stare decisis is to have the Supreme Court review en banc decisions of appeals courts and resolve splits on key legal issues.[161] The Supreme Court has previously stepped in to resolve internal divisions in the Federal Circuit, and it seems appropriate for the Court to resolve the confusion sooner rather than later.[162] In the

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156. *See, e.g.*, Retractable Techs., Inc. v. Becton, Dickinson and Co., 133 S. Ct. 833 (2013) (denying certiorari) (emphasizing the Supreme Court's lack of interest in intervention on the claim construction standard of review issue).

157. *See* BLACK'S LAW DICTIONARY 1537 (9th ed. 2009) (defining the limits on courts under stare decisis); *see also* Nat'l Org. of Veterans' Advocates, Inc. v. Sec'y of Veterans Affairs, 260 F.3d 1365, 1373 (Fed. Cir. 2001) ("[S]tare decisis is a doctrine that binds courts to follow their own earlier decisions or the decisions of a superior tribunal.").

158. *See* Neal v. United States, 516 U.S. 284, 295 (1996) (emphasizing that stare decisis is more important in statutory cases because "Congress is free to change this Court's interpretation of its legislation").

159. *See* BLACK'S LAW DICTIONARY 1537 (9th Ed. 2009) (reiterating that precedents cannot be abandoned absent compelling reasons).

160. Jeffrey C. Dobbins, *Structure and Precedent*, 108 MICH. L. REV. 1453, 1482 (2010) (noting that the rationale behind the Federal Circuit's creation elevates decisions from the Federal Circuit to a binding precedent level).

161. *See* Peter S. Menell & J. Jonas Anderson, *Claim Construction Catch-22: Why the Supreme Court Should Grant Certiorari in Retractable Technologies*, PATENTLYO (Dec. 5, 2012), http://www.patentlyo.com/patent/2012/12/guest-postclaim-construction-catch-22-why-the-supreme-court-should-grant-certiorari-in-retractable-t.html (asserting that the Supreme Court should use dissents from denials for rehearing en banc as evidence of an intra-circuit split in the Federal Circuit).

162. *See, e.g.*, Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki, Co. 535 U.S.

past with patent law, some commentators have compared the Supreme Court to a non-custodial parent that spends an occasional weekend with its kids.[163]

This disinterest has, in turn, led to the Federal Circuit shaping patent law to its own liking. The Federal Circuit first acted counter to stare decisis in 2005 when it granted rehearing en banc in *Phillips* and intentionally asked the parties to brief the issue regarding validity of the de novo standard of review for patent claim construction knowing that the Supreme Court had not considered the issue.[164] The Federal Circuit was bound by the decision in *Cybor*, and erroneously granted rehearing en banc on a settled issue. However, in the end its en banc decision in *Phillips* to not address the issue caused no harm.[165] If the Federal Circuit remains bound by the *Cybor* case, it appears illogical that it would unilaterally reconsider the standard under the principle of stare decisis; however, it has granted rehearing en banc twice since *Cybor*.[166] The intent of stare decisis was not to make the higher authority the same authority that created the standard, but rather to allow superior courts to review and adjust the law as needed.[167] By reconsidering an en banc standard with another en banc case, the Federal Circuit is contributing to uncertainty in patent law because it creates the possibility of change when, in fact, the correct change must come from the Supreme Court as it did in *Teva*.[168] In the end, the *Phillips* case was a harmless example; however, the Federal Circuit gave itself another opportunity to address the issue in the *Lighting Ballast* case and came to a surprising result.

B. Preserving the Power of Precedent: Reconsidering Cybor En Banc in Lighting Ballast.

The *Lighting Ballast* en banc rehearing presented a new opportunity for the Federal Circuit to reconsider the *Cybor* de novo standard of review.[169] However, it

722, 741 (2002) (resolving Federal Circuit confusion on prosecution history estoppel among other issues).

163. Rebecca S. Eisenberg, *The Supreme Court and the Federal Circuit: Visitation and Custody of Patent Law*, 106 MICH. L. REV. 28, 28 (2007) (implying that the Supreme Court does not pay sufficient attention to resolving patent law issues).

164. *See* Phillips v. AWH Corp., 376 F.3d 1382, 1382–83 (Fed. Cir. 2004) (granting rehearing en banc and listing seven issues for the parties to brief).

165. *See* Phillips v. AWH Corp., 415 F.3d 1303, 1328 (Fed. Cir. 2005) (en banc) (deciding the case without addressing *Cybor*).

166. *See* Lighting Ballast Control, LLC. v. Philips Elecs. N. Am. Corp., 500 Fed. App'x 951, 951 (Fed. Cir. 2013) (granting rehearing en banc); *Phillips* 376 F.3d at 1382–83 (granting rehearing en banc).

167. BLACK'S LAW DICTIONARY 1537 (9th ed. 2009) (asserting that horizontal stare decisis binds courts to their prior decisions which should preclude the Federal Circuit from even granting rehearing en banc of settled law).

168. *See* Andrews v. Hovey, 124 U.S. 694, 716 (1888) ("A question arising . . . cannot be regarded as judicially settled when it has not been so settled by the highest judicial authority which can pass upon the question.").

169. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 744 F.3d 1272, 1276 (Fed. Cir. 2014) (considering only the validity of *Cybor* and ignoring the

also presented a new opportunity for the Federal Circuit to act contrary to the principle of stare decisis by reconsidering established precedent without input from a higher authority given the weight Federal Circuit en banc decisions carry.[170] Judge Taranto recognized this concern in the oral argument for *Lighting Ballast* en banc when he questioned the attorneys as to the ability of the Federal Circuit to even consider a change of the *Cybor* standard under stare decisis, and the attorneys had no answer.[171] Judge Taranto astutely recognized by implication that allowing the Federal Circuit to reconsider its own en banc standards absent intervention from a higher authority runs counter to the principle of stare decisis, which, in turn, runs counter to the purpose of the Federal Circuit as a court of uniformity and consistency.[172] The other judges in the case did not mention stare decisis at all; however, in an interesting twist the issue of stare decisis carried the day.[173]

The en banc decision, written by Judge Newman, based its reasoning heavily on the importance of stare decisis.[174] Judge Newman argued that unless a development in judicial doctrine or an action by Congress reduced the conceptual underpinning of a standard, it should not be overruled.[175] Judge Newman also recognized the importance of stare decisis in creating consistency in patent law, which was a key reason the Federal Circuit was created in the first place.[176] Judge Taranto joined the majority opinion and together the majority reaffirmed *Cybor* under the principle of stare decisis.[177] In this instance, the Federal Circuit acted correctly in reaffirming the *Cybor* standard under stare decisis.[178]

However, this decision assumes that under stare decisis the Federal Circuit should rehear cases en banc on established precedent in the first place.[179] Judge Taranto indicated as much in the oral argument when one of the attorneys responded that the

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actual patent validity or infringement questions).

170. *See* Dobbins, *supra* note 160, at 1482 (demonstrating the Federal Circuit's belief that it creates binding precedent even on other circuits despite the issue not being so clear cut).

171. *See* Anderson, *supra* note 99 (noting that Judge Taranto's effort on the stare decisis issue was persistent).

172. *See id.* (showing Judge Lourie's concern with the effects an overrule of *Cybor* would have on national uniformity).

173. *See Lighting Ballast Control LLC*, 744 F.3d at 1281–86 (Fed. Cir. 2014) (remarking on the importance of applying stare decisis stressed by the Supreme Court).

174. *See id.* (citing large amounts of case law on stare decisis).

175. *See id.* at 1281–82 (presenting an interesting interpretation considering the lack of discussion on stare decisis at oral argument).

176. *See id.* at 1282 (echoing the concerns of Congress when it established the Federal Circuit).

177. *See id.* at 1285 (holding that *Cybor* was still workable therefore concluding it should not be overruled).

178. *See id.* (noting the court was bound by its prior precedents).

179. *See id.* (noting that the criteria for overruling *Cybor* were not met here which implies the court could overrule its own en banc standard in the first place).

court can review any case en banc at its discretion.[180] The dissent takes the view farther by arguing that the Federal Circuit can abrogate its own case law if it is wrongly decided, at odds with Congressional mandates, or has harmful consequences.[181] However, each of the examples the dissent cites involves the reconsideration of panel decisions, not of established en banc precedents.[182] If the court truly intends to adhere to stare decisis and recognize its importance, it is difficult to understand why it reconsiders these cases en banc at all because the literal definition of stare decisis appears to contradict this action.[183]

The reality is that any change in the *Cybor* standard without a ruling from the Supreme Court or a direct change in the law would have placed the Federal Circuit in a position of great power because it would allow the Federal Circuit to mold patent law unchecked as a pseudo-court of last resort.[184] While the Supreme Court may not enjoy or fully understand patent law, its role in the development of patent law is essential.[185]

The grant of certiorari in *Teva Pharameceuticals* addressing the de novo review issue, essentially destroyed any chance that *Lighting Ballast* will be reviewed for the stare decisis implications. The Court established as much when it granted, vacated, and remanded *Lighting Ballast* in light of *Teva*.[186] The primary need was for the Court to recognize the importance of the stare decisis implications, which *Teva* fails to address because it came from a panel decision, and to make the interplay between the two courts clear.

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180. *See* Oral Argument at 21:54, 55:53, Lighting Ballast Control LLC v. Philips Elecs. N. Am. Corp., 744 F.3d 1272 (Fed. Cir. 2013) (en banc), *available at* http://oralarguments.cafc.uscourts.gov/default.aspx?fl=2012-1014_9132013.mp3 (capturing Judge Taranto stating his belief that the court has the ability to review en banc standards with other en banc cases).

181. *See Lighting Ballast*, 744 F.3d at 1315 (O'Malley, J., dissenting) (citing to multiple cases where Federal Circuit precedent was abrogated or overruled).

182. *Cf. id.* (providing examples of only panel cases does not address the overarching issue on the reach of the Federal Circuit in overruling en banc standards with new en banc cases).

183. *See* BLACK'S LAW DICTIONARY 1537 (9th ed. 2009) (using the idea that higher authorities should review lower authorities to imply the Federal Circuit cannot re-review its own en banc decisions).

184. *See* Chu, *supra* note 133, at 1351 (emphasizing that the possibility for great power for the Federal Circuit exists because of the lack of Supreme Court review).

185. *See* Dyk, *supra* note 9, at 763 (recognizing the importance of the Supreme Court to patent law but also recognizing that Supreme Court involvement is disliked by the Patent Bar).

186. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., No. 13-1356, 2015 WL 303220 at *1 (U.S. Jan. 26, 2015).

C. *Disuniform, Uncertain, and All-Powerful: The Federal Circuit's Role if En Banc Decisions are Overruled En Banc.*

Two distinct questions exist if the Federal Circuit is permitted to reconsider previously-established en banc standards absent intervention from a higher authority: (1) what type of interplay exists between the Federal Circuit and the Supreme Court for stare decisis purposes; and (2) whether the Federal Circuit's expertise as the primary judicial entity for patent law grants the Federal Circuit certain flexibility in choosing when to apply stare decisis.

Academics have long presented varying views of the proper relationship between the Supreme Court and the Federal Circuit.[187] Professor Jonas Anderson envisions the relationship between the Supreme Court and the Federal Circuit as a dialogic relationship where the Supreme Court issues broad policy decisions that can spur the Federal Circuit to action.[188] However, this relationship presents a problem because it vests primary decision-making power in the Federal Circuit.[189] Under Professor Anderson's model, the Federal Circuit is the epicenter of action and development in patent law while the Supreme Court serves to correct the Federal Circuit without providing specific guidance on how to correct problems.[190] Essentially, this model diminishes the importance of vertical stare decisis and the institutional role of the Supreme Court to say what the law means.[191]

As the court of last resort, the Supreme Court's role must extend beyond merely stating the policy and must include enunciating some means that the Federal Circuit can use to develop patent law.[192] By providing the Federal Circuit with decision-

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187. *See, e.g.*, John F. Duffy, *The Festo Decision and the Return of the Supreme Court to the Bar of Patents*, 2002 SUP. CT. REV. 273, 284 (2002) (envisioning a model where the Federal Circuit signals important cases for Supreme Court review); Glynn S. Lunney, Jr., *Patent Law, the Federal Circuit, and the Supreme Court: A Quiet Revolution*, 11 SUP. CT. ECON. REV. 1, 2 (2003) (claiming the Supreme Court has allowed the Federal Circuit to essentially define and alter patent law).

188. *See* J. Jonas Anderson, *Patent Dialogue*, 92 N.C. L. REV. 1049, 1083 (2014) (noting that a dialogic relationship exists despite the Federal Circuit being the most reversed federal court).

189. *See id.* at 1066 (discussing the deference given by the Supreme Court to the Federal Circuit due to its expertise).

190. *See id.* at 1079–80 (providing examples of the Supreme Court spurring the Federal Circuit to act).

191. Marbury v. Madison, 5 U.S. 137, 177 (1803) ("It is emphatically the province and duty of the judicial department to say what the law is.").

192. *See* Eric Black, *How the Supreme Court has Come to Play a Policymaking Role*, MINNPOST (Nov. 20, 2012), http://www.minnpost.com/eric-black-ink/2012/11/how-supreme-court-has-come-play-policymaking-role (arguing that the Supreme Court is not as adept at creating useful patent rules and has developed a policy-making role normally saved for elected officials). *But See* John M. Golden, *The Supreme Court as "Prime Percolator": A Prescription for Appellate Review of Questions in Patent Law*, 56 UCLA. L. REV. 657, 674–84 (arguing the Supreme Court is not as adept to creating useful patent rules).

making power on the means, it creates a pseudo-court of last resort.[193] The Federal Circuit can hardly meet its mission of stability and uniformity in patent law when the Supreme Court leaves it to figure out the means for developing effective patent doctrine from broad policy pronouncements.[194] The Federal Circuit would be left in a more powerful position and indeed a more controversial position as a pseudo-court of last resort where politics and composition could play a role like in the Supreme Court.[195]

The Supreme Court and Congress consider the Federal Circuit the expert on patent law because of its unique jurisdiction for hearing appeals in all patent cases.[196] This expertise is used to explain the necessity of allowing the Federal Circuit to operate as the primary actor in shaping the future of patent law.[197] Furthermore, the argument persists that the expertise provides a greater incentive to give deference to the Federal Circuit's judgment when it comes to the development of patent law.[198] The problem is that stare decisis must weigh heavily on a court founded on the principle of uniformity like the Federal Circuit.[199] The Federal Circuit faced the unique issue of having an en banc precedent that the Supreme Court ignored for over fifteen years.[200] This same situation can arise again in a different area of patent law.

One other argument is that if other courts of appeal can, albeit infrequently, change binding precedents, why can't the Federal Circuit? The reason is that the Federal Circuit can face a pure absence of higher authority intervention before

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193. *See* Chu, *supra* note 133, at 1351 (cautioning that the Federal Circuit could become a pseudo-court of last resort).

194. *See* S. REP. NO. 97-275 at 2 (1981) (voicing the idea that the entire purpose of the Federal Circuit was to create a central venue for patent claims that would enable uniform interpretation of the substantive patent law in all courts).

195. *See* Adam Liptak, *Court Under Roberts is Most Conservative in Decades*, N.Y. TIMES (July 24, 2010), http://www.nytimes.com/2010/07/25/us/25roberts.html; William Laney, *Is There a Liberal Supreme Court in Our Foreseeable Future?*, THE HUFFINGTON POST (Aug. 8, 2013 1:57 PM), http//www.huffingtonpost.com/William-laney/is-there-a-liberal-supreme-court_b_3755839.html (demonstrating how the media views the polarization of the Supreme Court).

196. *See* Anderson, *supra* note 188, at 1068 (noting that Congress intended the Federal Circuit to be the primary policymaker on patents because of its role in interpreting the patent law).

197. *See id.* at 1067–68 (referring to the prominent role the Federal Circuit plays in the judicial dialogue because of expertise).

198. *See id.* at 1071–74 (stating that Congress removed reform provisions from patent legislation because of Federal Circuit case law).

199. *See* Lighting Ballast Control, LLC v. Philips Elecs. N. Am. Corp., 744 F.3d 1272, 1292 (Fed. Cir. 2014) (Lourie, J., concurring) (stating that uniformity and consistency, bolstered by stare decisis, were the factors Congress considered in creating the Federal Circuit).

200. *See* Retractable Techs., Inc. v. Becton, Dickinson and Co., 133 S. Ct. 833 (2013) (denying certiorari); AWH Corp. v. Phillips, 546 U.S. 1170 (2006) (denying certiorari).

changing the standard, which is contrary to stare decisis.[201] In most instances, under vertical stare decisis, a change in the law or opinion from the Supreme Court or Congress will allow a court of appeal to revisit its prior precedent and adjust or overrule it as needed.[202] However, the lack of review from a higher authority before *Teva* precluded the reconsideration of *Cybor* under stare decisis as the judges aptly noted in *Lighting Ballast*.[203] The Federal Circuit certainly believes it has the ability to reconsider en banc standards with new en banc cases as it noted in *Lighting Ballast*.[204] Despite the strong adherence to stare decisis, the Federal Circuit neglects the fact that a consistent application of stare decisis would prevent the Federal Circuit from reconsidering the standard because contention alone is not sufficient to justify review of established precedent.[205]

The policy behind the creation of the Federal Circuit was to promote consistency in patent law.[206] The Federal Circuit acted contrary to its policy mandate by accepting new en banc reviews of the *Cybor* decision absent higher authority intervention because the standard was established by the en banc decision in *Cybor*.[207] It is was up to the Supreme Court to take the next step.[208] Unfortunately, in granting certiorari for *Teva*, the Supreme Court dismissed an opportunity to discuss the stare decisis implications. By eroding the value of precedent, the Federal Circuit could cheapen the very foundation of the American legal system, which is, in part, based on using firmly established precedent as a guidepost for the limits of decisions.[209]

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201. *See* Dickerson v. United States, 530 U.S. 428, 443 (2000) (noting that special justifications are needed to reverse precedent).

202. *See* Joseph W. Mead, *Stare Decisis in the Inferior Courts of the United States*, 12 NEV. L.J. 787, 811 (2012) (explaining that the Federal Circuit is bound by its own precedent until overruled by the Supreme Court).

203. *See Lighting Ballast*, 744 F.3d at 1283 (citing *Festo* in stating that courts must be cautious before disrupting settled expectations in the law).

204. *See id.* at 1283–84 (discussing reasons why the court should not overrule *Cybor* based on unworkability, meaning the court considered it could overrule if needed).

205. *See* Watson v. United States, 552 U.S. 74, 82 (2007) (emphasizing that contention within the court does not re-open a case for another try).

206. *See* S. REP. NO. 97-275 at 2 (1981) (reemphasizing the important nature of uniformity to patent law because of the effects on the public participating in commerce).

207. *See* Cybor Corp. v. FAS Techs., Inc., 138 F.3d 1448, 1451 (holding that the affirmance of the Federal Circuit's *Markman I* decision was an endorsement of the de novo standard of review for claim construction).

208. *See* Menell & Anderson, *supra* note 161 (considering the issue of the patent claim construction standard of review as ripe for Supreme Court review since *Markman* was decided).

209. *See* MICHAEL J. HERHARDT, THE POWER OF PRECEDENT 148 (2008) (stating that precedents provide a framework for judicial decision-making).

D. *Stare Indecisis From the Courtroom to the Boardroom: Negative Effects on Business*

If the Federal Circuit is permitted to continually reconsider en banc decisions with other en banc decisions absent intervention, the uncertainty can create great risks for business.[210] Businesses have become very hesitant to enter into patent litigation because of its exorbitant costs, and the costs could increase if the Federal Circuit can change the standard for claim construction at will.[211] Business planning and strategy is typically done by lawyers and executives far ahead of time and is based on finding patterns and trends that are certain and can be easily applied.[212] For example, if the Federal Circuit were to shift a standard twice over a 10-year period, businesses will undoubtedly find themselves constantly re-planning to accommodate the ever-shifting patent claim construction standards. The uncertainty in the patent law is also likely to drive up costs when patent litigation is already costing between five hundred thousand and three million dollars per suit.[213]

Furthermore, businesses may be enticed to give up on patent litigation all together and instead focus on avoiding long litigation through settlement.[214] The threat of multiple en banc courts reconsidering the same issues undoubtedly creates confusion regarding the true meaning of the law, which, in turn, creates confusion for businesses because lawyers must have consistent standards to advise clients on litigation matters.[215] The logical question that follows is: if the law is not broken, why would the court reconsider it? NPEs may thrive in this scenario because businesses will not be enticed to challenge these small non-practicing patent holders with appeals to the Federal Circuit when no prediction can be made as to how the court may rule since the law over time will become extremely muddled over time.[216]

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210. Gretchen Ann Bender, *Uncertainty and Unpredictability in Patent Litigation: The Time is Ripe for a Consistent Claim Construction Methodology*, J. INTELL. PROP. L. 175, 175 (2001) ("Corporations, in-house counsel and even trial litigators require certainty and predictability in order to develop products, businesses, and litigation strategies.").

211. *See* Thier, *supra* note 59 (noting the existing high costs of patent litigation with room for growth due to technological improvements and developments).

212. *See* Bender, *supra* note 210, at 175 (emphasizing that certainty fuels business because businesses want a strong idea of value of an investment beforehand).

213. *See* Bronwyn H. Hall et al., *Prospects for Improving U.S. Patent Quality via Post-grant Opposition*, NAT'L BUREAU OF ECON. RESEARCH, WORKING PAPER NO. 9731 8 (2003), *available at* http://papers.nber.org/papers/W9731.pdf (noting that the cost can be higher or lower depending on the risk present).

214. *See* Jay P. Kesan & Gwendolyn G. Ball, *How Are Patent Cases Resolved? An Empirical Examination of the Adjudication and Settlement of Patent Disputes*, 84 WASH. L. REV. 237, 243 (2006) (stating that high litigation costs lead to settlements that are unfavorable yet preferable to the exorbitant litigation costs).

215. *See* Bender, *supra* note 210, at 175 (implying that certainty fuels investment by business, without one the other will decrease as well).

216. *See* Schumer, *supra* note 60 (reiterating that NPEs already cost businesses large amounts of money per year and uncertainty at the Federal Circuits could lead to

With patents steadily becoming a bigger and bigger part of corporate portfolios, inconsistent applications of law or uncertainty acts contrary to business objectives and may reduce interest in patents over time.[217]

Finally, businesses facing inconsistency or uncertainty in patent law are exactly what Congress attempted to avoid when it created the Federal Circuit.[218] Congress understood the growing role of patents in the American economy and sought to make patent litigation easier because patent law would be uniform and centralized.[219] Businesses prefer predictability because it reduces volatility and risk both of which are important strategic considerations.[220] Congress recognized the importance of strong business strategies and the negative effects of inconsistent patent law.[221] That being said, with threats to the uniformity of patent law, neither the Supreme Court nor Congress have stepped up, and the confusion and uncertainty have lingered long enough.

III. STEPPING TO THE PLATE: ADDRESSING THE CONTROVERSY BEFORE IT HAS A CHANCE TO BEGIN.

The issue of the Federal Circuit reconsidering en banc standards with new en banc cases needs to be addressed before it can become a major issue. Two possible solutions exist: (1) the Supreme Court makes a determination as to when the Federal Circuit may reconsider en banc precedents when the Supreme Court has not intervened and (2) Congress intervenes to clarify whether its intent for the Federal Circuit included de novo review.

The Federal Circuit had an opportunity in *Lighting Ballast* to clarify its position on reconsidering established en banc standards. While stare decisis ultimately carried the day in the *Lighting Ballast* case, the Federal Circuit maintained its ability to review established en banc standards en banc without explanation. The Federal Circuit placed great emphasis on stare decisis in its reasoning for adhering to *Cybor* but did not explain why it reconsidered *Cybor* in *Lighting Ballast* en banc in the first place. The panel decision in *Lighting Ballast* was sufficient to support *Cybor* under stare decisis and the proper avenue was to appeal directly to the Supreme Court.

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more costly settlements).

217. *See* POSNER, *supra* note 14, at 163 (arguing that the business community could work just fine without a patent system because the Tribunal Courts are overworked with limited amount of judges because the system wants uniformity).

218. *See* S. REP. NO. 97-275 at 2 (1981) (emphasizing the need for national uniformity in the patent law).

219. *See* S. REP. NO. 97-275 at 2 (1981) (noting that centralizing the patent law would fuel innovation and investment).

220. *See* Martin Reeves et al, *Your Strategy Needs a Strategy*, HARVARD BUS. REV., (September 2012), http://www.hbr.org/2012/09/your-strategy-needs-a-strategy/ar/1 (naming predictability as one of two key factors in any business strategy).

221. *See* S. REP. NO. 97-275 at 6 (1981) (stating that the decentralized nature of the patent law at the time had already discouraged innovation).

Regardless of its actual actions, the potential of allowing the Federal Circuit to clarify its own reach in reconsidering the established en banc standard is troublesome because an issue of law is not truly decided until the highest authorities intervene. If the Federal Circuit decided in *Lighting Ballast* or decides later that it can reconsider and overrule en banc decisions with other en banc decisions at whim, a great amount of power would vest in that court. However, there is no need to let the Federal Circuit enter that quagmire. If the Supreme Court decides the question of the reach of the Federal Circuit first, the issue will finally be laid to rest.

As the court of last resort in this country, it is the Supreme Court's duty to resolve splits in the law. Even though the Federal Circuit did not overrule *Cybor* in *Lighting Ballast*, the Supreme Court should consider the question of whether the Federal Circuit has the ability to continually reconsider established precedent in order to protect the principle of stare decisis. The Supreme Court has consistently supported the application of precedent by the lower courts and by itself. The Federal Circuit's attempt to act contrary to that principle is an affront to the Supreme Court's history of supporting strong precedent. The issue will not be truly resolved unless the Supreme Court definitively states how far an en banc Federal Circuit can go in reconsidering its previous en banc decisions absent intervention from the Court or Congress. The Supreme Court should focus narrowly on the Federal Circuit since it is the only appeals court in the unique situation where the higher authorities have not intervened in over fifteen years. The Supreme Court already gave up an opportunity to consider this important issue fully in *Lighting Ballast* by granting, vacating, and remanding the Federal Circuit's decision, which essentially determines it will not consider the case fully.

The Supreme Court's choice to take the very narrow route of simply choosing a side on the patent claim construction standard of review debate in the *Teva* case did not go far enought. The benefits of this approach were twofold: it eliminated the confusion with regard to patent claim construction and it temporarily eliminated the threat of acting contrary to the principles of stare decisis. The primary problem with this approach is that the relief to the stare decisis problem is not definitive. The claim construction issues was solved, yet, the overarching issue of the Federal Circuit reconsidering established en banc decisions absent intervention remains.

Certainly en banc standards that stand for more than fifteen years without intervention are rare; however, that does not mean contention over established standards cannot occur again. Businesses will benefit from a clear statement of the claim construction standard of review because uniformity and consistency would be restored. However, businesses may also suffer in the end should the Federal Circuit later assert an authority to overrule en banc standards with other en banc decisions in the absence of Supreme Court intervention in future cases.

Either way, the legal system would benefit from clarity. Clarity with a final decision on the proper patent claim construction standard of review is helpful but not definitive. True clarity comes from the Supreme Court accepting its responsibility as

the bastion of the American legal system by making a determination on the Federal Circuit's use of stare decisis. The benefits to stare decisis, patent law, uniformity principles, and the role of the courts will all be met with a clear pronouncement on how courts should operate.

CONCLUSION

Challenging the *Cybor* patent claim construction standard of review has become an issue for the Federal Circuit. The previous lack of intervention from the Supreme Court or Congress put the Federal Circuit in a position to continually reconsider or overrule its own en banc standards with new en banc decisions. This type of unilateral power in the Federal Circuit runs contrary to the guiding legal principle of stare decisis. In a commercial field like patents, businesses are being unfairly subjected to unnecessary uncertainty and disuniformity in the law because courts have failed to either limit themselves or definitively state the law. *Lighting Ballast* was a missed opportunity to definitively answer the important stare decisis questions in the Federal Circuit. Stare indecisis cannot become the new norm in the Federal Circuit because businesses and the legal community deserve the clarity that has eluded them for too long.

CURBING THE EXPLOITATION OF PASSIVE CREDITORS IN CHAPTER 11 REORGANIZATION BY LEVERAGING THE OVERSIGHT ROLE OF THE UNITED STATES TRUSTEE

ADDISON PIERCE*

The Bankruptcy Reform Act of 1978 is beginning to show its age in ways similar to the forty-year-old code it replaced. In addition to being ill-suited to address changes in the underlying credit market, the current code is confronting the development of an entirely new market place—a market in claims trading. While some praise the enhanced liquidity, others take issue with the strains placed on the efficacy of bankruptcy. Rather than engaging in the normative debate, this Comment seeks to redress a clear drawback to the current system: the harm endured by passive creditors. Unlike those economically empowered to participate in the reorganization process, the passive creditor lacks the economic ability and incentive to play an active role. This position leaves the passive creditor's ability to collect on its claim solely in the hands of another: the creditors' committee. While this committee may have provided adequate protection in 1978, the credit market and its participants are very different today. Some argue that this issue is systemic and can only be addressed by replacing the current code; however, this Comment argues that something can be done short of this massive task. The challenge is as follows: if too little is done, passive creditors will continue to be exploited and if too much is done the whole market could be damaged. Recognizing this challenge, this Comment proposes that passive creditors can be afforded adequate protection by leveraging the oversight power of the US Trustee to ensure the proper functioning of creditors' committees. Moreover, the recommendation of this Comment would enhance protection for passive creditor while remaining market neutral.

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INTRODUCTION

Bankruptcy is an attempt to prevent a tragedy of the commons.[1] Without bankruptcy, "creditors would resort to self-help measures to collect debts owed to them" by a failed or failing organization ("the debtor").[2] The foreclosure and liquidation assets would favor the sophisticated over the

1. *See* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621, 677 (1998) ("A tragedy of the commons can occur when too many individuals have privileges of use in a scarce resource. The tragedy is that rational individuals, acting separately, may collectively overconsume scarce resources.").

2. Michael H. Whitaker, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL'Y 303, 306 (1993).

passive and leave similarly situated creditors (similarly situated in *right* rather than ability to collect) in disparate positions.[3] Moreover, this process would be swift and crude, as creditors would favor efficiency over care when seeking to recover their claims.[4]

Instead, bankruptcy provides a safe haven for creditor and debtor alike by staying the liquidation process and allowing the debtor and its creditors to work together to maximize the value of the debtor's remaining assets.[5] Chapter 11 of the Bankruptcy Code ("Chapter 11") takes this idea a step further.[6] Rather than working to maximize the value of the *remaining assets*, Chapter 11 recognizes that more value may be realized by utilizing the going-concern value of the assets.[7] Instead of liquidation and dissolution, the debtor continues to operate under the safe haven of Chapter 11, proposes a plan of reorganization, restructures its existing debt, and starts anew.[8] Chapter 11 reflects the belief that the value of a business as a going-concern may greatly exceed the value of its assets sold individually and immediately.[9]

In 1978, when the Bankruptcy Code ("the Code" or "the 1978 Code") underwent its most recent overhaul,[10] bankruptcy proceedings were

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3. *See id.* ("[B]ankruptcy protects the interests of creditors as a group.").

4. *See id.* (typifying the self-interested taking of assets by a creditor as "harming assets that would have accrued to other creditors").

5. *See* 11 U.S.C. § 362 (2012) (providing an automatic stay on all proceeding against the debtor). *See generally id.* at §§ 501–11 (regulating the relationship between the creditors and the debtor and providing a means for creditors to participate in the reorganization).

6. *See* H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 (noting that unlike liquidation, "[t]he purpose of [Chapter 11] . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders").

7. *See id.*; *see also* Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1689 (1996) (restating going-concern value, as the value of "the continuation of the debtor's business" as opposed to the value of "dismemberment and piecemeal sale of the assets").

8. *See* Whitaker, *supra* note 2 ("[I]t may be in the best interests of society in general to allow the debtor to continue to operate, create a plan of reorganization, restructure its existing debt, and start [anew]."). *But see* 11 U.S.C. § 112 (2012) (providing the bankruptcy judge the authority to convert the case to Chapter 7 liquidation for cause, if for example, under (b)(4)(a) there is "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation").

9. *See, e.g.*, United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) ("By permitting reorganization . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap.'" (citation omitted)).

10. *See* Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C.) (replacing the 1898 code and its subsequent amendments with a new code).

straightforward.[11] A corporation in reorganization maintained a relatively simple capital structure.[12] A senior bank held a single note with a security interest in all of the debtor's assets, and the unsecured claims were held by a group of "dispersed, but homogenous creditors that could adequately be represented by a committee, typically made up of a small group of the largest unsecured claim holders."[13] With this structure, the bank, the committee, and the debtor's managers could all sit at the bargaining table and work out a reorganization plan.

Today, the simple structure has been replaced by a system of unprecedented complexity and sophistication.[14] The credit markets that underpin the entire system have undergone substantial evolution.[15] Single secured lenders have transformed into primary lenders who manage a web of syndicated loan parcels.[16] In addition to changes in the underlying markets, the system is also confronting the creation of a market in bankruptcy claims.[17] Professor Adam Levitin has characterized the development as one that:

> has changed the cast of characters involved in bankruptcies. In addition to long-standing relational creditors, like trade creditors or a single senior secured bank or bank group, bankruptcy cases now involve professional distressed debt investors, whose interests and behavior are often quite different than traditional relational counterparty creditors.[18]

As the market for claims trading grows,[19] the pressure placed on Chapter

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11. *See* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 651 (2009) (noting that parties "bargained with each other against a backdrop of well-developed norms").

12. *See id.* (describing the structure as "relatively simple").

13. *Id.*

14. *See id.* ("Today, we no longer have a single bank and dispersed general creditors. Dozens of constantly changing stakeholders occupy every tranche, each pursuing its own agenda. Some seek long-term control of the business, while others are passive, short-term investors. Others may hold a basket of both long and short positions in multiple tranches and complicated hedges involving other businesses.").

15. *See id.* and accompanying text.

16. *See id.*

17. See Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 68 (2009) (emphasizing that "nothing has changed the face of bankruptcy in the last decade as much [claims trading]").

18. *Id.*

19. *See* Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 86 (noting that "[a]lthough the exact size of the corporate bankruptcy claims trading market is unknown, it was estimated to be in the hundreds of billions of dollars about a decade ago and has seen a prodigious growth in recent years").

11 is disconcerting.[20] If the Code was passed with the relational creditor in mind, as this relationship erodes, so too does the Code's ability to function.[21]

Concurrent with the growth in this new market, is a *lack* of growth in the federal regulatory regime.[22] The Federal Rules of Bankruptcy ("Federal Rules") have proven permissive to the practice of claims trading,[23] and securities regulations have proven to be too narrow to reach the claims.[24] Free from regulatory scrutiny, it seems almost unquestionable that claims trading will continue to grow at a steadfast pace.[25]

The lack of regulation should not, however, be mistaken for approval. Scholarship on claims trading actually points to the opposite; that there is little agreement on the merits of the practice.[26] Those who favor claims trading focus on the enhanced liquidity and efficiency of the market place.[27] On the other side are those who argue that the *net effect* is negative and that claims trading is detrimental to the proper functioning of the Code.[28] What is clear from this debate is that "claims trading has cross-cutting impacts on the bankruptcy process with a net impact that is

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20. *See* Levitin, *supra* note 17 (explaining that this dynamic has placed the code under "tremendous pressure").

21. *See id.*

22. *See* Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 572 (2002) ("[T]here is an active, functioning, and enormous (in terms of dollar amount) market in distressed claims that is not actively regulated.").

23. *See* FED. R. BANKR. P. 3001(e) (allowing claims to be freely alienated, save for fraudulent transfers).

24. *See generally* Drain & Schwartz, *supra* note 22, at 571 (finding that claims in a bankrupt corporation are not recognized as securities, rendering the securities regulations inapplicable).

25. *See* Baird & Rasmussen, *supra* note 11, at 659 (expanding on the concept that deregulated markets provide opportunities that highly regulated markets do not, implying that the lack of regulation will encourage growth).

26. *Compare* Blake J. Brockway, *Applying Federal Securities Law to Chapter 11 Claims Conversions*, 7 DEPAUL BUS. & COM. L.J. 655, 668 (2008) ("The benefits of claims trading, such as increased liquidity and economies of scale, are a major driving force for those who support less restricted claims trading."), *and* Tung, *supra* note 7, at 1688–89 (highlighting some of the benefits of claims trading in the plan confirmation context), *with* Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 612 (2008) (discussing the problem of empty voting wrought by claims trading), *and* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 129–30 (2005) (criticizing the effects of distressed debt investors on the Chapter XI process).

27. *See, e.g.*, Brockway, *supra* note 26 and accompanying text.

28. *See, e.g.*, Miller & Waisman, *supra* note 26 and accompanying text.

indeterminate on the available evidence."[29] Further, it means, "claims trading is not well-suited for broad policy reforms . . . [and] at this point, we can merely identify several modest features of the claims trading market that can be improved."[30]

Recognizing claims trading as a "fundamental feature of bankruptcy,"[31] this Comment examines the relationship between claims investors and passive creditors, and argues that the Code is failing to serve the passive creditors in Chapter 11 proceedings.

Part II of this Comment examines the Bankruptcy Code with particular attention paid to Chapter 11. This Section briefly introduces the (a) foundation and purpose of bankruptcy. This Section then looks at (b) how these principals are served by the 1978 Code. Finally, this Section (c) examines how the same principals are being poorly served today due to (i) the evolution of the credit market and (ii) the growth in claims trading.

Part III examines how the current system is allowing for the exploitation of the passive creditors. This Section examines (a) the provisions in the Code that permit claims trading and (b) how these provisions undercut the principles of bankruptcy. This Section also examines (c) why this inequality should not go unchecked, and more specifically (d) why this inequality should draw concern.

Part IV then addresses the problems identified above by arguing that (a) creditors' committees have a duty to maximize returns for passive creditors. Further, this Section argues that (b) the United States Trustee ("Trustee") has a role in ensuring fulfillment of this duty. Finally, this Section (c) provides a means by which creditors' committees can fulfil their obligations.

I. CHAPTER 11'S RESPONSIVENESS TO EVOLVING CREDIT MARKETS AND THE RAPID GROWTH IN CLAIMS TRADING

To understand the harsh realities of the marketplace for passive creditors, and the extent of the challenges they face, this Section begins by introducing briefly (a) Chapter 11 bankruptcy as it was envisioned by the Code in 1978. From this foundation, this Section then examines (b) the market-forced evolution of bankruptcy as the Code faced unforeseen evolutions in the credit markets. Finally, this Section (c) examines how claims trading has exacerbated the problems brought by the evolution of the credit markets and how it has pushed Chapter 11 cases even further

29. Levitin, *supra* note 17, at 70.

30. *Id.*

31. Douglas G. Baird, *The Bankruptcy Exchange*, 4 BROOK. J. CORP. FIN. & COM. L. 23, 23 (2009).

from bankruptcy's normative goals.

A. *The Prevailing Goals of Chapter 11 Bankruptcy: Safe Haven for Debtors and Equality for Creditors*

Many different bankruptcy codes have come and gone since the U.S. Constitution granted congressional authority to establish uniform bankruptcy procedures.[32] What has remained is the impetus underlying the procedures.[33] Michael Whitaker describes the prevailing polices and their foundation as follows:

Bankruptcy law attempts to ensure that all similarly situated creditors are treated equally. More importantly, it protects the interests of creditors as a group. Without bankruptcy law, creditors would resort to self-help measures to collect the debts owed to them. Each creditor would act in its own best interest, in the process taking or harming assets that would have accrued to other creditors. Bankruptcy law attempts to minimize this harmful behavior and to ensure that the value of the debtor's remaining assets is maximized for all creditors.[34]

This account represents the prevailing characterization of bankruptcy in the United States and, generally, suggests two principal goals.[35] First is the provision of a safe harbor for debtors.[36] Upon filing a Chapter 11 petition[37] ("petition"), the debtor is provided an automatic stay preventing, among other actions, the commencement or continuation of judicial proceedings.[38] This allows the debtor to enter the next stages of bankruptcy largely intact, having avoided foreclosure on assets or enforcement of outstanding debts. The automatic stay in particular, along with other rights granted in the Code generally, provide means by which the debtor can seek safe haven

32. *See The Evolution of U.S. Bankruptcy Law*, FED. JUD. CENTER, *available at* http://www.rib.uscourts.gov/newhome/docs/the_evelution_of_bankruptcy_law.pdf (last visited Oct. 23, 2014) (analyzing the three codes passed between 1800 and 1878).

33. *See* Whitaker, *supra* note 2 ("The [same] need for and policies behind a federal bankruptcy procedure remain true today.").

34. *Id.*

35. *See* Tung, *supra* note 7 ("Bankruptcy law has two general aims: to provide relief to the debtor . . . and to treat all creditors equitably in distributi[on].").

36. *See id.*; *see, e.g.*, 11 U.S.C. § 362(a)(1) (2012) (providing, under Chapter 11, an automatic stay preventing, among other actions, the commencement or continuation of judicial proceedings).

37. *See* 11 U.S.C. §§ 301-303 (2012) (discussing voluntary, joint-case, and involuntary case petitions, respectively).

38. *See id.* at § 362(a) (stating that filing a bankruptcy petition operates as a stay applicable to, with limited exceptions, all entities).

from the marketplace.[39]

The second principal goal of bankruptcy can be characterized as providing a means of establishing equality among creditors.[40] By preventing foreclosure and immediate liquidation of assets, larger and more sophisticated creditors are limited in their ability to recover to the detriment of smaller, yet similarly situated creditors and those who file first are limited from depleting resources before those who file later can assert a claim.[41]

While many different bankruptcy codes have come and gone, the underlying need for a uniform bankruptcy code persists.[42] When financially distressed organizations approach the point of insolvency, bankruptcy provides a safe haven for the debtor, while ensuring equality among similarly situated creditors.

B. Chapter 11 and the 1978 Bankruptcy Code: Realigning the Code with the Goals

The formation of a new bankruptcy code in 1978 was in response to dramatic changes in the underlying credit market not envisioned by even the most recent amendments to the 1898 Code, the 1938 Chandler Act.[43]

Among the changes was the newly formed Chapter 11, geared to address reorganization cases more complex than those contemplated by the Chandler Act.[44] At the time, a debtor maintained a capital structure often

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39. *See, e.g., id. at* § 1121(b) ("Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter."). *But see Supra* text accompanying note 7 (discussing the power under section 112 to convert a case to Chapter 7).

40. *See* Tung, *supra* note 7; *Supra* text accompanying note 35; Patricia Rummer, *Chapter 11: Haven for Megacases?*, COM. L. BULL., July–Aug. 1988, at 12, 13 ("The equality of distribution concept inherent in bankruptcy proceedings means that all claimants get a chance to share in whatever funds are set aside for claims. It gives all the claimants a level playing field."); *see also* § 362 (providing an automatic stay that prevents creditors from receiving any distributions before the entire class of claimants is established).

41. *See* Rummer, *supra* note 40, at 14 (discussing *In re* A.H. Robins Co., 846 F.2d 267 (4th Cir. 1988)) (discussing the inequality based on timing issue by way of reference to a debtor who feared that if it "had been required to pay a substantial number of claims in a brief period of time, its resources would have been exhausted, and claimants at the end of the line would have been left with nothing").

42. *See* Whitaker, *supra* note 2; *Supra* text accompanying note 33.

43. *See* Robert J. Keach & Albert Togut, *Commission to Explore Overhauling Chapter 11*, 30 AM. BANKR. INST. J. 36 (2011) ("[I]n [1978], we said we need to revise the bankruptcy laws because the entire underlying credit economy in the business world had changed dramatically in the 40 years since the 1938 Chandler Act.").

44. *See id.* (implying that changes in the underlying credit market necessarily resulted in cases that are more complex).

consisting of a senior bank holding a single note with a security interest in all of the debtor's assets, and a group of dispersed, but homogenous, unsecured creditors who could adequately be represented by a committee, typically made up of a small group of the largest unsecured claim holders.[45] With this structure, the debtor, the bank, and the committee could all sit at the bargaining table and work out a reorganization plan.[46] Albert Togut has characterized the *classic reorganization* under the 1978 Code as:

> one in which a distressed company [could] find protection in the safe harbor of Chapter 11, dispose of unprofitable parts of the business [via liquidation or sale], stabilize what remain[ed], operate for a short time to see that the core business [could] be profitable, propose a plan based upon the smaller, profitable core business, restructure its balance sheet pursuant to a Chapter 11 plan, and emerge as a healthy, albeit smaller, business enterprise.[47]

This characterization demonstrates how the 1978 Code supported the goals of bankruptcy by providing equality for creditors and a safe haven for debtors. While still greatly exposed to the systemic uncertainty of bankruptcy, creditors were generally afforded adequate protection.[48] The Code provides that the creditors, as a uniform class, have a place at the bargaining table and can influence the reorganization plan.[49] In addition, as this class is represented by a committee, even those creditors who held valid claims but did not actively participate in the bankruptcy process reaped rewards as members of the homogeneous class of unsecured creditors.[50] In short, this example illustrates the 1978 Code as providing a system in which the debtor can seek the protection of bankruptcy and the

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45. *See* Baird & Rasmussen, *supra* note 11; 11 U.S.C. § 1102(a)(1) ("[A]s soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims . . . ."); § 1102(b)(1) ("A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee . . . .").

46. *See* Baird & Rasmussen, *supra* note 11 (noting that under the contemplated system, the parties "bargained with each other against a backdrop of well-developed norms").

47. Keach & Togut, *supra* note 43.

48. *See, e.g.*, Baird & Rasmussen, *supra* note 11, at 656 (articulating that the creditors were not only represented by a committee, but that the committee had the ability to hire accountants, investment bankers, lawyers, and others, at the expense of the debtor, to help protect the class).

49. *See id.* at 656–57 ("[A] debtor would be hard-pressed to confirm a plan of reorganization over the active opposition of the creditors . . . .").

50. *See* Baird & Rasmussen *supra* note 11; *Supra* text accompanying note 45.

creditors can be assured equal class treatment.[51]

C. Chapter 11 Today

Just as four decades of progress led to the demise of the Chandler Act of 1938, the 1978 Code is confronting seemingly insurmountable challenges. Two of the most pronounced, in the context of Chapter 11, are (i) the Code's inability to keep up with drastic evolution of credit markets, and (ii) the Code confronting the creation of a market in claims trading.

1. Failing to keep up with Evolving Credit Markets

Similar to the pressures weighing on the Chandler Act before its replacement, the 1978 Code is beginning to reach levels of critical stress.[52] Rich Levin, an attorney involved in shaping the 1978 Code, characterized the change at an American Bankruptcy Institute event and discussed how the same underlying need for revision has emerged today:

[A]t the time in [1978], we said we need to revise the bankruptcy laws because the entire underlying credit economy in the business world had changed dramatically in the 40 years since the 1938 Chandler Act. At the same time, we said we knew that there would need to be a bankruptcy reform act of 2018, 40 years hence, because the entire credit economy and business world would change again. Now, it's changed dramatically in 30 years, and I think we're at that point . . . that the system needs to be rethought. It's done very well keeping up with the dramatic changes in the underlying business and credit economy, but it's stretched dramatically . . ., it's not designed for the current economy, and it needs to be rethought.[53]

While legal scholars and practitioners continue to debate overhauling the 1978 Code, for now consider the principles envisioned in the 1978 Code, and how today's underlying credit market and business world are undercutting the value added by the Code.[54]

When a corporation seeks Chapter 11 protection, no longer is there a single senior bank holding a single note with a security interest in all of the debtor's assets.[55] No longer is there a group of dispersed, but homogenous,

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51. *See* Tung, *supra* note 7.

52. *See* Keach & Togut, *supra* note 43 (analogizing pressures on the Code before the 1978 overhaul and pressures on the Code today).

53. *Id.*

54. *See, e.g.*, Katy Stech, *Report on Corporate Bankruptcy Reform Expected in December 2014*, WALL ST. J., (Dec. 16, 2013), http://blogs.wsj.com/bankruptcy/2013/12/16/report-on-corporate-bankruptcy-reform-expected-in-december-2014/tab/print/) (detailing some of the contentions, for example, those who want to limit lender control, opposed to Keach & Togut, *supra* note 43).

55. *See* Baird & Rasmussen, *supra* note 11 (comparing the 1978 credit market to today's credit market).

unsecured creditors.[56] Instead, the traditional bank loan has evolved into a complex lending product often characterized by a web of syndicated loan parcels.[57] The traditional bank lender has transformed into a primary loan servicer charged with managing the loan on behalf of interested parties.[58] The unsecured creditors are no longer a class of homogeneous investors but rather a mix of massive, sophisticated hedge funds and institutional investors and a minority of small, passive creditors.[59] The evolution of the traditional bargaining parties makes the negotiation process vastly more complex.[60]

Chapter 11, however, has strained without breaking under this increased pressure.[61] If creditors' rights under Chapter 11 can be reduced to the idea that Chapter 11 not only promotes the interests of creditors as a group, but also ensures that similarly situated creditors are treated equally, the increased complexity has damaged the ability of Chapter 11 to serve these goals.[62] The creditors' interests as a class are still protected by the automatic stay, and the provisions that allow for efficient distribution of assets still encourage greater capitalization on remaining assets, but where Chapter 11 begins to fall short is in terms of the parties in interest. The secured lenders, greatly expanded in number, maintain the ability to work with the debtor to seek the best return on their claims, but equality among them is questionable as each may have a different agenda.[63] While Chapter 11 still recognizes that the value of a business as a going-concern may greatly exceed its liquidated value, the goal of Chapter 11 to ensure equal treatment among similarly situated creditors is becoming greatly underserved.

2. The Added Pressures of Claims Trading

Concurrent with the growth in the complexity of the parties involved in a Chapter 11 proceeding, is an evolution in the relationship among them.[64] Without question, the claim a creditor holds against a debtor represents an

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56. *See id.*

57. *See id.*

58. *See id.*

59. *See id.*

60. *See* Levitin, *supra* note 17; *Supra* text accompanying note 18.

61. *See* Keach & Togut, *supra* note 43; Levitin, *supra* note 17, at 67, 110 n.241 (noting that the system has held up "surprisingly well").

62. *See* Baird & Rasmussen, *supra* note 11, at 657 (describing the fitment of the new parties into the old system as awkward).

63. *See id.* (explaining that "[r]ather than dispersed and homogenous, [creditors' agendas] are close at hand, well informed, and radically different from one another").

64. *See id.* (lamenting the relationship as one that is disparate but served as if homogenous).

economic right, regardless of its eventual valuation.[65] During the bankruptcy case, "[a]s with most economic rights, claims enjoy a strong presumption of free alienability."[66] This presumption alters the relationship among the creditors as envisioned by the Code.[67] Rather than a dispersed, but homogenous class, claims trading allows unsecured creditors to be further reduced into any number of subclasses.[68] Some are passive creditors who typically hold their claims by virtue of a holding trade debt[69] preceding the filing and can be grouped as passive by a shared inability to participate in the bankruptcy proceedings. Others are massive claims holders hoping to assume control of the debtor by virtue of their large stake.[70] Still others seek value absent any desire to manage the corporation.[71] Far from homogeneous, the vast number of players in the bankruptcy process, combined with the free alienability of claims, has transformed bankruptcy into a market of its own.[72] It is with this evolution that the particular problem addressed by this Comment arises: claims trading and the dilemma of the passive creditor.

II. EXPLOITING THE PASSIVE CREDITOR

While the debate as to the merit of claims trading will press on for some time, even those who can see the value-adding nature of claims trading can readily identify improvable areas.[73] Drain and Schwartz describe one such area as the imbalance between passive and sophisticated creditors, noting that:

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65. *See* 11 U.S.C. § 101(5) (2012) (defining the term *claim* as a right to payment, regardless of its later determined value).

66. Tung, *supra* note 7, at 1687.

67. *See* Levitin, *supra* note 17.

68. *See* Baird & Rasmussen, *supra* note 11 and accompanying text.

69. Michelle Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM. L. REV. 703, 713 (2008) (typifying trade debt as a "claim against a [debtor] held by the [its] suppliers and vendors")

70. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 15 U. PA. L. REV. 1021, 1022 (2007) (noting the recent emergence of hedge funds taking an active part in acquiring and managing corporations).

71. *See, e.g.*, Baird & Rasmussen, *supra* note 11, at 661 n.57 (describing investment firm ESL's purchase of Kmart out of Chapter 11 bankruptcy for nearly $1 billion; selling Kmart's undervalued real estate assets for $900 million; and ultimately profit[ing] over $3 billion from selling off Kmart properties all without long-term management aspirations).

72. *See* Levitin, *supra* note 17 (discussing the transformation of bankruptcy into a market-driven process; one that is "a robust market for all types of claims against debtors . . .").

73. *See id.* at 110 (asserting that improvements can be made, regardless of greater debates as to the merits of claims trading).

> there is at least good anecdotal evidence that small unsophisticated sellers - trade creditors sometimes characterized as 'involuntary' participants because they did not buy their claims as investments but, rather, were stuck with their obligor's default - already are widely engaged in the distressed debt market and are taken advantage of.[74]

But is this a problem? Many heavily regulated markets allow for willing buyers and willing sellers to form disadvantageous agreements.[75] For example, the securities market, one of the most heavily regulated marketplaces, confronts issues of fraud while still allowing instances of great unfairness.[76] The issue, however, is that the logic that compares a market in claims to a market in securities, overlooks bankruptcy's anti-market approach.[77] That is, the design of the Code is to protect the debtor from the market place.[78] While participants in the securities market may be protected only from fraud, the protection brought by bankruptcy extends much further.[79]

To illustrate the problem facing passive creditors, this Section will first (a) look at claims trading as it relates to the code and to the passive investor. This Section will then (b) analyze how the process weighs on the ability of bankruptcy to meet the goals of providing equality to the creditors. Finally, this Section (c) will analyze provisions of the Code that seem operable in the context of claims trading, but are yet to be invoked.

A. The Bankruptcy Code and the Claims Trading Grift: Misuse, Abuse, or Something Else?

Perhaps what is most challenging about redressing the harm imposed on passive creditors is the Code's approval of the practice. Rather than misuse or abuse of the Code, claims trading is something else entirely. Consider first (i) how the Code permits the practice, and then (ii) how the trade is carried out.

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74. Drain & Schwartz, *supra* note 22, at 572–73.

75. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 232 (1980) (holding that under the U.S. Securities laws, "not every instance of financial unfairness constitutes fraudulent activity [actionable] under § 10(b)").

76. *See id.*

77. *See* Levitin, *supra* note 17, at 71 (finding that bankruptcy "protect[s] a firm from the forces of the market").

78. *Id.*

79. *See, e.g.*, Drain & Schwartz, *supra* note 22, at 573 ("Bankruptcy has its own disclosure, voting and remedial regime that, although not a perfect overlap with the securities laws, largely negates the need to apply them.").

1. Permitting the Grift

Perhaps for good reason, claims trading is referred to by some as vulture investing.[80] Like vultures, the investors circle above, waiting for the deeply insolvent corporation to fail before feasting on the remains.[81] While the imagery may be useful for some, the modern level of sophistication in the marketplace enables the market for claims trading to form well before an organization files its petition for Chapter 11 protection.[82] Sophisticated debt investors are best able to capitalize on the bankruptcy by purchasing claims when others, fearful of the unknown, are willing to sell at steep discounts.[83] This fear is perhaps most pronounced right before the entity files for bankruptcy protection, as creditors weary of their payment priority might want out before any filing.[84] Those who do not get out before filing must endure the process as set forth in the Code. So how does the Code regulate their activity?

The bankruptcy case begins with the filing of a Chapter 11 petition.[85] The filing operates as a stay upon all collection actions, applicable to all entities.[86] This stay covers, among other things, any attempt to "collect, assess, or recover a claim against the debtor that arose before the commencement of the case."[87] This provision both protects the debtor from a wave of collection actions, up to and including foreclosures and repossessions, and protects the creditors from one another by limiting the

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80. *See, e.g.*, Brockway, *supra* note 26, at 655 ("Many view bankruptcy as the death of an investment, but to a keen-eyed vulture investor it is the birth of opportunity.").

81. *See* Drain & Schwartz, *supra* note 22, at 571 ("[V]ulture investing, which often occurs with an eye to obtaining a controlling interest in the reorganized debtor's equity securities by means of acquiring bankruptcy claims . . ."); Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 732 (2008) (describing a vulture investor as one who, "when a firm gets into financial distress . . . accumulate[s] large stakes in a debt class that [is] likely to be pivotal in the expected restructuring").

82. *See* Hu & Black, *supra* note 81 (articulating that investors begin forming positions "when a firm gets into financial distress").

83. *See, e.g.*, Brockway, *supra* note 26 (stating that: "[a] bankruptcy filing is also among creditors' worst fears [as] [t]he value of their debt and the timing and amount of repayment is uncertain. Some creditors, especially those unfamiliar with bankruptcy, are willing to sell their claims against the bankrupt debtor for pennies on the dollar"); *In re* Chateaugay Corp., No. 86B11270, slip op. at 2 (Bankr. S.D.N.Y. Mar. 11, 1988) (order denying assignment) (reviewing a request for assignment of over 400 claims purchased at thirty three percent of their face value when purchaser planned to propose a plan paying one hundred percent of the claims face value after acquisition).

84. *See* Brockway, *supra* note 26, at 655; *Supra* text accompanying note 83.

85. *See supra* text accompany note 38.

86. *See* 11 U.S.C. § 362(a) (2012) ("[A] petition filed . . . operates as a stay . . . .").

87. *Id.* at § 362(a)(6).

drain on the corporate assets.[88] The protection for the creditors, however, is limited to each creditor's interaction with the debtor, and does not cover interactions among the creditors.[89] While the Code once provided a means by which the bankruptcy judge could manage these relationships, the provisions have subsequently been gutted.[90]

Federal Rule of Bankruptcy Procedure 3001 ("Rule 3001") recognizes a creditor's right to freely alienate his claim without judicial approval or oversight.[91] As initially passed, former Rule 3001 required that the transferee file disclosure documents with the court regarding the terms of transfer and the consideration therefore.[92] By requiring such disclosures, the bankruptcy judge *could* weigh in on the individual transactions.[93] This process was considered by some to be frustrating the goal of market liquidity because many courts refused to authorize the transfer of claims until "adequate information" was provided.[94] However, for a seller to be truly adequately informed, the seller would likely have to be informed of the details that make the deal worthwhile for the buyer.[95] For buyers, whose edge in the transaction is detailed knowledge of the debtor, enhanced disclosure requires them to show their hand, resulting in sellers unwilling to part with their claims at profitable discounts.[96]

Today, Rule 3001 requires only that the transferee provide evidence of the transfer to the court and that if the transferor does not object within twenty days the transfer is deemed settled.[97] Thus, the court's oversight role has been reduced from an ability to govern transfers to simply

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88. *See, e.g.*, Rummer *supra* note 40, at 14; *Supra* text accompanying note 41.

89. *See* § 362(a)(6) (limiting the ability for creditors to pursue the bankrupt firm, but not proscribing creditors from interacting with one another).

90. *See* FED. R. BANKR. P. 3001(e) advisory committee's note ("Subdivision (e) is amended to limit the court's role to the adjudication of disputes.").

91. *See id.* (allowing for the free alienation of claims).

92. *See* Andrew P. Logan III, Note, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 500 (1994) ("Former Bankruptcy Rule 3001(e) [] required disclosure of the 'terms of the transfer' and 'the consideration therefor.'").

93. *See id.* (finding that courts had the power to "refuse [] to authorize the transfer of claims").

94. *Id.*

95. *See, e.g.*, *In re* Allegheny Int'l, Inc., 100 B.R. 241 at 242–44 (Bankr. W.D. Pa. 1988) (seeking to remedy insufficient disclosure by imposing on the debtor "the duty of advising the potential assignor of the debtor's estimate of the value of the claim . . . until such time as a new plan of reorganization and disclosure statement are filed").

96. *See* Logan, *supra* note 92 (indicating that enhanced disclosure requirements imposed by the court were "frustrating the goal of providing a liquid market for the sale of claims").

97. FED. R. BANKR. P. 3001(e)(4).

resolving disputed transfers.[98] Critical to the amended rule is the absence of a requirement for the disclosure of terms or consideration.[99] By withholding this information from the record, creditors who are willing to sell their claims have no indication of how similar claims have been valued and are deprived of the benefit of class participation.

In its accompanying note to the 1991 Amendment, the advisory committee noted that the purpose of the Rule 3001 Amendment is:

> [T]o limit the court's role to the adjudication of disputes regarding transfers of claims. . . . This rule is not intended either to encourage or discourage post-petition transfers of claims or to affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.[100]

With this limitation placed in the Code, willing market participants are unprotected by the judiciary, unless there has been a fraudulent transfer.[101] With this reduction in oversight, the rapid growth in claims trading is far from unexpected.

2. The Grift

If the bankruptcy Code and Rules allow for claims trading, and in fact have been altered to restrict judicial oversight of claims trading, how can the exploitation germane to the changes be objectionable? Consider the actual trade that occurs between a passive investor and a sophisticated debt investor.

As noted above, bankruptcy proceedings begin upon filing of a Chapter 11 petition.[102] Then, the debtor must file with the court a list of creditors and a schedule of its assets and liabilities.[103] This list will serve as a

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98. *See* Logan, *supra* note 92 ("[T]he [amended] Rule eliminates any requirement that the filings with the court reflect either the "terms of the transfer" or "the consideration therefor.").

99. *See generally* FED. R. BANKR. P. 3001 (failing to impose disclosure requirements).

100. FED. R. BANKR. P. 3001 (quoting the advisory committee's note to the 1991 Amendment to Subsection (e)).

101. *See* Logan, *supra* note 92, at 501 ("Thus, Rule 3001(e)(2) restricts the court's function with respect to transferred claims to resolving whether a disputed transfer has in fact been made by the transferor, by providing only the transferor with standing to object to the transfer of a claim.").

102. *See supra* note 37 and accompanying text.

103. *See* 11 U.S.C. § 521(a) (2012) (referring to a section entitled "Debtor's Duties," this section provides that "(a) [t]he debtor shall (1) file (A) a list of creditors; and (B) unless the court orders otherwise (i) a schedule of assets and liabilities . . .").

preliminary snapshot of what the debtor has in way of assets, what claims the debtor has recognized, and what claims are disputed, contingent, or unliquidated.[104] Once this snapshot is filed with the court, those creditors who have been left out by the debtor will be given the opportunity to have their claims established by the court.[105] In the case where a claim is challenged, by either the debtor or creditor, the court, after notice and hearing, will determine the value of the claims as of the date of filing.[106] For passive creditors, this stage of the process can be inconsequential as their typical type of claim, if not already disclosed by the debtor, is easily established.[107] Nevertheless, what does affect the passive creditors is the result of this process. Once these steps have taken place, the court will have produced a list detailing the outstanding creditors and the claims they hold.[108] With this information, debt investors can begin to examine the claims currently held and begin to formulate investment strategies.[109] For the passive creditors, this is where things get troublesome.

As the bankruptcy case progresses, investors will begin to solicit claims holders.[110] The timing and valuation of these bids may vary wildly based on the investor's acute knowledge of the case.[111] When an investor locates a willing seller, the deal proceeds just as any transfer of right would. There are negotiations, purchase sale agreements, and, finally, a trade execution.[112] The final step in the trade is the purchaser filing a Notice of

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104. FED. R. BANK. P. 3003(b)(1).

105. *See* § 501 (providing that a creditor may file a proof of claim, in a timely manner); FED. R. BANKR. P. 3001 (providing the specific requirements for establishing a proof of claim, noting that "[a] proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim").

106. *See* § 502(b) ("[I]f such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim.").

107. *See* FED. R. BANKR. P. 3001 (providing the technical requirements for establishing a claim and allowing for an inference that trade debt should be easy to established the validity of, so long as adequately accounted for by the creditor); Harner, *supra* note 69 and accompanying text.

108. *See* § 521(a) (requiring a list to be filed with the court).

109. *See* Joshua Nahas, *Trade Claims Primer*, DISTRESSED DEBT INVESTING (Oct. 26, 2010), http://www.distressed-debt-investing.com/2010/10/trade-claims-primer_26.html ("For a sophisticated [] investor it is possible to begin negotiations to purchase a claim utilizing information [on the list].").

110. *See id.*

111. *See id.* ("[F]actors may come into play . . . that require a re-pricing or cancellation of the trade altogether.").

112. *See id.* (describing the entire process as determining validity of the claim; reconciling the value of the claim; establishing representations, warranties and indemnification provisions; and, executing the trade).

Transfer and Evidence of Transfer with the bankruptcy court.[113]

The transaction is little more than a purchase and sale of an economic right that is freely alienable. As a freely negotiated, arm's length contract, some say the transaction presents little concern.[114] After all, the Federal Rules were amended specifically so that the filing of this notice no longer affords the court the opportunity to assess the merit of the trade.[115] Rather, like most contract law, it only allows challenges in the case of fraudulent dealings.[116] While it may appear that this should settle the matter, recall that, unlike most parties to a contract, one of the parties to the transaction here is a protected class.[117]

B. Claims Trading, Inequality, and Information Asymmetry

One of the prevailing goals of bankruptcy is to provide equality for similarly situated creditors.[118] Reaching equality, however, is a challenge considering the great asymmetry of knowledge between the inside-investors and the passive creditor. Any trade may have an institutional investor on one side of the table and a passive creditor on the other.[119] The passive creditor knows only what it is out, that is, how much the claim was originally worth, with little ability to price the claim post-petition.[120] Conversely, the investor is a professional with the ability to more readily ascertain value, and monitor the value on an ongoing basis.[121] The investor

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113. *See* FED. BANKR. R. P. 3001(e)(2) ("[E]vidence of the transfer shall be filed by the transferee.").

114. *See, e.g.*, Levitin, *supra* note 17, at 73 (listing among the benefits, "allow[ing] a creditor to 'cash out' at a certain price" (citation omitted)).

115. *See* Logan, *supra* note 92, at 501 ("Thus, Rule 3001(e)(2) restricts the court's function with respect to transferred claims to resolving whether a disputed transfer has in fact been made by the transferor, by providing only the transferor with standing to object to the transfer of a claim.").

116. FED. R. BANKR. P. 3001 (quoting the advisory committee's note to the 1991 Amendment to Subsection (e)) ("This rule is not intended to . . . affect remedies otherwise available under non-bankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.").

117. *See* Baird & Rasmussen, *supra* note 11, at 656 (observing that the protection by the committee includes the right of the committee to hiring accountants, investment bankers, lawyers, and others as needed and at the expense of the debtor).

118. *See* Tung, *supra* note 7; *Supra* text accompanying note 35.

119. *See, e.g.*, *In re* Revere Copper & Brass, Inc., 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985) (finding that passive creditors sold their claims to a sophisticated investor for twenty percent face value shortly before approval of a reorganization plan paying sixty percent).

120. *See supra* text accompany note 119; *see* Levitin, *supra* note 17, at 73 (characterizing "payouts [as] speculative").

121. *See* Levitin, *supra* note 17, at 73 (describing the sophisticated investor as one who can "take the time and effort to monitor the debtor . . .").

likely possesses the specialized knowledge to determine the probability of receiving *any* distribution under the plan of reorganization as well as the timeframe of payout.[122] The result is an uninformed creditor being solicited exit opportunities at a price that discounts the value of the claim pursuant to the probability of payment, as well as the time value of money.[123] On top of this discount, there is the added margin by the investor looking to build in as much gain as possible.[124] The result is a sharply discounted price and virtually no policing mechanisms.[125] What claims trading at this level amounts to then, is a passive creditor negotiating with an experienced investor, in a world free from disclosure requirements or judicial intervention.

The severity of this exploitation can be garnered by a look at what the former Rule 3001 would prevent, and what its absence today would likely allow, in the case of *In re Revere Copper & Brass, Inc.*[126] In this case, Phoenix Capital Corporation ("Phoenix") negotiated the purchase of twenty-eight unsecured claims against the debtor.[127] The relevant terms of the transfer called for the payment by Phoenix to the creditors of twenty percent of the claims face value.[128] To passive creditors who have little information about the state of their claim, the sharp discount may be appealing as bankruptcy promises them nothing.[129] Shortly thereafter, however, *The Wall Street Journal* reported that the near-approved plan of reorganization was going to pay sixty-five percent of face value.[130] Relying on disclosure concerns, the court refused to approve the assignment, fearing the claims holders where not "advised of their rights and options."[131] Today, however, the check provided by Rule 3001 has

122. *See, e.g.*, *In re Revere Copper & Brass*, 58 B.R. at 2 (finding that the investor was able to determine the likely time and amount of payout when soliciting claims holders with offers of only a fraction thereof).

123. *See id.* at 2–3 ("One of the evils attendant upon a solicitation of assignment of claims for a cash payment such as is being made by Phoenix is that solicited creditors may be unaware of their rights and options and fall prey to the belief that bankruptcy inevitably will result in their receiving the proverbial 10 cents on the dollar or worse.").

124. *See id.*

125. *See id.*

126. *Id.* at 2–3.

127. *See id.* at 1 ("Our offer is to 20% of the face amount of any valid, uncontested, and unpaid claim.").

128. *See id.* at 2 (finding that "the assignor-creditors may indeed prefer the certainty of the 20% cash in hand" *even after* learning of the possibility of 65% at some eventual time).

129. *See id.*

130. *Id.* app. ("Revere Copper & Brass, Inc. . . . announced a reorganization plan that would settle various creditors' claims by paying from 65 cents" on the dollar.").

131. *Id.* at 3.

been removed, and similarly situated creditors would likely be unprotected by the court. The gutting of Rule 3001 has left the passive creditor markedly unprotected by the judiciary.[132]

C. *A Protected Class: The Role of Creditors' Committees*

The challenges faced by the passive creditor during a modern Chapter 11 seem insurmountable. The changes to Rule 3001(e) have left them unprotected by the courts, the evolution of the credit markets have pushed them out of a homogeneous class, and the growth in claims trading have left them exposed to predatory solicitation.[133]

It is easy to rationalize the problem of the passive creditor as one of dereliction—the idea that, as with any economic right, it is up to the possessor to exercise his right to the fullest of his ability. From this point of view, fraud continues to be actionable, but general issues of fairness yield to free market notions of willing buyers and sellers dealing at arm's length.[134] The issue however is not that of an individual passive creditor, but rather, of the class itself.

When the Code passed in 1978, bankruptcy proceedings were relatively simple.[135] Upon filing, the debtor was afforded the safe haven of Chapter 11 and creditors were represented as a homogeneous class. Under the Code, appointment of the creditors' committee ensured similarly situated unsecured creditors were represented as a class.[136] As noted, however, this area of the Code has been sufficiently damaged by the evolution of the credit markets and the gutting of Rule 3001.[137]

As these markets continue to evolve, the class of unsecured creditors will continue to fracture, undoing bankruptcy's goal of equal treatment among

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132. *See* Logan, *supra* note 92, at 501 (describing the limited judicial role as one that "simply requires the transferee to provide evidence of the transfer to the court").

133. *See* STEPHEN G. MOYER, DISTRESSED DEBT ANALYSIS: STRATEGIES FOR SPECULATIVE INVESTORS 298 (2004) (typifying the transaction as one where "the buyer is trying to present the picture that he or she is 'the only sucker on the planet dumb enough to buy these things; if you miss this bid, the next buyer will pay less.' And the buyer may, in fact, drop his or her bid for a day or two and then increase it to reinforce the reality that he or she is the only buyer in the market"); *see also supra* text accompanying note 123.

134. FED. R. BANKR. P. 3001(e) advisory committee's note to the 1991 Amendment ("This rule is not intended . . . affect remedies otherwise available under nonbankruptcy law to a transferor or transferee such as for misrepresentation in connection with the transfer of a claim.").

135. *See* Baird & Rasmussen, *supra* note 11 and accompanying text.

136. *See supra* text accompanying note 45.

137. *See* Logan, *supra* note 92, at 501 (describing the limited judicial role as one that "simply requires the transferee to provide evidence of the transfer to the court").

similarly situated creditors.[138] Seemingly, without adequate class representation, the problem for each passive creditor becomes one of collective action. Commenting on the problem, Baird and Rasmussen write:

> As a group, the unsecured creditors would have been better off by taking concerted action, but no one creditor was willing to take the laboring oar. The costs of participation fell on those who participated, but the benefits were distributed to all creditors. While for creditors as a group the best course of action was to participate in the reorganization discussions, for each individual creditor the rational thing to do was stay passive.[139]

Nevertheless, does this collective action issue, combined with the lack of affirmative class representation leave the passive creditors with no other choice than to try to participate in the reorganization? Not necessarily.

Under the Code, as soon as practicable after the order for relief under Chapter 11, the U.S. Trustee shall appoint a committee of creditors holding unsecured claims.[140] This committee is to be made up of the seven largest claims holders[141] and is charged with providing access to information for creditors who are not appointed to the committee.[142] Additionally, the committee is empowered to negotiate on behalf of the class and collect and process the information necessary to make informed decisions.[143]

Under the Code, the duties placed on the creditors committee establish a fiduciary relationship between the committee members and the non-committee members for whom they purport to act.[144] The fiduciary duty established includes the duty to maximize the return of the class as a whole.[145] This is embodied by the committee's unique place of power at

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138. *See* Levitin, *supra* note 17; *Supra* text accompanying note 18.

139. *See* Baird & Rasmussen, *supra* note 11, at 655.

140. 11 U.S.C. § 1102(a)(1) (2012).

141. *Id.* at § 1102(b)(1).

142. *Id.* at § 1102(b)(3).

143. *See id.* at §§ 1103(c)(2)-(3) (allowing for informed decisions under (c)(2) by providing that the committee may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan" and allowing for negotiation under (c)(3) which allows the committee to "participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan")

144. *See In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 717, 722 (Bankr. S.D.N.Y. 1992) (recognizing the existence of a fiduciary duty).

145. *See* Levitin, *supra* note 17, at 111 ("Arguably facilitating claims trading is part of creditors' committees' duties."); *see also In re Drexel Burnham Lambert*, 138 B.R.

the bargaining table.[146] Braid and Rasmussen characterize this power as the unique ability to "extract concession from the debtor . . . as [the debtor] would be hard-pressed to confirm a plan of reorganization over the active opposition of the creditors' committee."[147]

As claims trading continues to grow, and as Chapter 11 continues to go unrevised, the role of the creditors' committee will be of added importance to the passive creditors. The concern, however, is how well creditors' committees are actually serving their fiduciary roles. Unlike the players at the table in 1978, no longer are the committee members a homogeneous class.[148] The positions held today are incredibly complex and well outside of what the Code envisioned.[149] Committee members own debt up and down the tranches.[150] All are motivated by self-interest; for some that means holding the controlling stake post-bankruptcy, for others it may mean creating a credit event sufficient to trigger their credit default swaps.[151] For Baird and Rasmussen this means, "the idea of a committee as the principal vehicle for mediating the interests of the general creditors as a group may no longer work."[152]

D. Grifted, Now What?

When the Code was passed in 1978, the simplicity of the credit market yielded a rather simple solution for passive creditors: committee representation. As the markets have evolved however, the sophistication of passive creditors has not. With little readily ascertainable data about the entire claims trading market, it would be unfounded to suggest sweeping reform in light of this particular area of concern.[153] This is not to say,

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at 722 (recognizing the existence of a fiduciary duty as "extending to the class as a whole and not to its individual members").

146. *See* Baird & Rasmussen, *supra* note 11, at 656–57 (finding that the debtor has reason to listen to a committee but not an individual).

147. *Id.*

148. *Id.* at 651; *Supra* text accompanying note 14.

149. *See* Baird & Rasmussen, *supra* note 11, at 651; *Supra* text accompanying note 14.

150. *See* Baird & Rasmussen, *supra* note 11, at 651; *Supra* text accompanying note 14.

151. *See, e.g.*, Karl Denninger, *GM: Bankrupt, UNLESS . . .*, MARKET TICKER, (Apr. 1, 2009), http://market-ticker.denninger.net/archives/921-GM-Bankrupt,-UNLESSFalse.html (speculating that GM bondholders were refusing to negotiate with GM outside of bankruptcy because their bonds are backed by AIG credit default swaps that would pay in full if GM filed for bankruptcy).

152. Baird & Rasmussen, *supra* note 11, at 657.

153. *See* Levitin, *supra* note 17, at 70 ("[C]laims trading is not well-suited for broad policy reforms. Instead, at this point, we can merely identify several modest features of the claims trading market that can be improved.").

however, that nothing can or should be done. What is clear, is that the welfare of the passive creditor has shifted from the creditors' committee, who have a fiduciary duty to serve them, to the good conscious of investors, who have limitless motivation to exploit them.[154] But all is not lost.

III. REAFFIRMING THE ROLE OF THE CREDITORS' COMMITTEE

The harm imposed on passive creditors stems from an inability to value their economic rights.[155] The inability to value their claim has been exacerbated by solicitations from third parties trying to purchase the rights at sharply discounted prices.[156] At its inception, the Code would starve off this issue by affording equal class representation for claims holders and judicial oversight of claims purchasers.[157] The problem being confronted today is how to improve the case of the passive creditor absent the original protections.

Even with the amendment to Rule 3001, the answer to the problems continues to be valuation.[158] While disclosure to the court used to provide such, it did so in an onerous way that frustrated liquidity.[159] While others have reached this very conclusion, there is little discussion of how to reach a balance between the desire for disclosure and market liquidity.

In proposing such a solution, this Section will discuss (a) why disclosure is key to protecting passive creditors. However, because mandatory disclosure of full terms would be too onerous, this Section will also argue that (b) proper utilization of the creditors' committees presents a solution that balances the concerns. Then, this Section will (c) demonstrate how the creditor's committee can fulfill its duty to the passive creditors. Finally, (d) this Section will discuss the inherent limitations of any solution to this problem and how they may be overcome.

A. The Solution: Improved Price Disclosure

The biggest advantage the claims investor holds over the passive creditor is knowledge.[160] Even where the superior knowledge is not obtained

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154. Baird & Rasmussen, *supra* note 11, at 657 (advancing that the committee may no longer work, meaning that passive creditors are at the mercy of the investors).

155. *See, e.g.*, *In re* Revere Copper & Brass, Inc., 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985) (underscoring the fact harm stems from an inability to value a claim).

156. *See supra* text accompanying note 123.

157. *See* Baird & Rasmussen, *supra* note 11; *Supra* text accompanying note 48; Logan, *supra* note 92; *Supra* text accompanying note 155.

158. *See supra* text accompanying note 155.

159. *See* Logan, *supra* note 92; *Supra* text accompanying note 96.

160. *See, e.g.*, Levitin, *supra* note 17, at 110–11 (finding that "the most immediate

illicitly, where a trade is "colored with superior knowledge . . . assignments are similar to contracts of adhesion."[161] The solution where the courts have found such knowledge disparities was the imposition on the debtor "the duty of advising the potential assignor of the debtor's estimate of the value of the claim."[162] While this plan provided sufficient means for passive creditors to price claims, the plans were imposed before judicial oversight was eliminated by the amendment to Rule 3001.

While the means to impose this solution have been undone, the need for such a solution has not.[163] In fact, with the growth in claims trading, the need has grown. A claim as a freely alienated right presents little concern, but what has become a concern is how *freely* these rights are being alienated. As the court noted in, *In re Allegheny*, massive disparities in knowledge have resulted in what are essentially contracts of adhesion, where one party dictates the terms while the other sits in fear of the "ten-cent-on-the-dollar" alternative.[164] What would alleviate this cohesion is the means for a passive creditor to price its claim.[165] The issue then, is how to achieve this without former Rule 3001.

B. Requiring the Creditors' Committee to Serve as a Committee for the Creditors

With judicial oversight stripped away, passive creditors are protected by the Code only by way of the creditors' committee. While the membership of the creditors' committee has changed, its fiduciary role has not.[166] Creditors' committees have the duty to maximize returns for the class.[167] This duty can be fulfilled only one of two ways: plan improvement, *or* exit opportunity improvement.[168] If a passive creditor instead holds their claim until plan confirmation, no exploitation has occurred as the court has

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improvement that can be made of claims trading is improved price disclosure").

161. *In re* Allegheny Int'l, Inc., 100 B.R. 241, 243 (Bankr. W.D. Pa. 1988).

162. *Id.* (imposing the duty only until a reorganization plan is reached and agreed upon).

163. *See* Levitin, *supra* note 17, at 110–11; *Supra* text accompanying note 160.

164. *See supra* text accompanying note 123.

165. *See generally* Whitaker, *supra* 2, at 339 (arguing that "mandatory disclosure" would allow "those wishing to receive cash for their claims [to] do so" for reasons including better valuation).

166. *See* Levitin, *supra* note 17, at 111 (describing the duty as one that is owed to the class "as it exists at any given time").

167. *See id.* ("Arguably facilitating claims trading is part of creditors' committees' duties.").

168. *See id.* ("[M]aximizing the return . . . could be accomplished either through working for a better plan or by providing their constituents with improved immediate exit opportunities.").

necessary considered the stake of all claims holders in confirming the plan. The duty as it relates to passive creditors, then, is enhancing the exit opportunity. Rather than leaving this to the free will of the committee or to a third party, enhancing or reaffirming this duty should be accomplished by the U.S. Trustee.

The Code charges the U.S. Trustee with appointing the creditors' committee,[169] as well as the duty of monitoring the committee.[170] When making appointments, the U.S. Trustee must confront issues such as "adequacy of representation" and safeguarding of the interests of the creditor *class as a whole.*[171] When monitoring the committee, the U.S. Trustee must ensure, among other things, that "[e]ach committee upholds the interests of the creditor group it represents, such as unsecured creditors."[172] The importance of U.S. Trustee's role can hardly be understated.[173]

As claims trading grows and bankruptcy continues to evolve, the obligations and duties of the U.S. Trustee can be leveraged to ensure that modern Chapter 11 protects passive creditors. When the U.S. Trustee appoints members to the committee, he or she must ensure that, even in cases dominated by investors vying for control, the passive creditors are still provided for.[174] This seems to be an impossible task as passive creditors realize a cost benefit in *not participating in the reorganization.* By their very nature, a passive creditor cannot sit on the committee and protect similarly situated class members. The remedy then, is to condition committee membership on requiring the facilitation of *non-coercive* exit opportunities for passive creditors.

Affirmative duties levied on committee members are far from novel. In *In re Federated Department Stores, Inc.*, ("*FDS*") the bankruptcy court considered the presumptively inappropriate committee membership of a

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169. *See supra* note 140 and accompanying text.

170. *See* 28 U.S.C. § 586(a)(3)(e) (2012) (stating that each U.S. Trustee shall "supervise the administration of cases" by, when considered appropriate, "monitoring creditors' committees").

171. *See* Greg M. Zipes & Lisa L. Lambert, *Creditors' Committee Formation Dynamics: Issues in the Real World*, 77 AM. BANKR. L.J. 229, 255–56 (2003).

172. *See The U.S. Trustee's Role in Chapter 11 Bankruptcy Cases*, U.S. DEP'T OF JUST., (Feb. 21, 2013, 4:50 PM), http://www.justice.gov/ust/eo/public_affairs/factsheet/docs/fsch11duties.htm (Last visited Feb. 22, 2015) (listing the duties and obligations of the US trustee in Chapter 11 Bankruptcies).

173. *See* Zipes & Lambert, *supra* note 172, at 255 ("In practice, the United States trustee must resolve a variety of tensions that are inherent in the appointment process.").

174. *See* 11 U.S.C. § 1102(a)(1) (2012) (defining representation without regard to class).

claims trader.[175] Considering that committee members owe fiduciary duties to the class they represent, a member trading in claims would likely violate its duty.[176] In *FDS*, rather than barring committee membership, the member was permitted to serve so long as it took steps to protect itself from breaching its duty. The court stated that the Movant: "will not be violating its fiduciary duties as a committee member . . . by trading in securities of the Debtors . . . during the pendency of these Cases, *provided that Fidelity employs an appropriate information blocking device.*"[177]

Since the *FDS* decision, the U.S. Trustee has appointed creditors subject to appropriate safeguards to ensure that they can fulfill their fiduciary duties."[178]

Because the U.S. Trustee can contractually condition participation on a committee, the US Trustee should exercise this power by conditioning committee membership on the facilitation of *non-coercive* exit opportunities for passive creditors.

C. Facilitation of the Non-coercive Exit Opportunity

The harm claims trading imposes on passive creditors can be addressed by increased scrutiny of the U.S. Trustee. Rather than imposing such a requirement without providing guidance, the uncertainty of which could seize liquidity, it is important to establish what would constitute fulfillment of those duties. Because too much intervention for the sake of the passive creditors could seize market liquidity and prove detrimental to the process, it is important that the level of intervention be balanced.

Such balance can be struck by requiring that the creditors' committees play an active role in facilitating claims trading for the passive creditors.[179] In practice, some committees have already taken steps in this direction. For example, the Official Unsecured Creditors' Committee in the Dana Corporation listed the contact information of claims purchasers on its website to help creditors it represented obtain maximum value for their claims.[180] While this process fails to level the playing field in ways similar

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175. *See In re* Federated Department Stores, Inc., Bankr. No. 1–90–0130, 1991 WL 79143 at *1 (Bankr. S.D. Ohio Mar. 7, 1991).

176. *See* Zipes & Lambert, *supra* note 172, at 246 (discussing the appearance of impropriety that arises if a committee member engages in trading claims).

177. *In re* Federated Department Stores, Inc., Bankr. No. 1–90–0130, 1991 WL 79143 at *1 (Bankr. S.D. Ohio Mar. 7, 1991).

178. *See* Zipes & Lambert, *supra* note 172, at 246 (noting that the U.S. Trustee has imposed similar duties since the FDS decision).

179. *See* Levitin, *supra* note 17, at 110–11; *Supra* text accompanying note 160.

180. See Levitin, *supra* note 17, at 111 (noting that Dana's Official Unsecured Creditors' Committee listed the contact information of claims purchasers on its website to help the creditors it represented obtain maximum value for their claims).

to judicial intervention, it represents a step in the right direction.

What is key to the role of the creditors' committees is that passive creditors be apprised of some ability to value their claim and to understand the trading process. A more limited role by a committee might include informing the passive creditors of the opportunity to trade and the general risk inherent in trading, while also providing periodic valuation of the most prevalent debt type. Protection that is more substantial is embodied by actively posting prices of known trades, along with providing contact information of parties interested in purchasing claims.[181] This more active representation would allow a solicited claims holder to reach out to other registered purchasers to shop for a better offer.

What is critical to any approach employed, is not guaranteeing the best price, but narrowing the knowledge gap between buyer and seller, sufficient to make an assignment less coercive and more freely negotiated.

D. Limitations on Reform: U.S. Trustee Program Budget Constraints

The systemic limitation on any proposal that calls for enhanced governmental action is the necessarily enhanced costs. The U.S. Trustee Program operates in a self-funding manor, with fees collected deposited into the U.S. Trustee Program Fund (the "Fund") for which offsetting collections are available to the U.S. Trustee as specified in Appropriations Acts.[182] While the Fund currently operates at a surplus,[183] the fiscal year 2014 budget proposal notes general fund instability related to fluctuations in bankruptcy filings.[184] The current system contains two fees: a filing fee paid at the inception of chapter 7, 11, 12 and 13 cases; and a quarterly fee by chapter 11 debtors based on cash disbursement levels of the debtor.[185] While the fee system has been sufficient for some time, enhanced duties by the U.S. Trustee appointed to a bankruptcy case may put pressure on this system.

Although the Fund currently operates at a surplus, the U.S. Trustee Program's current fee structure could not likely support any rule changes that imposed more taxing duties on the Trustees. Funding constraints have

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181. *See id.* (one means of enhancing the exit opportunity would be by simply "informing claimholders of the possibilities of claim purchases and issues in the market").

182. United States Trustee Program FY 2014 Budget Request, U.S. DEP'T OF JUSTICE 10, *available at* http://www.justice.gov/sites/default/files/jmd/legacy/2014/05/09/ustp-justification.pdf.

183. *Id.* at 6 (noting that offsetting collections from bankruptcy fees exceeded the program's appropriations in all but fiscal years 2006, 2007, and 2008).

184. *Id.* (discussing the fluctuation from fiscal year 2013, drawing down the Fund by $7 million, to fiscal year 2014, contributing to the Fund a projected $35 million).

185. *Id.* at 10.

already limited the role of the program.[186] Hiring freezes and vacancies due to attrition have left the program understaffed.[187] Debtor audits and other operations of the program have been reduced or eliminated.[188] If the solution to the exploitation of passive creditor turns on heightened scrutiny of committees by the U.S. Trustee, the solution necessarily turns on alterations of the fee structure of the U.S. Trustee Program. While the specifics of the needed changes to the fee structure are beyond the scope of this Comment, it is critical that heightened duties imposed on the U.S. Trustee be complimented by funding; be it alterations to the current fees or imposition of new fees.

CONCLUSION

Claims trading is a feature of the bankruptcy world that is here to stay.[189] Much debate centers on its merit; trying to classify the practice as beneficial or detrimental.[190] Regardless of that much larger debate, it is undeniable that there are ways in which it can be improved.[191] Some have resolved that improvement of Chapter 11 demands replacing Chapter 11 as it has become "hopelessly flawed."[192] Others "resolve to a credo of markets correcting themselves."[193] In the meantime, much can be done to improve the harms endured under the current system without bearing on the liquidity of the overall marketplace.

One such harm endured is the exploitation of the passive creditor by sophisticated debt investors. The exploitation arises from the intersection of a dated Code and a modern credit market where the knowledgeable investment firms can exploit the unassuming passive investor. Adding to this dilemma is the deteriorating role of the creditors' committee as a means to protect the unsecured creditors *as a class* because of

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186. *Id.* at 9 (enumerating some constraints based on funding such as "imposing a hiring freeze, temporarily suspending debtor audit activities and later reinstating the audits at a reduced level, and by reducing or eliminating all other categories of expense.")

187. *Id.*

188. *Id.*

189. *See* Baird, *supra* note 31, at 23 ("Long passed is the time when we could usefully debate whether claims trading in bankruptcy was a good or a bad thing. We should accept that it has become a fundamental feature of bankruptcy.").

190. *See supra* note 26 and accompanying text.

191. *See* Levitin, *supra* note 17, at 110 ("If claims trading is to be a feature of the bankruptcy world (and this may very well be a good thing), there are ways in which it can be improved.").

192. David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 951 (2003) (citing "other commentators").

193. Levitin, *supra* note 17, at 110.

unprecedented growth in claims trading.

This is not to say that nothing can be done. While it would be premature to impose any sweeping regulation, the U.S. Trustee and creditors' committees can still address the problems faced by the passive creditor. By looking to the fiduciary duty to maximize the value of the claims held by the unsecured creditors as a class, the committees can be required to facilitate claims trading for the class. This duty could be met in a number of ways, all of which revolve around the concept of an increased ability to value a claim. While a committee may not be willing to assume such a role voluntarily, enhanced oversight by the U.S. Trustee can contractually obligate the committees to begin working in this direction.

Reliance on the creditors' committee is far from the ideal mechanism to protect passive creditors, but for the time being, it represents an achievable step in light of an unwillingness to make changes that are more sweeping.

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THE EXPANDING REACH OF THE EXECUTIVE IN FOREIGN DIRECT INVESTMENT: HOW *RALLS V. CFIUS* WILL ALTER THE FDI LANDSCAPE IN THE UNITED STATES

HUNTER DEELEY*

The Committee on Foreign Investment in the United States ("CFIUS" or the "Committee") is a little known regulatory body in the Treasury Department with an almost limitless mandate: protect the nation's security from threats arising from Foreign Direct Investment ("FDI"). CFIUS began through Presidential Order as a tiny interagency body that would monitor investment trends and advise on related policy decisions. Despite objections from the Committee, Congress increased CFIUS's power over the years in response to growing concerns over the influx of foreign capital. At various points, the President attempted to head off a Legislative fix with an Executive Order that reflected a concern for remaining open to foreign investment. It wasn't enough. This Comment discusses the evolution of CFIUS from its role as a monitoring body to its present day position as a gatekeeper to the U.S. economy. With the recent Ralls v. CFIUS court ruling affirming the President's broad authority to suspend or prohibit certain transactions for national security reasons, the Committee will only grow stronger as more companies submit proposed investments for review out of an abundance of caution. Following the Ralls ruling, if the Committee hopes to promote a climate of open investment, it will need to adapt and provide a more clarified position on what is subject to review. "We might as well face the situation. We cannot supply all the required capital in the United States. We must look to European countries for assistance, and while this demand for capital continues, we should be most careful not to frighten that capital from our shores."[1]

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1. MIRA WILKINS, THE HISTORY OF FOREIGN INVESTMENT IN THE UNITED STATES

INTRODUCTION

In 1914, the total stock of foreign investments in the U.S. economy made up about one-fifth of annual Gross Domestic Product (GDP).[2] That same year, foreign direct investment (FDI) in the United States reached $1.3 billion in nominal terms.[3] Since the turn of the twentieth century, FDI has played a vital role in the development and modernization of the United States economy.[4]

According to the White House, foreign firms in the United States currently employ 5.6 million people, totaling 4.1 percent of the private-

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TO 1914 190 (1989) (quoting Address of W. W. Miller of Hornblower, Miller & Potter to the first Annual Meeting of the Investment Banker's Association of America, *Report of Meeting*, 48 (1912)).

2. *See* EDWARD M. GRAHAM & DAVID M. MARCHICK, U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 3 (2006) (clarifying that this percentage represents portfolio investments, which are defined as an equity investor who exerts no managerial control over the investment).

3. *See, e.g., id.* at 1 (discussing the early emergence of national security concerns by the U.S. government over the large presence of foreign investment in the U.S. economy).

4. *See id.* at 2–3 (noting Carnegie Steel began as a foreign investment until Andrew Carnegie became a U.S. citizen and mentioning the role FDI played in the development of industries such as telecommunications and transportation); *see also* WILKINS, *supra* note 1, at 190 (discussing the role of foreign investment in the development of the railroad and how this opened up new markets for foreign investment including land and mining).

sector workforce.[5] Compensation at these U.S.-based foreign affiliates is consistently higher than the economic average.[6] Additionally, these firms account for almost a third of all U.S. imports.[7] In an effort to highlight the benefits of FDI, the administration released a study in October 2013 breaking down the essential role foreign capital plays in the U.S. economy.[8] The White House commissioned study is part of the administration's broader initiative to buck the recent downward trend in FDI and make sure the U.S. remains an attractive location for foreign investors.[9]

FDI dropped sharply in 2012 after a slow climb following the Great Recession of 2008.[10] Foreign companies invested $166 billion in the U.S. economy in 2012; this represents a 28 percent drop, or $66 billion decrease, compared to 2011.[11] While numbers have been down since 2008, the United States continues to be the world's largest recipient of FDI, a title it has held since 2006.[12] However, America's place at the top is not as secure when looking at the latest trends.[13] The United States saw a 22 percent

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5. *See* Press Release, The White House, New Report: Foreign Direct Investment in the United States (Oct. 31, 2013), *available at* http://www.whitehouse.gov/the-press-office/2013/10/31/new-report-foreign-direct-investment-united-states (noting one third of these jobs are in the manufacturing sector).

6. *See* U.S. DEP'T OF COMMERCE & PRESIDENT'S COUNCIL OF ECON. ADVISERS, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 8 (2013) (specifying pay averaged around $77,000 per employee in 2011 at U.S. based affiliates compared to $58,000 for the economy as a whole).

7. *See id.* (highlighting how these firms connect the United States to the global economy and contribute to the negative trade balance by importing 28.4 percent of total U.S. imports).

8. *See id.* (explaining that FDI strengthens the economy by supporting jobs, expanding exports, and funding research and development); *see also* TAZEEM PASHA & RACHEL CRABTREE, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: DRIVERS OF U.S. ECONOMIC COMPETITIVENESS 1, (2013), *available at* http://www.selectusa.commerce.gov/.

9. *See* James Politi, *Barack Obama Mounts Big Push to Bolster FDI in US*, FIN. TIMES (Oct. 27, 2013, 5:21 PM), *available at* http://www.ft.com/intl/cms/s/0/c5119344-3f0a-11e3-b665-00144feabdc0.html#axzz2pa87zrGt (mentioning President Obama attending the Commerce Department's first ever conference aimed at bringing together foreign investors, US economic development agencies, and state and local officials).

10. *See* JAMES K. JACKSON, CONG. RESEARCH SERV., RS 21857, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: AN ECONOMIC ANALYSIS ii–1 (2013) (noting global FDI inflows in 2012 were down 18 percent from 2011 as well).

11. *See id.* at 3 ("Foreign Direct Investment in the United States dropped sharply in 2012 after rebound[ing] slowly in 2010 and 2011 after falling from the $310 billion recorded in 2008.").

12. *See, e.g.*, Press Release, The White House, *supra* note 5 (citing, among other reasons, the world's largest consumer market, a skilled workforce, and desirable legal protections).

13. *See* Brenda Cronin, *Shrinking Share of Overseas Cash Headed to U.S.*, WALL

drop in FDI during the first two quarters of 2013 compared with the same time in 2012.[14] Whether this drop is a reflection of a global downward trend in FDI or evidence of investor uncertainty in the U.S. market (or a combination) is unclear.[15]

Regardless, the trend was enough to force a reaction from the Obama Administration.[16] The new initiative is recognition that the United States needs to do more if it wishes to remain competitive for global capital.[17] In the past, the reasons for investing in America may have been "self-evident," but the study calls for an effort to build upon what has historically made the United States a popular destination for investors, including "an open investment regime" and a "predictable and stable regulatory" landscape.[18]

Nestled away in the Treasury Department is a little known interagency committee that has the potential to complicate this "open" and "predictable" investment landscape. The Committee on Foreign Investment in the United States (hereinafter "CFIUS" or "the Committee"), is charged with keeping the United States secure from threats to national

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ST. J. (Dec. 8, 2013, 5:00 PM), http://online.wsj.com/news/articles/SB10001424052702303722104579242302568186732 (noting while the United States remains the largest recipient of FDI, trends show the United States is losing out to developing economies).

14. *See* JAMES K. JACKSON, CONG. RESEARCH SERV., RS 21857, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: AN ECONOMIC ANALYSIS 3 (2013). (stating further that 2013 FDI rates likely would lag behind 2012 rates for the remainder of the year); *cf.* Cronin, *supra* note 13 (mentioning a United Nations forecast stating global FDI would not pick up until after 2013).

15. *See* Cronin, *supra* note 13 ("America's smaller slice of global FDI 'is a worrying indicator that our policy environment is . . . unattractive,' said Matthew Slaughter, a professor at Dartmouth's Tuck School of Business. It also reflects that companies have 'multiple opportunities around the world.'").

16. *See* James Politi & Russell Birkett, *US FDI: The Numbers the White House Wishes Were Bigger*, FIN. TIMES (Oct. 30, 2013, 6:16 PM), http://www.ft.com/cms/s/0/fc754c20-4187-11e3-9073-00144feabdc0.html#slide0 (describing President Obama as a salesman for "brand USA" at a conference designed to attract more investment from abroad).

17. *Cf.* Politi, *supra* note 9 (mentioning the involvement of three Cabinet level Secretaries and the United States Trade Representative in the Commerce Department's event, which shows a coordinated approach between various governmental agencies designed to spur investment). *But see* Eli Lehrer, *Actions, Not Obama Rhetoric, Will Lure FDI Back to the U.S.*, REAL CLEAR MKTS. (Nov. 11, 2013), http://www1.realclearmarkets.com/printpage/?url=http://www.realclearmarkets.com/articles/2013/11/11/actions_not_obama_rhetoric_will_lure_fdi_back_to_the_us_100722.html (arguing there is a disconnect between the President's attempts to attract more FDI and certain policies including a proposed tariff on the insurance industry).

18. *See* Politi, *supra* note 9 (noting the self-evident reason for investors was America's status as the world's largest economy); *see also* U.S DEP'T OF COMMERCE & PRESIDENT'S COUNCIL OF ECON. ADVISERS, *supra* note 6, at 8.

security masked as legitimate inward bound investment.[19] CFIUS has the statutory authority "to review transactions that could result in control of a U.S. business by a foreign person, in order to determine the effect of such transactions on the national security of the United States."[20] Whether the parties submit to a review voluntarily is immaterial; the Committee possesses the power to unilaterally initiate proceedings for any covered transaction.[21]

Under 50 U.S.C. § 2170, the Defense Production Act, CFIUS can take up to thirty days to review a covered transaction in order to determine its effects on national security.[22] If it finds that the covered transaction threatens to impair the national security of the U.S., that any concerns have not been mitigated during the review period, or that the deal would result in foreign control of critical infrastructure, CFIUS can then take another 45 days to investigate the matter.[23] Following the end of this period, the Committee can recommend to the President that he take action on the covered transaction.[24] The President must decide within fifteen days

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19. *See* Holly Shulman, *CFIUS at a Glance*, TREASURY NOTES (Feb. 19, 2013), http://www.treasury.gov/connect/blog/Pages/CFIUS-at-a-Glance.aspx ("The Committee on Foreign Investment in the United States (CFIUS) has only one purpose: to review the potential national security effects of transactions in which a foreign company obtains control of a U.S. company.").

20. *The Committee on Foreign Investment in the United States*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/resource-center/international/Pages/Committee-on-Foreign-Investment-in-US.aspx (last updated Dec. 20, 2012).

21. *See* 50 U.S.C. app. § 2170(b)(1)(D)(i) (2012) ("[T]he President or the Committee may initiate a review under subparagraph (A) of— (i) any covered transaction); *see also* 31 C.F.R. § 800.207 (2008) (defining a covered transaction as "any transaction . . . by or with any foreign person, which could result in control of a U.S. business by a foreign person).

22. *See* 50 U.S.C. app. § 2170(b)(1)(E) (2012) (noting the thirty day timeline begins at the time written notice from a party is accepted by the chairperson or the initiation of a unilateral review); *see also* 50 U.S.C. app. § 2170(f) (2012) (listing factors for consideration when determining a transaction's impact on national security including "domestic production needed for national defense;" "the capability and capacity of domestic industries to meet national defense requirements;" the transactions effects on "major energy assets;" and "potential national security-related effects on . . . critical infrastructure").

23. *See* 50 U.S.C. app. § 2170(b)(2)(A)-(B) (2012) (requiring the Committee to immediately conduct an investigation when any a covered transaction meets any one factor); *see also* 31 C.F.R. § 800.503(b) (2008) ("The Committee shall also undertake, after review of a covered transaction . . . an investigation . . . that: (2) Would result in control by a foreign person of critical infrastructure of or within the United States[.]").

24. Exec. Order No. 13,456, Sec. 6(c) (2008) (stating the Committee will send a report to the President requesting his action); *see also* 31 C.F.R. § 800.506(c) (2008) (requiring CFIUS include in the report information stating there is credible evidence that the foreign interest exercising control might take action to impair the nation's security).

whether or not to suspend or prohibit the transaction.[25]

Despite publicity over recent high-profile acquisitions, CFIUS remains hidden in the shadows of the government's national security apparatus.[26] It is not the weak Committee President Gerald Ford established forty years ago.[27] Today, CFIUS is a strong, secretive regulatory body with the potential to undermine the economic policies that the Obama administration claims makes the United States the number one destination for FDI. Until CIFUS adopts clear policies, foreign companies looking to acquire U.S. businesses will be forced to navigate an opaque regulatory landscape scattered with loosely defined terms, determinations based on classified information, and decisions that offer little to no redress.[28]

This Comment argues that the District Court for the District of Columbia, in a case of first impression, inadvertently strengthened CFIUS's reach beyond its historical scope. By affirming the President's expanded authority to limit FDI for the sake of national security, the District Court all but mandated that foreign companies interested in securing a foothold within the U.S. market submit for review under CFIUS prior to any potential deal. While submitting to a review does not automatically mean the Committee will investigate, more submissions grant the Committee the appearance of precedential authority, which creates a snowball effect and elicits more submissions from the private sector. It was never intended for CFIUS to be a catch-all for foreign acquisitions of U.S. companies; it has always been a body designed to review the exceptional. However, with this latest ruling, ordinary transactions are subject to higher scrutiny, requiring parties to a deal to exercise extreme caution.

This Comment begins in Section II by exploring the evolution of the Committee from a body charged with making policy recommendations to an opaque regulator with authority to review and railroad investments on

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25. *See* 50 U.S.C. app. § 2170(d)(2) (2012) (specifying the President shall announce his decision no later than fifteen days after an investigation is completed).

26. *See* 50 U.S.C. app. § 2170(c) (2012) (exempting any information or materials filed in a CFIUS review from disclosure under the Freedom of Information Act, 5 U.S.C. § 552, and stating no materials will be made public unless required for an administrative or judicial action).

27. *See generally* Exec. Order No. 11,858, 3 C.F.R. (1971–1975) (creating the Committee through Executive Order).

28. *Compare* 50 U.S.C. app. § 2170 (2012) (noting the involvement of intelligence assessments from the Director of National Intelligence and Congress's decision that actions by the President shall not be subject to judicial review), *with* 31 C.F.R. § 800.208 (2008) (leaving the essential term "critical infrastructure" broadly defined), *and* 50 U.S.C. § 2170(f)(11) (2012) (listing factors to consider for determining impacts on national security including an open ended category of "such other factors" deemed to be appropriate in the eyes of the President and Committee).

behalf of foreign nationals. It highlights the Executive's desire to limit the scope and review the power of CFIUS through Executive Orders and policy shifts. It shows how Congress responded each time by further empowering the Committee through legislation. Section III looks at the Court's affirmation of the President's broad authority under FINSA in the *Ralls* ruling. It argues the *Ralls* ruling increases the unpredictability of government action for covered transactions and shows that investors have little choice but to submit for a review. Section III also explores the expanding definition of "critical infrastructure," a result of parties to non-traditional and high value covered transactions filing with CFIUS. It also argues foreign investors are on an uneven playing field in deals where a domestic competitor might show interest. Finally, Section IV offers ways the Committee could make itself appear more open to FDI while maintaining the requisite national security balance needed to keep the nation's critical infrastructure safe.

I. THE DEVELOPMENT OF THE CFIUS REVIEW PROCESS

CFIUS today is a far cry from the Committee's initial mandate over forty years ago; it did not transform into a boundless regulatory body overnight.[29] In order to understand the surprising nature of the Committee's newly acquired powers, it is necessary to first trace its evolution from a passive advisor on investment policies to an active gatekeeper, suspicious of foreign individuals, entities, and governments looking to enter the U.S. market.

A. The Reviewer Becomes a Regulator

Under President Gerald Ford, Executive Order No. 11858 founded CFIUS in 1975.[30] Worried that Congress would create a body with excessive power to regulate FDI from OPEC countries, Ford's Executive Order preempted the Legislative Branch and created a Committee with limited powers.[31] The directive charged the Committee with "monitoring"

29. *Compare* Exec. Order No. 11,858, 3 C.F.R. 990 (1971–1975) (using passive language such as "monitoring" and "coordinating"), *with* 31 C.F.R. § 800.801 (2013) (using active language such as "suspend[ing]," "prohibit[ing]," and "mitigat[ing]").

30. Exec. Order No. 11,858, *supra* note 27 at section 1 (stating membership would consist of representatives at the Assistant Secretary level or above from the Departments of State, Treasury, Commerce, Defense, the Assistant to the President for Economic Affairs, and the Executive Director of the Council on International Economic Policy).

31. *See, e.g.*, David Zaring, *CFIUS as a Congressional Notification Service*, 83 S. CAL. L. REV. 81, 92–93 (2009) (discussing Ford's worry over Congressional legislation impacting FDI originating from OPEC countries following the end of the 1975 oil embargo).

FDI and "coordinating" related policy in the U.S.[32]

For much of its early life, the Committee embraced its limited role.[33] The Treasury Department, prior to CFIUS's first meeting, commissioned a study to look at policy implications of the growing level of FDI within U.S. borders.[34] Among the key issues addressed were whether recent OPEC investments within the U.S. could impact U.S. foreign and domestic policy, and whether regulations in place at the time could address concerns over "undesirable behavior by foreign investors or undesirable foreign investment."[35] From the beginning, the Committee recognized the impact on public perception caused by reviews of specific transactions.[36] The Committee also noted that it never intended to review transactions as a matter of course simply because the proposed deal involved a foreign government or a company in the defense sector.[37] Accordingly, the Committee only met six times over the first four years of its existence.[38]

It was not until the late 1980s that a growing concern among members of Congress pushed the Committee into uncharted territory.[39] Prior to this point, the Committee continually touted the importance of the Executive's

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32. *See* Exec. Order No. 11,858, *supra* note 27 at section 1(b)(3) (stating in order to effectuate these responsibilities, the Committee would review investments with major implications for United States national interests).

33. *See Federal Response to OPEC Country Investments in the United States (Part 2, Investment in Sensitive Sectors of the U.S. Economy: Kuwait Petroleum Corporation Takeover of Santa Fe International Corporation): Hearings Before Commerce, Consumer, and Monetary Affairs Subcomm. of the H. Comm. on Gov't. Operations*, 97th Cong. 4 (1981) (statement of Marc E. Leland, Assistant Secretary for Internal Affairs, U.S. Department of the Treasury) ("The CFIUS is a monitoring body. It has not been given authority to approve or disapprove foreign investments in the United States.").

34. *See The Operations of Federal Agencies in Monitoring, Reporting on, and Analyzing Foreign Investments in the U.S. (Part 3, Examination of the Committee on Foreign Investments in the U.S.): Hearing Before Commece, Consumer, and Monetary Affairs Subcomm. of the H. Comm. on Gov't. Operations*, 96th Cong. 248–54 (1979) (assessing the growing level of FDI capital within the existing regulatory and policy landscape and recommending four options for future U.S. policy toward FDI).

35. *See id.* at 248 (clarifying that undesirable foreign investment includes investment concentrated in a particular industry of great importance to the nation's security).

36. *See id.* at 283 (highlighting that a review might suggest the U.S. Government is less than neutral on the particular transaction or on FDI in general).

37. *See id.* at 281 (making note that existing safeguards were thought adequate to deal with transactions involving companies in the defense sector).

38. *See id.* (stating two of those meetings involved foreign government backed investments by Romania and Iran, investments that the Committee ultimately did not find problematic).

39. *See* Zaring, *supra* note 31, at 93 (discussing Congressional concerns over the growing level of FDI originating from Japan in the 1980s and frustration with CFIUS and the infrequency of the Committee's meetings).

policy toward open investment in the United States and pointed to other regulatory tools capable of addressing concerns related to controversial FDIs.[40] In the event a proposed transaction caused legitimate concerns, the Justice Department could block it on antitrust grounds; the Department of Defense could sever sensitive contracts or withhold security clearances from the foreign acquirer; and the Department of Commerce could use export control laws to prevent the transfer of sensitive technology into foreign hands.[41]

In 1988, Congress passed the Exon-Florio provision to the Defense Production Act.[42] Congress gave the President the authority, which it presumably wished the Executive had back when President Ford issued Executive Order No. 11858 in 1975. The amendment granted the President the power to take "such action for such time as the President considers appropriate to suspend or prohibit any covered transaction that threatens to impair the national security of the United States."[43] That same year, President Reagan delegated administration of the authority vested in the President under Exon-Florio to CFIUS.[44] After thirteen years, CFIUS finally had statutory power to suspend or prohibit, by recommendation to the President, a deal which threatened national security.[45] It was a power the Committee previously felt was unnecessary and now felt should not expand.[46] Congress disagreed.

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40. *See Foreign Takeovers and National Security: Hearing Before the Subcomm. on Commerce, Consumer Prot., & Competitiveness of the H. Comm. on Energy & Commerce*, 100th Cong. 16–17 (1987) (statement of J. Michael Farren, Deputy Under Secretary for International Trade, U.S. Department of Commerce) [hereinafter *Foreign Takeovers and National Security*] (testifying the CFIUS system in place at the time was working and warning that further regulatory action would have a negative economic impact on FDI and possibly on U.S. investment abroad).

41. *See, e.g., id.* (discussing prior instances where transactions with potential national security concerns were adequately addressed through existing control regimes under the Departments of Justice and Defense).

42. 50 U.S.C. app. § 2170 (2012).

43. 50 U.S.C. app. § 2170(d)(1) (2012); *see also* 50 U.S.C. app. § 2170(d)(3) (2012) (granting the President the power to use the Attorney General to implement his order under § 2170(d)(1)).

44. *See* Exec. Order No. 12,661, 3 C.F.R. 618 (1988) (delegating duties to CFIUS in order to better achieve the economic, foreign policy, and national security objectives of the United States).

45. *See id.* pt. III § 3-201 (instructing CFIUS to present the President with a unanimous recommendation for action following the completion of an investigation and requiring a report detailing differing views in the event unanimity cannot be reached).

46. *Compare Foreign Takeovers and National Security*, *supra* note 40, at 17–18 (noting the pre Exon-Florio review system was designed to review transactions and then recommend other USG regulatory regimes take action and stating these existing regulatory regimes were sufficient to address any national security problems); *with*

B. Unwanted Empowerment

In May 1992, Senator Robert Byrd criticized what he believed to be CFIUS inaction under Exon-Florio.[47] He introduced S. 2704 "to prevent any foreign person from purchasing or otherwise acquiring the LTV Aerospace and Defense Co."[48] He argued the proposed sale of the company's missile division to a French company amounted to "the French Government nationaliz[ing]" the United States' defense industry.[49] While the proposed legislation failed, Senator Byrd succeeded in passing a later version requiring CFIUS to investigate proposed deals when "the acquirer is controlled by or acting on behalf of a foreign government; and the acquisition results in the control of a person engaged in interstate commerce in the United States that could affect the national security of the United States."[50] It was the first time the Committee was required to investigate a proposed deal.

C. Dubai and FINSA

From 1992 until December 2007, CFIUS investigated twenty-four potential deals out of 1,176 notifications filed with the Committee.[51] Its decision not to investigate the acquisition of the Peninsula and Oriental Steamship Navigation Company ("P&O") by Dubai Ports ("DP") World, however, drew harsh Congressional criticism spurring further changes.[52]

Oversight of the Exon-Florio Amendment: Hearing Before S. Comm. on Commerce, Sci., and Transp., 102d Cong. 6 (1991) (statement of Olin Wethington, Assistant Secretary for International Affairs, U.S. Department of the Treasury) (noting Exon-Florio's effective implementation and concerns that further restrictions and "burdensome regulations" in the name of national security interests might deter FDI).

47. *See* 138 CONG. REC. S6599 (daily ed. May 13, 1992) (statement of Sen. Byrd) (criticizing CFIUS for reviewing just 13 of 700 foreign acquisitions in the four years following Exon-Florio and highlighting the President's decision not to use his broad authority afforded to him under the statute).

48. *See* S. 2704, 102d Cong. (as referred to the Committee on Banking, May 13, 1992) (defining "foreign person" very broadly to include organizations, corporations, or individuals of a foreign country).

49. 138 CONG. REC. S6599, *supra* note 47 (expressing worries that U.S. investors could not outbid foreign governments looking to invest in ailing defense firms in a contracting industry).

50. National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484, 106 Stat. 2315 (1992) (codified as amended at 50 U.S.C. § 2170 (2012)).

51. *See cf.* Zaring, *supra* note 31, at 103 (table) (showing a correlation between a change in the CFIUS process and an increase in the number of notifications submitted to CFIUS).

52. *See Briefing by Representatives from the Departments and Agencies Represented on the Committee on Foreign Investment in the United States (CFIUS) to Discuss the National Security Implications of the Acquisition of Peninsular and Oriental Steamship Navigation Company by Dubai Ports World, A Government-Owned and Controlled Firm of the United Arab Emirates (UAE): Hearing Before the S.*

CFIUS took the 30-day review period to look into DP World's acquisition of U.K. based P&O, a company operating many of the ports in the United States.[53] It ultimately decided not to investigate the deal, finding that although DP World was a state-backed company, it posed no unresolved threat to national security.[54]

President George W. Bush, in another attempt by the Executive to preempt legislative action, instituted a policy leaving open the opportunity for CFIUS to review previously closed transactions for national security purposes.[55] However, Congress acted the following year to pass the Foreign Investment and National Security Act of 2007, commonly known as FINSA.[56] FINSA represented the latest legislative "fix" to CFIUS and ushered in the regulatory process facing overseas investors today.[57]

FINSA left in place many of the past Congressional adjustments under the Exon-Florio amendment; however, it also empowered the Committee by broadening definitions and extending the Committee's reach into new industries.[58] FINSA widened the definition of "national security" to

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Comm. on Armed Services, 109th Cong. 6 (2006) [hereinafter *Dubai Ports World Briefing*] (remarks by Sen. Hilary Clinton) (expressing concerns that the statutory requirements necessitating a 45 day investigation were not followed despite port security concerning the nation's security and the Dubai government controlling DP World).

53. *See* Jessica Holzer, *Was the Law Followed on Dubai Ports Deal OK?*, FORBES, (Feb. 23, 2006, 6:00 AM), http://www.forbes.com/2006/02/22/logistics-ports-dubai-cx_jh_0223cfius.html (describing the Committee's thirty day review of the transaction as a rubber stamp). *But see Dubai Ports World Briefing*, *supra* note 52 at 11–12 (statement of Robert Kimmit, Deputy Secretary, U.S. Department of the Treasury) (testifying the DP World review was not rushed and noting that the parties and CFIUS engaged in almost two months of informal talks prior to the start of the thirty day statutory review period).

54. *See* Holzer, *supra* note 53 (pointing to the statutory provision allowing CFIUS to sign off on a deal after thirty days when the Committee determines the deal does not threaten national security); *see also* Press Release, The White House, Fact Sheet: The CFIUS Process and the DP World Transaction (Feb. 22, 2006), *available at* http://georgewbush-whitehouse.archives.gov/news/releases/2006/02/20060222-11.html (announcing the President firmly stood behind the review and the decision to allow the deal to proceed).

55. *See* Jeremy Pelofsky, UPDATE 1- *Businesses Object to US Move on Foreign Investment*, REUTERS (Dec. 6, 2006, 12:49 AM), http://uk.reuters.com/article/2006/12/06/usa-investment-idUKN0534982920061206 (describing private sector concerns over CFIUS requiring French based Alcatel SA to sign a national security agreement (NSA) prior to its acquisition of US-based Lucent Technologies, a telecommunications company, permitting the government to undo the deal if the parties failed to comply at any time with the NSA).

56. *See generally* Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007).

57. *See* 50 U.S.C. app. § 2170 (2012) (noting no subsequent amendments since the passage of FINSA in 2007).

58. See 50 U.S.C. app. § 2170(a)(5)-(7) (2012) (expanding the definition of

include homeland security and inserted a new "trigger" for when the Committee must investigate: when a deal will result in foreign "control of any critical infrastructure."[59] Furthermore, Congress ordered the Director of National Intelligence ("DNI") to conduct his own analysis of any potential threats to national security posed by a covered transaction.[60]

D. Wind Farms Are National Security Interests

On September 28, 2012, President Obama, citing national security concerns and acting under the statutory authority vested in him through 50 U.S.C. § 2170(d)(1), ordered Ralls Corporation to divest all interests in four wind farm project companies in Oregon.[61] It was the first time a president took such action in twenty-two years.[62]

Ralls, owned by two Chinese Nationals who also were officers in the Chinese manufacturing company Sany Group, purchased the wind farm project companies from Terna Energy USA Holding Corporation in March of 2012.[63] The four wind farms were in close proximity to restricted airspace used by the U.S. Navy for drone test flights and other electronic warfare aircraft.[64] Ralls did not submit the deal to CFIUS for review prior to the purchase and did so only after members of the Committee contacted

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national security to include homeland security and broadly defining critical infrastructure and critical technologies).

59. *See* Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49 at Sec. 2(a)(5), (b)(2)(B)(i)(I); *see also* 50 U.S.C. app. §§ 2170(a)(5)-(6), (b)(2)(B) (2012) (defining critical infrastructure as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security").

60. *See* 50 U.S.C. app. § 2170(b)(4) (2012) (limiting the DNI's review to no longer than twenty days after the Committee has accepted notice of the transaction and directing the DNI to include any relevant intelligence agencies in its assessment).

61. *See* 50 U.S.C. app. § 2170(d)(1) (2012); Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281, 60,282 (Oct. 3, 2012) ("There is credible evidence that leads me to believe that Ralls Corporation . . . through exercising control of [the Project Companies] . . . might take action that threatens to impair the national security of the United States.").

62. *See* Helene Cooper, *Obama Orders Chinese Company to End Investment at Sites Near Drone Base*, N.Y. TIMES, A16, Sept. 28, 2012, *available at*, http://www.nytimes.com/2012/09/29/us/politics/chinese-company-ordered-to-give-up-stake-in-wind-farms-near-navy-base.html?_r=0 (describing President Obama's decision as an example of his increasingly tougher approach to dealing with China).

63. *See* Ralls Corp. v. Comm. on Foreign Inv. in the United States, 926 F. Supp. 2d 71, 78 (D.D.C. 2013) (stating Terna owned four separate limited liability companies, each of which was associated with a particular five-turbine wind farm project in north-central Oregon).

64. *See* Cooper, *supra* note 62 (highlighting U.S. Government concerns over drone use expanding to their foreign governments and noting the potential for the Chinese government to collect intelligence o drone technology form the wind farm sites).

Ralls and invited the company to file a voluntary notice.[65] As a result, Ralls invested substantial amounts of time and money into the project prior to the Committee's recommendation that the President issue the Executive Order.[66] Following the end of the forty-five day investigation period, President Obama issued his directive ordering the divestiture.[67]

Ralls filed suit challenging the Presidential Order arguing the President exceeded the statutory authority granted to him under Section 721 of the Defense Production Act.[68] Specifically, Ralls argued the President could not: (1) order the company to remove items from the wind farms, (2) block access by foreign nationals to the wind farms, (3) prohibit the sale of the property to a third party until removal of the items, and (4) authorize CFIUS to implement burdensome measures 'that would allegedly protect United States' national security interests.[69]

The District Court for the District of Columbia disagreed. According to the ruling, Ralls' interpretation of Section 721(d)(1) of the Defense Production Act does not limit the President only to the "suspen[sion]" or

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65. *Compare* Defendants' Memorandum in Support of Motion to Dismiss, Ralls Corp. v. Obama, No. 1:12-CV-015130-ABJ, 2013 WL 1334728 at *3 (D.D.C. Mar. 21, 2013) (describing a phone call from Deputy Assistant Secretary Mark Jaskowiak and Ralls's representatives stating the Department of Defense would file an agency notice if Ralls decided not to voluntarily submit for a review), *with* Amended Complaint at ¶ 74, Ralls Corp. v. Obama, No. 1:12-CV-01513-ABJ (D.D.C. Oct. 1, 2013) (stating Ralls had one opportunity to meet with CFIUS when the review began and were not provided with any information or notice of any potential national security concerns).

66. *See* Plaintiff's Response to Defendant's Motion to Dismiss at 3–4, Ralls Corp. v. Obama, No. 1:12-CV-01513-ABJ (D.D.C. Apr. 8, 2013) (stating Ralls engaged in direct talks with the U.S. Navy and agreed to move one windfarm at its own expense in order to reduce conflicts with low level aircraft training and noting Ralls secured local land use permits with the Navy's support); *see also* Amended Complaint at ¶¶ 63–65, Ralls Corp. v. Obama, No. 1:12-CV-01513-ABJ (D.D.C. Oct. 01, 2012). (stating the US Navy appreciated Ralls's "cooperation and consideration" in moving certain windfarms).

67. *See* Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281, 60,282 (Oct. 3, 2012); *cf.* Cooper, *supra* note 62 (basing her discussion on the reasons for the President's decision on speculation from industry analysts and prior U.S. government intelligence activities). *But see* Plaintiffs' Response to Defendants' Motion to Dismiss, *supra* note 66, at 19–23 (discussing the governmental interest in neither disclosing the reasons for the President's decision nor the evidence upon which it is based).

68. *See generally Ralls Corp.*, 926 F. Supp. 2d at 82; *see also* Amended Complaint, *supra* note 65, at ¶¶ 133–39 (arguing Ultra Vires action facially violating the statute and regulations).

69. *See Ralls Corp.*, 926 F. Supp. 2d at 82–83 (noting Ralls contested the legality of government inspections and reviews of financial data, equipment, and employees); *see also* Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. at 60,281, 60,282.

"prohibit[ion]" of a transaction.[70] Rather, "the statute expressly authorizes the President to do what he deems necessary to accomplish or implement the prohibition – not merely issue it."[71] Furthermore, since the President's actions "f[ell] well within the scope" of the statutory language, "their imposition was a Presidential action under subsection (d)(1) of the statute, and those actions have been declared unreviewable by Congress."[72]

On July 15, 2014, the U.S. Court of Appeals for the District of Columbia ruled that Congress did not intend to preclude Ralls' constitutional due process claim from judicial review. While this ruling overturned the lower court, in dicta, the Court of Appeals noted the statute bars courts from reviewing the President's actions taken to suspend or prohibit a transaction. A constitutional challenge to the process leading up to these actions is reviewable by the courts, however.

E. Pork: Smells Like a Threat

Shuanghui International, a Chinese company, and Smithfield Food, Inc., a U.S. based pork producer, announced in May 2013 that Shuanghui would acquire all outstanding shares of Smithfield in a deal valued around $4.7 billion.[73] On the same day of the announcement, Smithfield CEO Larry Pope announced the parties' intentions to voluntarily file for review by CFIUS stating the decision was motivated by "an abundance of caution."[74] Pope's voluntary submission was a chance to take advantage of what CFIUS experts refer to as the "safe harbor" provision.[75] CFIUS regulations

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70. *See Ralls Corp.*, 926 F. Supp. 2d at 88–89 (stating Ralls's interpretation is flawed because statutes are never to be interpreted in a manner where the interpretation renders any part meaningless); *see also* 50 U.S.C. app. § 2170(d)(1) (2012).

71. *Ralls Corp.*, 926 F. Supp. 2d at 88–89 (describing the President's authority as "extremely broad"); *see also* 50 U.S.C. app. § 2170(d)(1) (2012).

72. *Ralls Corp.*, 926 F. Supp. 2d at 89 (stating the challenged action is the type that is shielded from review); *see also* 50 U.S.C. app. § 2170(d)(1) (2012).

73. *See* Press Release, Smithfield Int'l Holdings, Shuanghui Int'l & Smithfield Foods Agree to Strategic Combination Creating Leading Global Pork Enterprise (May 29, 2013), *available at* http://investors.smithfieldfoods.com/releasedetail.cfm?ReleaseID=767743 (announcing the transaction's closing is subject to approval of U.S. regulatory agencies including CFIUS).

74. *See, e.g.*, Raymond Barrett & David Baumann, *US Regulators to Examine Whether Smithfield Foods Sale is Kosher*, FORBES (May 29, 2013, 4:29 PM), *available at* http://www.forbes.com/sites/mergermarket/2013/05/29/us-regulators-to-examine-whether-smithfield-foods-sale-is-kosher/ (quoting Smithfield CEO Larry Pope as saying he was not worried about the review, but filed with CFIUS anyway).

75. *See generally* Leon B. Greenfield & Perry Lange, *The CFIUS Process: A Primer*, THRESHOLD, (Winter 2005-2006), at 10, 15, *available at* http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/Greenfield_Lange_CFIUS_Process.pdf (stating companies that file for review and obtain a favorable approval from CFIUS cannot be reviewed again).

prevent the Committee or President from taking any further action on a covered transaction after the Committee has reviewed and approved the deal.[76]The deal was the largest Chinese takeover of an American company following the *Ralls* decision, and the largest Chinese takeover of an American company in history.[77] CFIUS ultimately cleared the deal without any mitigation measures; however, the Committee took the full forty-five day timeline to investigate any potential national security concerns.[78] Unlike the Ralls transaction, which caught the public eye because it involved a case of first impression, CFIUS practitioners watched the Smithfield deal closely because it represented the first time the Committee concerned itself with food safety.[79]

II. REGULATOR TO RAILROADER: HOW A POST-*RALLS* CFIUS WILL IMPACT FDI

Until 2012, no party subject to a CFIUS review, investigation, or Presidential order based on Section 721 of the Defense Production Act elected to challenge the scope of the Committee or President's authority.[80] The last time the President and CFIUS faced intense backlash from a decision related to a covered transaction was in 2006 when they required Alcatel SA and Lucent technologies to sign onto a National Security Agreement ("NSA"), which could unwind the deal if the two parties failed at any point to comply with specific terms laid out in the NSA with

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76. *See* 31 C.F.R. § 800.601 (2008) (stating the Committee will not exercise its power to block transactions if the Committee has notified parties that the transaction is not a covered transaction, that the Committee has concluded a review, or the President has announced that he will not act to block the transaction).

77. Louise Gong, *Could the Smithfield Deal Evidence a New Trend in Chinese Investment in the US?*, LEXOLOGY (July 25, 2013), http://www.lexology.com/library/detail.aspx?g=85dd98ae-708c-46ab-b035-ae9f59e5b022 (noting the deal may have received less scrutiny because Shuanghui is not a State Owned Enterprise (SOE) unlike other Chinese investments).

78. *See* Bill McConnell, *The Deal: No CFIUS Strings Attached to Smithfield Deal*, STREET (Sept. 9, 2013, 5:02 PM), http://www.thestreet.com/story/12031338/1/the-deal-no-cfius-strings-attached-to-smithfield-deal.html ("CFIUS experts picked up through the grapevine over recent days that mitigation was indeed absent from the Smithfield approval.").

79. *See* Bill Black, *U.S. Senate Hearing on Smithfield Foods Poses Challenge to CFIUS*, FORBES (July 9, 2013, 11:49 PM), http://www.forbes.com/sites/simonmontlake/2013/07/09/u-s-senate-hearing-on-smithfield-foods-poses-challenge-to-cifus/ (noting the classification of the food supply as a national security interest expands the scope of CFIUS and complicates U.S. trade policy trying spur FDI).

80. Daniel B. Pickard, Nova J. Daly, & Usha Neelakantan, *Ralls Case Affirms President's Broad CFIUS Authority*, WILEY REIN LLP (Mar. 14, 2013), http://www.wileyrein.com/publications.cfm?sp=articles&id=8720#_ftn4 (characterizing Ralls' decision to sue as "unprecedented").

CFIUS.[81] Ralls' decision to sue, rather than lobby the administration like the business community following Alcatel-Lucent, triggered a series of decisions which has unwittingly strengthened the Executive's discretionary authority to stifle FDI, whether the Executive wishes to or not.[82]

A. Post Ralls: Submit for a review or face limitless Executive Authority

Ralls argued in Count III of its suit against CFIUS and President Obama that, "[n]either any other provision of Section 721, nor the implementing regulations, nor any Executive Order grants the President any powers beyond 'suspend[ing] or prohibit[ing]' a 'covered transaction.'"[83] Since the parties had already completed the transaction at the time of the order, Ralls's argument carried more weight. Section 721(d)(1) states "the President may take such action for such time as the President considers appropriate to *suspend* or *prohibit* any covered transaction . . . ."[84] Prior readings and prior Presidential action under this Section presumed it to mean that the President was limited only to suspending or prohibiting a deal, completed or pending.[85] In 1990, the last time a president acted under this authority, President Bush limited the scope of his order by requiring China National Aero Technology Import and Export Corporation (CATIC) to divest all interests in MAMCO Manufacturing, Inc.[86]

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81. JAMES K. JACKSON, CONG. RESEARCH SERV., RL 33388, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES 6-7 (CFIUS) (2013) (describing the arrangement as "controversial").

82. Pelofsky, *supra* note 55 (describing a number of U.S. and international business groups objecting to the Bush administration's policy decision).

83. Amended Complaint, *supra* note 65 at ¶ 133 (arguing in Count III that the President's action was ultra vires and violated the statute and regulations).

84. 50 U.S.C. app. § 2170(d)(1) (emphasizing the specific options laid out in the statutory language).

85. *Compare* Amended Complaint, *supra* note 64, at ¶ 133 ("The President may only 'take such action for such time as the President considers appropriate to suspend or prohibit any covered transaction.' Neither any other provision of Section 721, nor the implementing regulations, nor any Executive Order grants the President any powers beyond 'suspend[ing] or prohibit[ing]' a 'covered transaction.'") *with* MEREDITH M. BROWN, ET. AL., TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS, 13–33 (3d ed. 2013) (limiting the discussion of options open to the President at the end of the fifteen day timeline to suspension or prohibition of a covered transaction).

86. *See* Message to Congress on the China National Aero-Technology Import and Export Corporation Divestiture of MAMCO Manufacturing, Incorporated, 26 WEEKLY COMP. PRES. DOC. 164 (Feb. 2, 1990) [hereinafter Message on CNATI & MAMCO] (noting there are limited exceptions to when the U.S. government will act contrary to its policy of maintaining an open investment landscape); *see also* Harriet King, *China Ends Silence on Deal U.S. Rescinded*, N.Y. TIMES (February 20, 1990), http://www.nytimes.com/1990/02/20/business/china-ends-silence-on-deal-us-rescinded.html (noting the deal closed on November 30 and President Bush issued his order on February 2 following a recommendation from eight agencies (CFIUS) that the purchase be rescinded).

While the Executive Orders pertaining to CATIC and Ralls constituted presidential action on finalized deals, Ralls faced numerous other burdensome requirements that CATIC did not.[87] The Court determined the President's right to exercise this power came from the expressed statutory language in front of the words, "suspend" and "prohibit," specifically the clause "take *such action* for *such time* as the President considers appropriate."[88] This adds a new level of uncertainty to an already secretive and vague process.[89] There are statutory limitations for the allotted time the Committee has to review and investigate a transaction, thirty and forty five days, respectively.[90] Additionally, Section 721 limits the President's decision to announce whether he will take action pursuant to the Committee's recommendation to fifteen days following the end of an investigation.[91] "Such time," however, has no limit under the Court's interpretation, which permits the President to retroactively unwind deals.[92] By prefacing subsequent action with "in order to effectuate" the suspension or prohibition, the President can invoke the statutory power of "such action for such time" that is necessary to effectuate his Order.[93] This gives the President broad latitude to engage in retroactive review of closed deals and require and restrict action by the parties— action that is difficult, if not impossible, to predict.[94] Furthermore, in the context of suspending a deal, the President could conceivably require that parties to a transaction remain

87. *Compare* Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281, 60,282 (Oct. 3, 2012) (preventing Ralls from selling the property to a third party until it complied with provisions in subsection (f)(i)-(iii)) *with* Message on CNATI and MAMCO, *supra* note 86 (limiting the order to divestiture and not imposing more burdensome restrictions on the parties).

88. *See* Ralls Corp. v. Comm. on Foreign Inv. In the United States, 925 F. Supp. 2d 71, 89 (D.D.C. 2013) (emphasis added) (stating "for such time" is an open ended temporal phrase granting the President an unlimited period of time to take action necessary to accomplish or implement the prohibition of a deal).

89. *See* 50 U.S.C. app. § 2170(c) (2012) ("Any information or documentary material filed with the President or the President's designee pursuant to this section shall be exempt from disclosure[.]").

90. 50 U.S.C. app. § 2170(b)(1)(E), (2)(C) (2012).

91. 50 U.S.C. app. § 2170(d)(2) (2012) ("Not later than 15 days after the date on which an investigation . . . is completed.").

92. *See Ralls Corp.*, 926 F. Supp. 2d at 88 (stating if the President were limited to just a decision on whether to prohibit or permit a deal prior to its closing, he would not need an unlimited period of time granted to him with the phrase, "for such time").

93. *See id.* (describing the sequence of Presidential action to include a declaration that a transaction is prohibited even it the deal has closed, then classifying further action as steps necessary to prohibit the transaction).

94. *See id.* (discussing the President's order, which called for a removal of Chinese turbines, prevention of their use in the future, and restrictions on foreign nationals accessing the wind farm).

in some type of perpetual limbo because he "consider[ed] [such action] appropriate to suspend" a covered transaction.[95] It is conceivable that the President could require the divestiture of any transactions deemed to threaten national security that occurred after FINSA, but were not reviewed by CFIUS.

Under the court's interpretation, "such action" is also an open-ended term that increases unpredictability.[96] The Presidential Order, in Section 2, subsection (b) ordered Ralls to divest all interests in the wind farms, a move comparable to President Bush's requirements for Alcatel.[97] However, President Obama went far beyond Alcatel by blocking or prohibiting: (1) access to the properties by anyone from or acting on behalf of Ralls, (2) the sale of the property to a third party without meeting certain conditions, and (3) the use of any items made by a particular Chinese firm for use at the location.[98] The court did not elaborate on its reasoning, simply declaring these orders as "such action" necessary to prohibit the Ralls transaction.[99] Furthermore, the court did not clarify a standard for determining when a particular action is sufficiently related to the prohibition of a transaction to be classified as "such action . . . the President considers appropriate."[100] Therefore, the court takes a very broad and permissive stance on the statutory language surrounding the limits (or lack thereof) of the President's authority.

As long as the President's actions fall within the undefined "such action at such time" category, parties to a covered transaction face no other option than to take advantage of the "safe harbor" provision.[101] The affirmation that the President's ruling is not subject to judicial redress underscores the

95. *See id.* (stating "the statute expressly authorizes the President to do what he deems necessary to accomplish or implement the prohibition." Since *Ralls* dealt with the prohibition of a deal, the discussion in this sense stops there; however, it is fair to assume the same interpretation applies to the President's ability to do whatever is necessary to effectuate a "suspension" of the deal.).

96. *See id.* at 89 (noting what the President deems necessary is up to his judgment).

97. Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281, 60,282 (Oct. 3, 2012).

98. *Id.*

99. *Ralls Corp.*, 926 F. Supp. 2d at 89 (stating the additional restrictions fell within the scope of the President's authority but failing to elaborate how or why).

100. *See id.* (noting the Defense Production Act affords the President broad authority but providing no explanation or reasoning why certain actions are necessary in order to effectuate the prohibition of the transaction instead highlighting that the actions are not reviewable).

101. *See* 31 C.F.R. § 800.601 (2008) (discussing when the President's divestment authority will not be available).

importance of submitting to a review.[102] If the Committee, during the review period, determines not to undertake an investigation of a covered transaction or the Committee determines, at the end of an investigation, not to take further action, then the President "shall not" exercise his authority available to him under Section 721(d).[103] It offers the only sense of predictability in an otherwise unpredictable process.

B. Ham is Critical Infrastructure So Your Deal Is Probably Covered Too

Since CFIUS reviews each case on a fact specific basis, it follows that there is no precedential value for the Committee's past rulings when compared with future rulings.[104] While this holds true for the decisions the Committee makes when it reviews covered transactions, it is still valuable for companies to know which transactions are chosen for review.[105] Companies can only guess whether their deal will be a covered transaction based on a variety of statutory factors and prior reviews within their respective industry.[106] The perception among investors is that CFIUS reviewing one deal means it is likely to review similar transactions.

The Smithfield-Shuanghui deal represented the first time CFIUS reviewed a merger dealing with food supply.[107] The deal likely fell within the reach of CFIUS because Smithfield is the largest pork producer in the United States and "has a significant impact on U.S. food supply."[108] While

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102. *Ralls Corp.*, 926 F. Supp. 2d at 89 ("[T]his Court finds that the challenged action 'is of the sort shielded from review.'").

103. *See* 31 C.F.R. §§ 800.601(a), (a)(2).

104. COMM. ON FOREIGN INV. IN THE UNITED STATES, ANNUAL REPORT TO CONGRESS 3 (2013), *available at* http://www.treasury.gov/resource-center/international/foreign-investment/Documents/2013%20CFIUS%20Annual%20Report%20PUBLIC.pdf ("Apart from the general correlation of the number of notices with macroeconomic conditions, the information in the table . . . is not indicative of discernable trends. CFIUS considers each transaction on a case-by-case basis[.]").

105. *Cf. Committee on Foreign Investment in the United States Filing Instructions*, U.S. DEPARTMENT OF THE TREASURY, *available at* http://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-filing-instructions.aspx ("CFIUS does not issue advisory opinions as to whether a transaction might raise national security concerns or be considered a covered transaction subject to review.").

106. *See* 31 C.F.R. § 800.208 (2008) (defining "critical infrastructure" broadly with general terms like "system" and "asset" forcing companies to look to previous deals within a specific industry to determine whether the deal fell into this category in order to make a determination of whether this definition applies).

107. *See* McConnell, *supra* note 78 (stating CFIUS experts believe the Committee's review for food safety concerns would be a first).

108. *See* "Re: Shuanghui's International Holdings, Ltd. proposed purchase of Smithfield Foods," Letter from Concerned Industry Players (July 9, 2013) [hereinafter "Letter to Cabinet Members Expressing Opposition of Smithfield Deal"] *available at* http://www.chinaustradelawblog.com/wp-content/uploads/sites/164/2013/07/farm-

most would agree that the domestic food supply should fall within the definition of critical infrastructure, especially because "the incapacity or destruction of the particular system . . . would have a debilitating impact on national security," it is the companies' stated reason for filing, "an abundance of caution," and the subsequent precedent it sets for potential deals within the industry that is a troubling indicator of a widening CFIUS net.[109]

As noted before, the deal emerged without mitigation.[110] The President cannot suspend or prohibit a transaction where other provisions of law "provide adequate and appropriate authority" to protect the nation's security.[111] Since the food industry is already highly regulated, the Committee may have felt any mitigation efforts on their part would be unnecessary, if not illegal, because of U.S. Department of Agriculture oversight.[112] But the damage is done.

CFIUS sent a signal to foreign companies contemplating investing in the U.S. domestic food market when it accepted the Smithfield-Shuanghui filing and conducted a forty-five day investigation: food is on our list.[113] Smithfield shows the problems associated with leaving an ambiguous definition for what constitutes critical infrastructure. By failing to define

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letter-on-cfius.pdf (calling for CFIUS to block the merger because the deal threatens the security of the nation's food supply); *see also Smithfield and Beyond– Examining Foreign Purchases of American Food Companies: Hearing Before S. Comm. on Agric., Nutrition, and Forestry*, 112th Cong. (2013) (statement of Sen. Debbie Stabenow, Chairman, S. Comm. on Agric., Nutrition, and Forestry) (describing food security as essential to the national security and declaring it essential to examine the impact of the deal on the nation's food supply).

109. *See* 31 C.F.R. § 800.208 (2008) (defining critical infrastructure broadly to include physical and virtual assets); Press Release, Smithfield Int'l Holdings, *supra* note 73 (describing the companies' motives to submit as "out of an abundance of caution").

110. *See e.g.*, McConnell, *supra* note 78 (stating CFIUS cleared the deal with no strings attached).

111. *Cf.* 50 U.S.C. app. § 2170(d)(4)(B) (2012) (stating whether a particular provision of law adequately protects the nation's security is up to the judgment of the President).

112. *See* 31 CFR § 800.101 (2008) (limiting the scope of the President's authority by prohibiting action when other provisions of law can adequately protect the nation's security).

113. *See* Louise Gong & Amanda Forsythe, *CFIUS and Chinese Investments: Lessons from the Smithfield Deal*, LEXOLOGY (November 26, 2013), http://www.lexology.com/library/detail.aspx?g=8d72c8a1-d89b-4d95-83a2-9e5143d66f37 ("A 45 day investigation was undertaken by CFIUS against a highly political backdrop, with CFIUS being asked to look into how food safety and food security threats may affect national security[.]"); *see also Smithfield and Beyond – Examining Foreign Purchases of American Food Companies*, *supra* note 108 (describing Shuanghui's acquisition as the first, but not the last and calling for an examination of the approval process because of the case's precedent setting nature).

the category more thoroughly, any foreign company looking to enter into a broad array of industries will feel forced to submit for a review "out of an abundance of caution."[114]

The Smithfield review sent another sign to investors: the loose definition of critical infrastructure can be a political tool.[115] The events surrounding the review support this notion. Numerous agricultural organizations opposed the purchase in a letter to Cabinet members who sit on CFIUS.[116] Additionally, the U.S. Senate Committee on Agriculture held a hearing in July 2013 to examine the deal.[117] Nowhere in the CFIUS mandate does it permit the Committee to examine a deal for the economic impact it might have on competition.[118] Examining the deal under the guise of food security, however, helped placate the interests of the industry and of members of Congress. As a result, foreign investors party to large acquisitions in industries not traditionally covered by CFIUS may feel forced to submit for review because political and industry pressure could push CFIUS to initiate a non-notified review after a deal has begun.[119]

If Smithfield-Shuanghui's "abundance of caution" included submitting the deal because of its unprecedented value, this is the sign of another disturbing trend, particularly because CFIUS is not charged with looking into these economic impacts.[120] In 2012, CFIUS reviewed, and ultimately cleared, the acquisition of AMC Entertainment by Dalian Wanda Group for

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114. *See* Press Release, Smithfield Int'l Holdings, *supra* note 73.

115. *See* Black, *supra* note 79 (stating CFIUS is not authorized to look at the economic impact of a deal and arguing a U.S. Senate Hearing held during the review period was aimed at putting pressure on CFIUS to conduct a very close review).

116. *See* Letter to Cabinet Members Expressing Opposition of Smithfield Deal, *supra* note 108 (arguing the nation's food supply should fall into the definition of critical infrastructure and noting the extensive contracts Smithfield has with the U.S. military and arguing the deal would threaten the ability of the military to feed troops).

117. *See, e.g.*, Edward Wyatt, *Senators Question Chinese Takeover of Smithfield*, N.Y. TIMES, B7, July 10, 2013, *available at* http://dealbook.nytimes.com/2013/07/10/lawmakers-have-concerns-over-chinese-takeover-of-smithfield/?_php=true&_type=blogs&_r=0 (discussing lawmakers' concerns and over the deal and noting sixteen members of the Agriculture Committee sent a letter to the Treasury Department asking Treasury to include the Department of Agriculture and the Food and Drug Administration in the CFIUS review process for the deal).

118. *See* 50 U.S.C. app. § 2170(f) (2012) (listing various factors the President and Committee can consider including the impact on the nation's defense apparatus and international leadership in technology but not mentioning economic impacts). *But see Smithfield and Beyond – Examining Foreign Purchases of American Food Companies*, *supra* note 108 (encouraging CFIUS to factor in the nation's economic security when reviewing a transaction for national security implications).

119. *Cf.* Barrett & Baumann, *supra* note 74 (discussing the ways in which industry competitors can use political tools such as lobbyists to interfere with pending transactions).

120. *See* 50 U.S.C. app. § 2170(f) (2012).

$2.6 billion.[121] The transaction fell under the "covered transaction" requirement; however, its impact on national security is questionable.[122] Is AMC's ownership and operation of 338 movie theaters around the United States considered "so vital" that the incapacitation of the business would "have a debilitating impact on national security?"[123] Like Smithfield, AMC was an acquisition by a Chinese firm of large stakeholders in an industry symbolic of American culture: entertainment. It is more likely that the parties submitted the transaction for review because of the deal's large value; at the time, it was the largest completed Chinese-US acquisition in history.[124] Since CFIUS does not have a mandate to review transactions for economic impacts, the idea that companies are submitting for review because of the value of a deal rather than the potential that it falls within the CFIUS mandate is disturbing. As a result of this review, China- based investors entering into high valued deals in the entertainment industry, and investors from other countries with sensitive diplomatic ties, may feel pressured to submit for review.[125]

C. International vs. Domestic Investors: More Power Means More Filings Which Put International Investors in Second

There were 155 notices filed with CFIUS in 2008, up from 138 the previous year.[126] During that same time, Congress passed FINSA and President Bush implemented the law at the beginning of 2008, the last

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121. *See* JAMES K. JACKSON, CONG. RESEARCH SERV., RS 21857, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES: AN ECONOMIC ANALYSIS 9 (2013). (discussing prior high profile cases CFIUS reviewed).

122. *See id.* (describing the deal as an acquisition therefore constituting control of a U.S. business by a foreign person).

123. *See id.* (describing AMC Entertainment's business operation); *see also* 31 C.F.R. § 800.208 (2008) (defining critical infrastructure).

124. *See* Thilo Hanemann, *Chinese FDI in the United States: Q3 2012 Update*, RHODIUM GROUP (Oct. 18, 2012), http://rhg.com/notes/chinese-fdi-in-the-united-states-q3-2012-update (valuing the deal at $2.6 billion).

125. *See, e.g.*, William Mauldin *Chinese Firms Lead in Seeking Deals Needing U.S. Security Clearance*, WALL ST. J. (Dec. 19, 2013, 10:57 PM), http://online.wsj.com/news/articles/SB10001424052702304773104579268722994281350 (noting Chinese firms filed 23 acquisitions in 2012 compared to 13 in 2011 and highlighting that only six of the twenty-three acquisitions involved critical technology); *cf. Smithfield and Beyond – Examining Foreign Purchases of American Food Companies*, *supra* note 108, at 6 (statement of Daniel M. Slane, US-China Econ. and Sec. Review Comm'n.) (showing the political nature of reviews when Congress is involved by concluding his remarks with the recommendation that Congress re-examine FDI from China and determine whether FINSA should be amended to include an economic benefits test).

126. *See* COMM. ON FOREIGN INV. IN THE UNITED STATES, *supra* note 104 at 3 (table).

major change and clarification related to the CFIUS process.[127] The jump represents a precautionary reaction by the private sector attempting to adjust to new, broader regulations for FDI. Of those 155 notices, eighteen were withdrawn during review, twenty-three were investigated, and five were withdrawn during the investigation period.[128] The companies associated with all 155 acquisitions were forced to wait a minimum of thirty additional days to close on a deal. Twenty-three out of these 155 transactions, which is fourteen percent of all notices, had to wait an additional forty-five days for clearance from the investigation phase.

These excess delays represent a minor inconvenience for most transactions; however, in a post-*Ralls* environment, where firms are filing out of fear and uncertainty, the delays are an unnecessary impediment for most who will submit for review.[129] In 2012, there were 114 notices and forty-five investigations.[130] Forty percent of covered transactions filed in 2012 were stalled for seventy-five days of regulatory review.

Companies facing a regulatory delay are often subject to very public and politicized scrutiny.[131] One deal, the acquisition of Sprint-Nextel Corp. by Japan's SoftBank Corp, highlights how a regulatory delay in a system filled with ambiguity could be disastrous to international investors.[132] DISH Network, a competitor with SoftBank in the deal, launched a lobbying campaign arguing outstanding national security concerns.[133] Leaving a

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127. *See generally* JAMES K. JACKSON, CONG. RESEARCH SERV., RL 33388, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) 7 (2013).(describing the amended process post FINSA).

128. *See* COMM. ON FOREIGN INV. IN THE UNITED STATES, *supra* note 104 at 3 (stating the increase in withdrawals in 2012 is a result of specific facts and circumstances of the particular transaction).

129. *See* Amanda Forsythe, *"But I'm Canadian!" and Other CFIUS Dilemmas*, CHADBOURNE & PARKE LLP (Dec. 2013), http://www.chadbourne.com/files/Publication/37853f8d-ff78-42e4-a84d-3f65bdc01bda/Presentation/PublicationAttachment/8f284480-8084-45c6-bced-445635e89eec/CanadianCFIUSDilemmas_Dec13.PDF. ("Although there are statutory deadlines for certain phases of the process, the exact timing of the process is hard to predict.").

130. *See* COMM. ON FOREIGN INV. IN THE UNITED STATES, *supra* note 104 at 3 (stating the increase in number of notices filed from 2010 to 2012 coincides with the continued recovery from the financial crisis of 2008-2009).

131. *See, e.g.*, Peter Overby, *Lobbyist's Last-Minute Bid Set Off Ports Controversy*, NAT'L PUB. RADIO (March 8, 2006, 4:00 PM), http://www.npr.org/templates/story/story.php?storyId=5252263 (discussing a lobbyist's campaign to bring increased scrutiny to the DP World deal on Capitol Hill).

132. *See* Alina Selyukh, *Spring, Softbank agree to U.S. National Security Deal*, REUTERS (May 29, 2013, 6:27 PM), http://www.reuters.com/article/2013/05/29/us-sprint-offer-idUSBRE94S0IG20130529 (describing as aggressive DISH Network's attempts to convince lawmakers that the transaction would threaten the nation's security).

133. *See, e.g., DISH Statement on Softbank and CFIUS*, DISH NETWORK CORP.

deal open for seventy-five days gives a leg-up to domestic companies looking to acquire target companies. They are not subject to the same delay and may be more appealing to shareholders should CFIUS find it needs to further investigate, or ultimately mitigate, a deal. Hormel Foods Corporation, a domestic competitor of Smithfield, declined to say whether it would lobby against Shuanghui when the deal was under review.[134] Hormel did not act and DISH was unsuccessful in its attempts; however, the threat is real. Shell Gas successfully lobbied Congress to introduce legislation in 2005 that would have stifled the bid by China National Offshore Oil Corporation ("CNOOC") to acquire the U.S. based oil company, Unocal.[135] CNOOC eventually abandoned the transaction amid public backlash.[136]

It would be imprudent to say these reviews served no purpose; however, as more companies subject themselves to CFIUS review because of endless uncertainty, international investors remain at a severe disadvantage when they challenge U.S.-based companies in a bidding war.[137] "There is a concern about the length of time that the deals are taking and whether or not [the companies] feel like they are at a disadvantage."[138] When companies feel like they must self-report out of caution and due diligence, the United States presents itself as a protectionist investment market suspicious of outsiders.[139]

(May 23, 2013, 6:00 AM), http://about.dish.com/press-release/financial/dish-statement-softbank-and-cfius (pointing to serious national security risks of SoftBank acquiring Spring and calling on Congress to scrutinize the CFIUS review process).

134. *See* Barrett & Baumann, *supra* note 74 (highlighting the risks Smithfield would face if Hormel attempted to lobby Congress to block the transaction).

135. *See id.* (comparing what Shell did to the CNOOC – Unocal deal to what Hormel could do to the Smithfield-Shuanghui deal).

136. *See id.*; *see also* Isabella Steger, *Cnooc's Unocal Lessons*, WALL ST. J. BLOGS (July 23, 2012, 10:10 AM), http://blogs.wsj.com/deals/2012/07/23/cnoocs-unocal-lessons/ (describing the deal as a poster child for what happens when U.S.-China trade issues get in the way of a deal).

137. *Cf. Smithfield and Beyond – Examining Foreign Purchases of American Food Companies*, *supra* note 108, at 6 (statement of Daniel M. Slane, US-China Econ. and Sec. Review Comm'n.) (stating Congress should expect a wave of Chinese investment in the U.S. food and agriculture industry, which means these parties will feel obligated to submit for CFIUS reviews regardless of whether the deal is covered under the statutory guidelines).

138. *See CFIUS Chair Stays Silent on Specifics*, MAIN JUST. (March 26, 2012, 11:24 AM), http://www.mainjustice.com/2012/03/26/cfius-chair-stays-silent-on-specifics/ (quoting Nancy McLernon, president and CEO of the Organization for International Investment)

139. *See, cf.* 50 U.S.C. app. § 2170(b)(2)(B)(i)(II) (2012) (requiring CFIUS to investigate covered transactions when the acquirer is or is backed by a foreign government which means the acquiring company has the burden of proof to show it is not a threat to the security of the nation).

III. THE NEED FOR CLARITY

Following the *Ralls* decisions, CFIUS faces an identity crisis. On the one hand, the Committee must remain vigilant in its mandate to ensure its first priority, the nation's security, when reviewing covered transactions. This is all the more important when viewed amidst the backdrop of the Committee's inclusion in its public annual report of a U.S. Intelligence Community Assessment stating "that foreign governments are extremely likely to continue to use a range of collection methods to obtain critical U.S. technologies."[140] On the other hand, it is the Obama Administration's stated goal that it wishes to encourage FDI, a goal traditionally left to the states, but which the administration deems important enough to bring under the umbrella of the Federal Government.[141] The question is how CFIUS can conform to the goal of promoting what historically has made America an attractive investment landscape, specifically an "open investment" climate and a "predictable and stable regulatory regime."[142]

In order to reconcile this split, CFIUS and the Executive must increase transparency and predictability in the review process by changing the policy on advisory opinions. Asking the Committee to definitively state what "national security" entails would be impossible. Furthermore, it is in the interest of the nation not to limit the meaning of national security because of the ever-changing domestic and international milieu.[143] But the Committee could issue advisory opinions following a determination that a particular transaction is not covered if that particular transaction does not fall within the purview of "critical infrastructure." The Committee can determine a transaction is not covered or that there are no outstanding national security concerns under sections 800.504 or 800.506 of its

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140. *See* COMM. ON FOREIGN INV. IN THE UNITED STATES, *supra* note 104, at 29 (answering the question of whether foreign governments used espionage activities to obtain commercial secrets related to critical technologies).

141. *See* Politi, *supra* note 9 (stating, in the past, the federal government has avoided large scale initiatives targeting foreign investment and leaving this to state governments).

142. *See* U.S. DEP'T OF COMMERCE & PRESIDENT'S COUNCIL OF ECON. ADVISERS, *supra* note 6, at 11 (noting most investments originate from industrialized countries, but highlighting the role emerging markets will play as those countries continue to grow economically).

143. *Compare*, *cf.* THE WHITE HOUSE, THE NATIONAL SECURITY STRATEGY OF THE UNITED STATES OF AMERICA (2002), *available at* http://nssarchive.us/NSSR/2002.pdf; *with* THE WHITE HOUSE, THE NATIONAL SECURITY STRATEGY OF THE UNITED STATES OF AMERICA (2006), *available at* http://nssarchive.us/NSSR/2006.pdf *and* THE WHITE HOUSE, THE NATIONAL SECURITY STRATEGY OF THE UNITED STATES OF AMERICA (2010), *available at* http://www.whitehouse.gov/sites/default/files/rss_viewer/national_security_strategy.pdf (noting the need to revise strategies three times in eight years in order to better respond to a evolving threats and an unpredictable global landscape).

regulations.

The finality of the action should permit the Committee to issue a public opinion describing why it chose not to review a transaction.[144] This would require acquiescence on behalf of members to the particular transaction; however, achieving this likely would not be difficult, especially because the publicized opinion would involve a transaction that is *not* covered. Currently, parties that submit to a review may withdraw a notice prior "to conclusion of all action under section 721."[145] Doing so helps avoid an unfavorable ruling and parties can resubmit at a later time.[146] Parties to a transaction understandably may wish to avoid public knowledge of a withdrawal because of financial implications; however, publication of a decision by CFIUS not to review, investigate, or rule on a transaction would not carry the same negative consequences. It would require an adjustment of the regulations under 31 C.F.R. § 800.702, which prohibit the Committee from disclosing information filed even after a "determin[ation] that a notified transaction is not a covered transaction."[147] Accordingly, it would be in the interest of the business community to acquiesce to this change in regulation.

The Committee could shed more light on its decision-making process by explaining its justification for negative rulings. National security concerns make it difficult, and likely illegal, for a full debrief of why the Committee ultimately recommended the suspension or prohibition of a deal. This would involve a breakdown of rulings into broad categories, which would provide guidance without giving specific reasons that might involve decisions based on classified material.

Currently, the Committee, in its annual report to Congress, breaks down notified covered transactions by sector.[148] Among the sectors included are Manufacturing; Finance, Information and Services; and Mining, Utilities, and Transportation. The categories are further broken down into subcategories that give a general idea of the sub-industry in which the deal originated; however, the information is not enough to garner specifics

144. *See* 31 C.F.R. §§ 800.504, 800.506(d), & 800.601 (2008) (describing the various points in the CFIUS process where finality provisions kick in).

145. *See* § 800.507(a) (2008) (stating requests to withdrawal from a review will ordinarily be granted, but reserving the Committee's right to deny the withdrawal request).

146. *See* § 800.507(c)(2) (2008) (stating the Committee will specify a time frame for a resubmission).

147. *See* § 800.702(b)(3) (2008) (stating the regulation covering confidentiality will continue to apply even though a decision has been reached).

148. COMM. ON FOREIGN INV. IN THE UNITED STATES, *supra* note 104, at 4 (noting the greatest number of filings in 2012 occurred in the manufacturing and finance sectors).

about the "critical technology" involved, as might be the case for Manufacturing's "semiconductor" subsector. The Committee could create similar categories to reflect negative rulings. It was reported that the wind farms purchased by Ralls were within or adjacent to U.S. military instillations.[149] The Committee could classify this ruling under a category entitled "situational concerns." This gives guidance to future investors who might attempt to acquire property in proximity to sensitive locations. Citing "situational concerns" as a reason for a negative ruling would do little to threaten or reveal sensitive information related to national security.

Although CFIUS cleared the SoftBank-Sprint deal last spring, it placed conditions on the clearance in order to mitigate outstanding concerns related to SoftBank's use of equipment made by a Chinese company.[150] In this instance, the Committee could site "technological concerns" as its reason for requiring the mitigation measures. This makes potential investors aware that mergers and acquisitions resulting in foreign control of telecommunication companies likely fall under the "critical infrastructure" or "critical technology" rubric. The importance is to develop guidance and clarity, not specifics and pinpointed answers for those looking to invest.

Further clarification for rulings provides guidance for foreign investors, something that supports the administration's goal of remaining an open marketplace with a predictable regulatory landscape. It also prevents misperception, a worry that should be at the forefront of the Committee's mind. Guidance on negative rulings or rulings involving mitigation could help reduce unnecessary filings, which would reduce the misperception from investors who might reside in countries with less than ideal diplomatic relations with the United States.

CONCLUSION

The Committee reviews a small fraction of total deals involving foreign acquisition of U.S.-based companies. The direct economic impact of CFIUS' review of transactions is difficult to measure; however, unless the Committee clarifies its policies in light of its new power and reach, it risks alienating certain foreign companies from investing in the United States.

Ralls has shown the world the dangers of what may happen when parties forge ahead with an acquisition without submitting first for clearance by CFIUS. Not only can the President block a deal, but he can undo a deal and require seemingly boundless actions and restrictions in order to

149. *See* Defendants' Memorandum in Support of Motion to Dismiss, *supra* note 65, at 4.

150. *See* Selyukh, *supra* note 132 (citing sources who stated SoftBank agreed to remove equipment from Sprint and Clearwire Corp's networks made by Huawei Technologies Co Ltd., a Chinese company, if the deal was completed by 2016).

effectuate the order. The heavy-handed action chips away at the open, predictable, and stable economy that draws in foreign capital.

Smithfield-Shuanghui is an example of what to expect unless CFIUS can provide more guidance and transparency in its review process. Foreign firms will submit for review because the cost-benefit analysis post-*Ralls* demands it. The current administration risks driving the U.S. economy down a path where FDI is presumptively suspect. When companies feel the need, as a default, to submit for a review, the Committee risks entering the territory where companies feel as though they must show they are not a threat. New industries will fall under the "critical infrastructure" umbrella, which will drive more investors to self-report to CFIUS. Whether the deal is actually covered under the "critical infrastructure" definition is immaterial without transparency, advisory opinions, or further clarification.

TO PAY OR NOT TO PAY: INTERPRETATION OF SECTION 302 OF THE LABOR MANAGEMENT RELATIONS ACT AS EVIDENCED BY *TITAN TIRE*

DYLAN MOONEY*

In November 2013, the United States Court of Appeals for the Seventh Circuit held that the payments of full-time salaries to union representatives on leave from their previous employment were unlawful under Section 302 of the Labor Management Relations Act ("LMRA") in Titan Tire Corp. of Freeport, Inc. v. United Steel Workers. This decision overturned an arbitrator's award that had previously allowed payment of salaries to the union representatives. The majority found that the salaries of the representatives disproportionate to their previous salary, and thus, void against public policy. This decision directly opposes prior rulings by the Second, Third, and Ninth Circuits that allowed the payment of union representatives under Section 302 of the LMRA and creates a split among the circuits. This Comment argues that the Seventh Circuit's ruling in Titan Tire was arbitrary. It will apply a hypothetical scenario with two analyses; one analysis will allow compensation and the other will deny compensation. This Comment will discuss the implications of both analyses and will examine how the Titan Tire decision is contrary to the legislative intent of Section 302 of the LMRA.

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INTRODUCTION

This Comment addresses the recent circuit split concerning the interpretation of Section 302 of the Labor Management Relations Act ("LMRA") with regard to the payment of on leave union representatives. Furthermore, it discusses whether Section 302 of the LMRA allows a company to pay a full-time salary of a union representative, who on leave will represent a company and its employees. The Seventh Circuit has taken an approach that expressly disagrees with the Third Circuit in its application of Section 302 of the LMRA in *Titan Tire Corp. of Freeport,*

Inc. v. United Steelworkers.[1] The Seventh Circuit held that an arbitration award requiring the company to honor a contract provision for the payments of full-time union salaries of employees who took leave to hold local union office was void against public policy and directly violated Section 302 the LMRA.[2] Furthermore, the court concluded that the union representatives' compensation under the terms of the collective bargaining agreement was disproportionate with the officers' former employment so as not to come within the Section 302(c) exceptions clause for payments made "by reason of" former employment.[3] This Comment will apply two different approaches to a hypothetical issue under Section 302 of the LMRA and suggest which Circuit's interpretation, if any, should be accepted in consideration of the effects it will have on employers, employees, and their union representatives.

Part II of this Comment examines the enactment of the LMRA from its inception and the purposes for the enactment of the statute. This Section reviews a plain meaning analysis of both Section 302(a) and 302(c). The focus then shifts to the various interpretations of Section 302 of the LMRA. Several circuits have expressly allowed payments of full-time union representative salaries under the LMRA, such as the Second, Third, and Ninth Circuits.[4] A brief discussion of these decisions is examined, as these interpretations are in direct opposition of the Seventh Circuit's ruling.

Part III applies a hypothetical issue with two different approaches. The hypothetical scenario involves a company that is unionized and allows an employee to take a leave of absence in order to fulfill a full-time union representative position for the company. One approach involves the Third Circuit's reasoning and will allow compensation of the union representative under the LMRA. The second approach critiques the Seventh Circuit's reasoning and denies compensation of the representative because of the increase in pay as a violation of Section 302 of the LMRA. In light of this hypothetical analysis, this Comment discusses the benefits and drawbacks

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1. 734 F.3d 708 (7th Cir. 2013).

2. *See id.* at 712.

3. *See id.* at 720 (emphasizing the plain language of Section 302 of the LMRA does not encompass payments to union representatives "by reason of" their service to the company).

4. *Compare* BASF Wyandotte Corp. v. Local 227, 791 F.2d 1046, 1048 (2d Cir. 1986) (explaining that payments to union representatives do not violate the LMRA); *with* Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1054 (3d Cir. 1997) (noting that Section 302(c) of the LMRA may allow compensation to union representatives by the reason of the services they provide); *and* Int'l. Ass'n. of Machinists & Aerospace Workers v. BF Goodrich Aerospace Aerostructures Grp., 387 F.3d 1046, 1060 (9th Cir. 2004) (elaborating that a union steward who files grievances on behalf of a company's employees qualified his compensation as lawful under Section 302 of LMRA).

of the opposing interpretations of the hypothetical scenario.

Finally, Part IV explains that the Seventh Circuit interpretation in *Titan Tire* is contrary to prior case law and inconsistent with the legislative intent of Section of the LMRA and will have implications on future decisions involving payments to union representatives and whether they are unlawful under the LMRA.[5]

I. DEVELOPMENT OF THE REGULATION OF EMPLOYER PAYMENTS TO UNION WELFARE FUNDS

This Comment begins with a brief summary of the enactment of the LMRA as well as the specific language used in Section 302. The focus then shifts to the history of case law leading up to the *Titan Tire* decision.

A. LMRA Enacted to Combat Bribery and Coercion of Union Representatives

Senator Robert Taft and Representative Fred A. Hartley, Jr. sponsored the Labor Management Relations Act as a means of preventing bribery, extortion, and corruption of union representatives in 1947.[6] Prior to the LMRA, the National Labor Relations Act was enacted in 1935.[7] The LMRA amended the National Labor Relations Act and was met with much criticism, including a presidential veto by President Truman.[8] The LMRA,

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5. *See, e.g.*, Shane Faman, *Supreme Court Hears Union Organizing Case*, TALK RADIO NEWS SERV. (Nov. 14, 2013), http://www.talkradionews.com/supreme-court/2013/11/14/supreme-court-hears-union-organizing-case.html#.Utl3vnn0Ds0 (addressing a recent Supreme Court oral argument that was heard to determine if a ground-rules agreement between an employer and its union is a "thing of value" under the LMRA).

6. *See* 93 CONG. REC. 4678 (1947) (noting that Congress required specific definitions of payable benefits in order to prevent union members from being controlled for political purposes or for political gain).

7. *See, e.g.*, THOMAS R. COLOSI & ARTHUR ELIOT BERKELEY, COLLECTIVE BARGAINING: HOW IT WORKS AND WHY 12 (3d ed. 1997) (explaining that private sector employees had no protection for unions until the passage of the NLRA).

8. *Compare* Alexander Cockburn, *How Many Democrats Voted for Taft-Hartley?*, COUNTERPUNCH (Sept. 6, 2004), http://www.counterpunch.org/2004/09/06/how-many-democrats-voted-for-taft-hartley/ (reviewing how President Truman and others thought of the bill as nothing more than a "slave labor bill"), *with* Rich Yeselson, *Fortress Unionism*, DEMOCRACY: A.J. OF IDEAS (Summer 2013), *available at* http://www.democracyjournal.org/29/fortress-unionism.php (quoting President Truman as saying, the Taft-Hartley Act was "a shocking piece of legislation . . . is unfair to the working people of this country. It clearly abuses the right, which millions of our citizens now enjoy, to join together and bargain with their employers for fair wages and fair working conditions. Under no circumstances could I have signed this bill."), *and* SIDNEY M. MILIKIS & JEROME M. MILEUR, THE NEW DEAL AND THE TRIUMPH OF LIBERALISM, 139–40 (2002) (voicing the acting President of the Congress of Industrial Organizations (CIO) [before merging with the American Federation of Labor to

also known as the Taft-Hartley Act, regulates payments of employers to union representatives through Section 302 of the Act.[9] The purpose behind the enactment of the LMRA is three-fold and includes: (1) the proscription of rights of both employees and employers in a workplace relationship, (2) the promotion of orderly procedures involving the interference of the rights of either party as well as the protection of their individual rights, and (3) definition of labor practices on both the part of employees and management.[10]

B. Restrictions on Financial Transactions Involving Employers and Employees Within Section 302 of the LMRA

Section 302(a) of the LMRA states, "It shall be unlawful for any employer . . . to pay, lend, or deliver, or agree to pay, lend or deliver, any money or other thing of value . . . to any representative of any of his employees who are employed in an industry affecting commerce."[11] The language within the statute is broad and over-inclusive, which allows for a wide variety of regulation of monetary items that could pass from an employer to its employees.[12] The main focus of this legislation is to eliminate any thing of value being paid by the employer to a union representative in the form of a bribe.[13] Furthermore, because of the over-

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become the AFL-CIO], Phillip Murray, stated that if the Taft-Hartley Act was to become law it would bring a fascist control over men, women, and children in the United States).

9. *E.g.*, 29 U.S.C. § 186 (1994) (suggesting this statute specifically prohibits an employer from paying a representative of the employees to receive anything of value under Section (a) and (b)).

10. *E.g.*, 29 U.S.C. § 141 (1947); *see also* Arroyo v. United States, 359 U.S. 419, 426 (1959) (explaining the Congressional debates leading to the enactment of the LMRA were spearheaded by supporters of the bill who were concerned with the corruption of collective bargaining agreements through the bribery of employee representatives by their employers).

11. *See* 29 U.S.C. § 186 (1994) (noting the ambiguous language used in this provision such as "any money or other thing of value").

12. *Compare* Unite Here Local 355 v. Mulhall, 134 S. Ct. 594, 594 (2013) (acknowledging whether or not an employer violates Section 302(a)'s statutory language, specifically "a thing of value," when it promises to remain neutral in response to its union's efforts to organize its employees, that the union will be given access to areas of the employer's premises, and that the union will receive a list of employee names and contact information), *with* United States v. Ryan, 350 U.S. 299, 305 (1956) (asserting that Section 302 prohibits all payments between employer and a union representative unless it is categorized under the exceptions clause). *But see* Samuel Estreicher, *Freedom of Contract and Labor Law Reform: Opening Up the Possibilities for Value-Added Unionism*, 71 N.Y.U. L. REV. 827, 843 (1996) (asserting Section 302 of the LMRA was drafted overly broad so as to permit an increased freedom of contract for companies to pay the salaries of former employees who take a leave of absence in order to fulfill union roles).

13. *See, e.g.*, Toth v. USX Corp., 883 F.2d 1297, 1305 (7th Cir. 1989) (finding that

inclusiveness of the language used in the statute, exceptions are mentioned in Section 302(c) of the statute. Section 302(c) provides two general exceptions to the provisions listed in Section 302(a) and allows payments from an employer to an employee as compensation for, or by reason of, his or her service to their employer.[14] Section 302(a) essentially makes it unlawful for employers to make payments to a union representative who represents its employees, whereas Section 302(c) makes a general prohibition inapplicable if the representative is the employee and the compensation is "for" or "by reason of" his service under his employment.[15] The lack of boundaries given by the exceptions provision leaves the issue open for judicial interpretation as to what qualifies as an exception.[16]

The language used for the exceptions clause has led several courts to differing conclusions regarding the specific clauses of the statute.[17] Additionally, problems arise applying Section 302 when payments do not fit squarely into one of the exceptions listed.[18] Grey areas within the law lead to conflicting interpretations of what is covered.[19] A main contention of the Seventh Circuit's interpretation in *Titan Tire* involves the "by reason of" language and concludes that the salaries of the full-time union

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the payment at issue was suggestive of a bribe of union officials in order to agree to concessions in a contract negotiation).

14. *See* 29 U.S.C. § 186 (1994) (stating specifically that "any money or things of value . . . payable by an employer to . . . any representative of its employees, or to any officer or employee of a labor organization, who is also an employee or former employee such employer, as compensation for, or by reason of, his service as an employee of such employer").

15. *Compare* BASF Wyandotte Corp. v. Local 227, 791 F.2d 1046, 1048 (2d Cir. 1986) (holding "no-docking" provisions do not violate anti-bribery measures of the LMRA because they are "by reason of" services they may perform in the future), *with* Commc'ns Workers of Am. v. Bell Atl. Network Servs., Inc., 670 F. Supp. 416 (D.D.C. 1987) (recognizing the "by reason of" payments in Section 302 of the statute are fringe benefits owed to the employee because of the services they provide to their employer and must be compensated for).

16. *See BASF Wyandotte Corp.*, 791 F.2d at 1049 (describing the boundaries of the statute are not concrete, but logic suggests what is covered and what is not covered).

17. *See, e.g.*, Christopher J. Garofalo, *Section 302 of the LMRA: Make Way for The Employer-Paid Union Representative*, 75 N.Y.U.L. REV. 775 (2000) (arguing the difficulty courts face when interpreting clauses such as "as compensation for" and "by reason of").

18. *E.g.*, 93 CONG. REC. 4805 (1947) (clarifying Section 302(c)'s exemptions should be listed, but cannot be all inclusive); *see also* 29 U.S.C. § 186 (1994) (noting the statutory language of "by reason of" is purposefully broad so as to encompass various types of payments that are not considered compensation).

19. *See* Garofalo, *supra* note 17, at 789 (finding that both no-docking provisions and paid union leave fall into this category).

representatives are not covered under the LMRA.[20] This decision is in direct opposition to decisions by the Second, Third, and Ninth Circuits.[21] This Comment argues that the Seventh Circuit's interpretation is improper and should be rejected by other Circuits.

C. *Twenty-Seven Years of Precedent in Turmoil: Decisions Leading up to Titan Tire*

In *Caterpillar, Inc. v. UAW*,[22] the Third Circuit held that anti-docking provisions contained in the collective bargaining agreement and payments in dispute were considered within the scope and allowable under Section 302.[23] The court reasoned that the payments fit under the statutory language "by reason of" their past service of the employer, which is within the statutory language of the exceptions clause under Section 302(c).[24]

This case is factually similar to that of *Titan Tire*. In *Caterpillar*, the United Auto Workers and Caterpillar were both parties to a collective bargaining agreement since 1954.[25] From its inception until 1973, the agreement contained a "no docking" provision that allowed employees acting as union stewards to devote part of their day to processing union grievances without losing any wages or benefits.[26] Furthermore, in 1973 this provision was expanded to full-time union representatives so that they may devote their entire workweek to union business without losing their pay, as they were placed on leave.[27]

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20. *See, e.g.*, Titan Tire Corp. of Freeport, Inc. v. United Steelworkers, 734 F.3d 708, 725 (7th Cir. 2013) (distinguishing the salaries of union representatives have no firm connection to their prior services provided to their employer and are thus ineligible under the "by reason of" exception of Section 302).

21. *See BASF Wyandotte Corp.*, 791 F.2d at 1048 (allowing compensation of union representatives on leave under Section 302(c) they serve the company's interest); *see also* Int'l. Ass'n. of Machinists & Aerospace Workers v. BF Goodrich Aerospace Aerostructures Grp., 387 F.3d 1046 (9th Cir. 2004) (examining the individual's role as union steward required resolving employee grievances on behalf of the company and thus qualified him as an employee and allowed his compensation as lawful under Section 302 of LMRA).

22. 107 F.3d 1052 (3d Cir. 1997).

23. *See id.* at 1057 (suggesting these payments do not harm the collective bargaining process and do not violate Section 302).

24. *E.g.*, *id.* (suggesting the payments were legally sound payments under the exception).

25. *See id.* at 1054 (explaining that the bargaining agreement had been in place for over forty years at time of this suit).

26. *See id.* at 1053; *see also* Garofalo, *supra* note 17, at 778 (detailing this common practice that allows employer-paid union representatives to take time off during a regular workday to conduct union business and that employee not docked for any time spent working for the union).

27. *See Caterpillar, Inc.*, 107 F.3d at 1053 (clarifying that the representatives

A nationwide labor dispute led the workers to return to work without a labor contract.[28] A year later, Caterpillar questioned the legality of the payments to the union representatives and consequently refused to compensate them. The company brought a lawsuit seeking declaratory judgment that payments to the representatives is a direct violation of Section 302 of the LMRA.[29]

Analyzing the statutory language of 302(a) of the LMRA and the employee/employer relationship, the court held that the salaries of such union representatives would be unlawful on the face of the statute.[30] However, the exceptions provision of the statute allows payments to a representative as compensation or "by reason of" his services as an employee.[31] Therefore, the Third Circuit found the payments lawful and noted that language used in 302(c) legalizes such payments to current or former employees based on their "services" or "by reason of" their past services and not their status.[32] Similar rulings among the circuits allowed the compensation of union representatives albeit, with different reasoning.

The Second Circuit's analysis in *BASF Wyandotte Corp. v. Local 227*[33] allowed payments to union officials who were granted four hours paid time off per day in order to conduct affairs affiliated with official union business.[34] This case is factually similar to *Caterpillar* because it involves another no-docking collective bargaining agreement between an employer and union representatives.

The collective bargaining agreement between BASF and the union allowed representatives to attend meetings during their regularly scheduled working hours and allowed the compensation of the union representatives for the time spent at the meetings at their regular rate of pay.[35] Furthermore, it permitted the uUnion Ppresident and sSecretary to conduct

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conducted business from a union hall and were under no direct control of Caterpillar).

28. *See, e.g., id.* at 1054.

29. *See id.* at 1054 (reasoning this was a unilateral decision made by Caterpillar that resulted in the union filing an unfair labor charge with the NLRB).

30. *See id.* at 1054–55 (assuming that payments from an employer to an employee representative are unlawful under Section 302(a) of the LMRA).

31. *E.g., id.* at 1055 (noting this specific term differs from the other categories of payment listed as compensation in the statute).

32. *See, e.g., id.* at 1055–56 (referencing the legislative intent that certain payments would be legal even though they did not involve a service).

33. 791 F.2d 1046 (2d Cir. 1986).

34. *See id.* at 1050 (2d Cir. 1986) (explaining "no-docking" references that workers are not docked for pay while conducting union business).

35. *E.g., id.* at 1047 (suggesting that "no-docking" provisions are common amongst unionized workplaces).

union business for at least four hours each day.[36] In 1982, BASF implemented the position that Section 302 of the LMRA did not allow the compensation of the union representatives and would no longer compensate them aside from the time spent meeting with BASF management.[37] This ultimately led to the union filing an unfair labor practices charge against BASF alleging a unilateral repudiation of the no-docking provision.

The Second Circuit affirmed the district court's ruling that BASF was in violation of Section 302 of the LMRA, stating its employees' wages did not present an interference with the LMRA when they took time off to conduct union business at their regular rate of pay.[38] Furthermore, the court found Congress used the language in order to cover both wages and compensation that the employee has performed or will perform, but which is not directly for that work.[39] The court noted that this compensation does not directly have to benefit the employer, but focuses on whether the union representative is a bona fide employee of the payor.[40] Because fringe benefits are included in the exception of the LMRA and these benefits may directly benefit an employer; the more relevant aspect under the statute is that the person compensated by the employer is also the same individual who performs services for the employer.[41] Thus, the court concluded that a no docking provision is, therefore, no different than fringe benefits and should be a covered form of compensation under the LMRA Section 302(c) exception provision.[42] Other courts have reached the same conclusion

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36. *See id.* at 1047–48 (listing union business as meeting with management, investigating employee grievances, and preparing reports and lawsuits).

37. *See, e.g., id.* at 1047 (explaining the salaries were previously covered by the bargaining agreement for more than a year before management decided this compensation was in violation of Section 302 of the LMRA).

38. *See id.* at 1047–49 (expanding that a contractual obligation providing compensation for a union representative to take leave of up to four hours under a no-docking provision to conduct union business such as filing employee grievances is covered under the plain language used in Section 302(a) of the LMRA).

39. *See, e.g., id.* at 1049 (describing the latter category as fringe benefits such as vacation or sick pay).

40. *Compare id.* at 1050 (distinguishing the purpose behind the LMRA is to combat bribery and making sure an employee is being paid for performing work is the crux as to if payments qualify as either "by reason of" or "for compensation" the work performed), *and* NLRB v. BASF Wyandotte Corp., 798 F.2d 849, 858 (5th Cir. 1986) (elaborating that payments such as these are allowed under the LMRA for bona fide employees), *with* Garner v. Universal Machining Co., No. 01-A-01-9003-CH00115, 1990 WL 138985 at *6 (Sept. 26, 1990) (explaining that a bona fide employee is defined as a person employed by a contractor and subject to the contractors supervision and control with regard to time, place, and manner).

41. *See BASF Wyandotte Corp.*, 791 F.2d at 1049 (expanding that fringe benefits do not benefit an employer, but instead benefit society and this is similar to compensating representatives for serving their constituents).

42. *See, e.g., id.* at 1049 (showing "by reason of" payments under Section 302(c)

allowing the compensation of union representatives under the LMRA.

The Ninth Circuit allowed compensation of full-time union representatives on leave during the investigation and prosecution of union grievances in *International Ass'n of Machinists & Aerospace Workers, Local 964 v. BF Goodrich Aerospace Aerostructures Group* ("*Goodrich*").[43] Goodrich and the union entered into a longstanding collective bargaining agreement that allowed members of the union to elect a chief steward, who drew his salary and benefits while working primarily on the investigation and prosecution of union grievances for the union members.[44]

While on duty as the union representative, the steward volunteered for overtime maintenance work assignments on several occasions, but was always denied by Goodrich.[45] The steward then filed a grievance alleging that Goodrich's refusal to assign him overtime hours violated the bargaining agreement.[46] An arbitration hearing held on the matter determined that Goodrich's actions violated the agreement and required it to make the union representative whole.[47] Goodrich then filed suit in the Central District of California to vacate the arbitration award on the grounds that it violated the LMRA.[48]

The Ninth Circuit adopted a plain meaning approach where Section 302(a) prohibits the payments at issue and Section 302(c) establishes a number of exceptions to the rule.[49] The court agreed with the Second

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imply a service that is or will be performed by an employee, but is not payment directly for said service and is considered a form of fringe payment).

43. 387 F.3d 1046 (9th Cir. 2004).

44. *See id.* at 1047–48 (9th Cir. 2004) (believing the chief steward's essential role includes monitoring Goodrich's compliance with the collective bargaining agreement with the union); *see also* Garofalo, *supra* note 17 (embracing that union stewards play a vital role by enforcing the rights of unionized employees in the workplace and protecting the employers from violating laws).

45. *See, e.g., Int'l. Ass'n of Machinists & Aerospace Workers*, 387 F.3d at 1048 (suggesting the requests were outside the scope of his union duties, but were voluntary and would minimize the cost of Goodrich contracting the work out to subcontractors).

46. *E.g., id.* at 1048.

47. *See, e.g., id.* at 1048 (voicing that Goodrich violated the bargaining agreement by denying the steward's attempted requests for overtime work, even though he had retained his former classification as a maintenance mechanic and was thus qualified to perform).

48. *See id.* at 1048 (observing that Goodrich requested a declaratory judgment voiding portions of the bargaining agreement requiring to pay salary and benefits because they were unlawful under the LMRA).

49. *See, e.g., id.* at 1056; *see also* Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1058 (3d Cir. 1997) (Mansmann, J., dissenting) (discussing that Section 302(c)'s "by reason of" language may entitle one to receive payments from their employers that arise from their services provided, but not do not fit under the classification of "as compensation

Circuit and found the statutory language "by reason of" as a designation of alternative forms of compensation other than salaries, such as medical leave, and was specifically done so by Congress.[50] Then the court focused on whether or not the chief steward provides a service to Goodrich. The court further elaborated that although the representative does not operate machinery like other workers, but does play a vital role in enforcing terms of the bargaining agreement and resolving disputes between laborers and management.[51] Thus, the court concluded that the steward's role primarily involved resolving conflicts between the parties, the role required him to avoid expensive litigation and promote efficiencies of the workflow, and this role was traceable to the services he provided to Goodrich and allowed under Section 302(c) of the LMRA.[52]

D. Titan Tire: Union Representatives Salary Not Covered Under the Section 302 Exceptions Clause

The Seventh Circuit's ruling in *Titan Tire*[53] directly conflicts with the Second, Third, and Ninth Circuits' ruling allowing the compensation of full-time union representatives on leave under the exceptions clause of the LMRA.[54] This case is factually similar to the rest of the cases analyzed in this Comment, yet the Seventh Circuit reaches an opposite conclusion.[55] This Comment argues that the Seventh Circuit's will lead to many inconsistencies, and therefore, should be rejected by other courts.

Titan Tire Corporation ("Titan") purchased a tire manufacturing business in December 2005 and entered into a number of collective bargaining

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for" as required Section 302(c) of the LMRA).

50. *See Int'l. Ass'n of Machinists & Aerospace Workers*, 387 F.3d at 1056–57; *see also* United States v. Phillips, 19 F.3d 1565, 1575 (11th Cir. 1994) (suggesting that Congress prohibited two types of payments under this statute, wages and other forms of payment that are not classified as compensation).

51. *E.g.*, *Int'l. Ass'n of Machinists & Aerospace Workers*, 387 F.3d at 1057; *see also* NLRB v. J. Weingarten, Inc., 420 U.S. 251, 261–62 (1975) (insisting the roles performed by union representatives serve employers interests more often than not).

52. *See Int'l. Ass'n of Machinists & Aerospace Workers*, 387 F.3d at 1057–58 (establishing that union representatives working under a bargaining agreement provide a number services that are both beneficial to the unionized employees as well as the company).

53. 734 F.3d 708 (7th Cir. 2013).

54. *See, e.g.*, *id.* 711–12 (examining other courts have allowed union representatives' compensation under Section 302 of the LMRA, but when the payment becomes inconsistent with their previous salary that is does not qualify); *see also* Toth v. USX Corp., 883 F.2d 1297, 1305 (7th Cir. 1989) (accepting that compensation that is disproportionate with the union representatives' previous pay is unlawful under the LMRA).

55. *See Titan Tire Corp.*, 734 F.3d at 720 (concluding payments such as these violated Section 302 of the LMRA).

agreements with Local 745, which was responsible for representing employees of Titan.[56] Initially, Titan paid the salaries of both the President and Benefit Representative who were on leave from the Titan facility and worked at other locations on union matters.[57] Almost three years later, Titan informed the union that it would no longer be paying the representatives as it was in direct violation of Section 302 of the LMRA because the union representatives within Local 745 represented both the workers at the Titan facility *and* a local school district.[58] Furthermore, the salaries of the union representatives were illegal because the President and Benefits Representative were not working full-time at the Titan center and were not under Titan's control.[59]

The union filed a grievance against Titan, arguing that Titan was in violation of its various labor agreements and the payments to the union representative were lawful under Section 302(c) of the LMRA "by reason of" their service provided to the employees of Titan as union representatives as well as former employees of the company..[60] An arbitrator agreed and found that Titan made the salary payments "by reason of" their former employment with Titan and ordered the employer to resume payment of the representative's full-time salaries.[61] Titan filed suit in federal district court to vacate the arbitrator's award and the union counterclaimed for the enforcement of the award.[62] The district court

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56. *See, e.g., id.* at 710.

57. *E.g., id.* at 715 (elaborating the president of the union would physically work out of the Titan plant on union business for a total of four hours a week and the other representative covered the remaining three days of shifts at the Titan facility).

58. *See id.* at 710–11 (emphasizing Titan was not solely responsible to pay the salaries if these individuals were responsible for filing grievances on behalf of other employers).

59. *Compare id.* at 710–11 (noting that Titan was not responsible for these payments as they were not full-time employees and not under Titan's control), *with* Trailways Lines, Inc., v. Trailways Inc., 785 F.2d 101, 106 (3d Cir. 1986) (detailing Section 302(c)(5) does not allow compensation to former employees while on leave because they are former employees and not under the employer's control). *But see* Int'l. Ass'n of Machinists & Aero. Workers v. BF Goodrich Aerospace Aerostructures Grp., 387 F.3d 1046, 1059 (9th Cir. 2004) (rationalizing the law of agency determines who qualifies as an employee and a number of factors such as location of the work and duration of the relationship can determine this).

60. *E.g., Titan Tire Corp.*, 734 F.3d at 713; *see also* 29 U.S.C. § 186(c)(1)-(2) (1994) (stating that this exception allows any money or thing of value payable by an employer to a representative of his employee or any officer of an labor organization that is a former employee of such an employer).

61. *See Titan Tire Corp.*, 734 F.3d at 711 (announcing that Titan violated their collective bargaining agreement when it stopped paying the salaries the men were entitled to as former Titan employees and the payments did not violate the LMRA because these payments fit under the "by reason of" the services they provided).

62. *Compare* Prate Installations, Inc. v. Chi. Reg'l. Council of Carpenters, 607

granted the union's motion enforcing the arbitrator's decision and allowing compensation of the union representatives, which Titan appealed to the Seventh Circuit.[63]

The Seventh Circuit overturned the arbitrator's award holding this interpretation of the collective bargaining agreement violated public policy, and therefore, should not be implemented.[64] It reasoned that an interpretation is in direct violation of public policy if it goes against a statute or other positively treated law and an arbitrator lacks the authority to violate a positive law.[65] The majority then addressed the union's argument that the union representatives' salaries are within the limits of the "by reason of" exception of 302(c) and thus, supported by *Caterpillar*.[66]

Looking toward the plain meaning of the statute, the Seventh Circuit's majority found that "by reason of" recognizes that both current and former employees have a right to receive payments from their employers when they provide a service for their employer; yet this payment is not classified as compensation but rather as a fringe benefit such as pensions, life insurance, or jury duty.[67] The main focus of this analysis requires that

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F.3d 467, 470 (7th Cir. 2010) (enunciating "Judicial review of arbitration awards is extremely limited."), *and* W.R. Grace & Co. v. Local Union, 759, 461 U.S. 757, 764 (1983) (inferring that a court cannot enforce a bargaining agreement that is contrary to public policy, but an arbitrator award that is contrary to public policy may be decided by the courts), *with* Daniel A. Farber, *Statutory Interpretation and Legislative Supremacy*, 78 GEO. L.J. 281 (1989) (arguing the judiciary is subordinate to legislatures in making public policy and thus have limited roles in the interpretation of statutes in ways that execute notions of public policy).

63. *See Titan Tire Corp.*, 734 F.3d at 711 (articulating any payments to the President or Benefits Representative of the union were exempt from the general provision of the Labor Management Relations Act).

64. *See id.* at 712; *see also W.R. Grace & Co.*, 461 U.S. at 764 (stating a federal court may only overrule an arbitrator's decision which does not comport with the collective bargaining agreement).

65. *E.g.*, *Titan Tire Corp.*, 734 F.3d at 716–17 (7th Cir. 2013) (emphasizing the clearest form of public policy involves an apparent violation of a statute or law (citing EEOC v. Ind. Bell Tel. Co., 256 F.3d 516 (7th Cir. 2001))).

66. *See id.* at 719; *see also* Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1054 (3d Cir. 1997) (explaining a union grievance chairman could not be compensated under Section 302(a)'s general prohibitions, but based on Section 302(c)'s exceptions clause would allow compensation by the reason of the services they provide to their employer such as filing grievances).

67. *See Titan Tire Corp.*, 734 F.3d at 720–21 (discussing that paying a former employee a salary to do a completely separate job is completely different). *But see* United States v. Phillips, 19 F.3d 1565, 1575 (11th Cir. 1994) (suggesting fringe benefits such as sick and vacation pay are allowed under the "by reason of" language); BASF Wyandotte Corp. v. Local 227, 791 F.2d 1046, 1049 (2d Cir. 1986) (concluding that "by reason of" payments include paid leave for jury duty or military leave and other similar forms of leave).

these payments come from the service that the employee performs.[68] Furthermore, the plain meaning of the language "by reason of" is similar to "because of," thus when an employee provides a service for his employer, he is entitled to compensation or payment because of the service performed for the employer.[69]

Using this line of analysis, the majority held that the salaries of the union representatives did not fit within the bounds of Section 302(c) and its statutory language because the representatives were former employees of Titan and provided a service to both the school district and Titan employees.[70] This meant that Titan did not receive a direct benefit from the representatives due to the splitting of delegations between the two organizations. Therefore, Titan was not required to compensate them for the services provided as the representatives were not under Titan's control, nor did Titan technically employ them.[71] Furthermore, the annual salary of the President of the union was $80,000 and the Benefit Representative was paid $50,000 annually. Thus they would not qualify as payments "by reason of" their former employment at Titan because the respective salaries paid to these individuals were so incommensurate with their previous salary and would not qualify under the collective bargaining agreement or Section 302(c) of the LMRA as evidenced in *Toth v. USX Corp.*[72] Under the Seventh Circuit's analysis, compensation of full-time union representatives does not qualify under Section 302(c) of the LMRA if the services provided do not exclusively benefit the employer and the payment "by reason of" the representative's service is incommensurate with his previous wages.[73]

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68. *See Titan Tire Corp.*, 734 F.3d at 711 (explaining the services provided by the union representatives is more applicable to the union rather than services provided to Titan's employees).

69. *E.g.*, *id.* at 720–21 (recognizing the union representatives receive their salaries because of the services they provide to the union, which includes both Titan employees and members of the local school district and thus makes their salaries compensation unlawful under Section 302).

70. *See id.* at 715 (insisting the union representatives have limited hours when they work within the Titan facility).

71. *See, e.g.*, *id.* at 729 (arguing the representatives may have been assisting individuals with retirement and health insurance benefits as well as aiding individuals laid off in obtaining unemployment benefits, but they were also benefitting workers from the school district and thus were ineligible for compensation from Titan).

72. *See* Toth v. USX Corp., 883 F.2d 1297, 1305 (7th Cir. 1989) (extrapolating a collective bargaining agreement can be agreed upon by both sides, but also be void against public policy based upon the agreed upon terms).

73. *E.g.*, *Titan Tire Corp.*, 734 F.3d at 712 (concluding that the union representatives' compensation is "by reason of" their service to the union, which includes both Titan employees as well as employees of the local school district).

II. *TITAN TIRE* GIVES RISE TO A HYPOTHETICAL SCENARIO THAT COULD ALLOW COMPENSATION OF UNION REPRESENTATIVES UNDER THE LMRA

This Comment now shifts toward a hypothetical scenario involving a company that is unionized and allows an employee to take a leave of absence in order to fulfill a full-time union representative position for the company. One approach will allow compensation of the union representative and the other will not. In light of this hypothetical analysis, this Comment discusses the benefits and disadvantages of the opposing interpretations of the scenario.

A. Testing the Boundaries: A Hypothetical Approach to Section 302 of the LMRA

This Comment argues that the Seventh Circuit's conclusion is inconsistent with prior decisions regarding the compensation of on-leave union representatives, which previously have been within the limits of Section 302(c) of the LMRA. This decision does not fit within the scope of the statute.[74] If Congress intended to differentiate which forms of payments are excluded from Section 302(a) in the exceptions clause, it would have explicitly done so.[75] As noted in Justice Woods' dissent, the law must be applied as written.[76] Moreover, there is a standard of review that must be followed with regard to an arbitrator's award that was

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74. *See id.* at 731 (Wood, J., dissenting) (asserting that the majority attempts to distinguish salary from other fringe benefits, but the statutory language makes no distinction); *see also* 29 U.S.C. § 186 (1994) (saying the only language similar to this differentiation is the language "thing of value"). *But see* Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1054 (3d Cir. 1997) (explaining when an employer is in an industry that affects commerce and the union members are representatives for their employees, payment to these representatives is unlawful on the face of the statute, but if the representatives receive compensation "by reason of their service as employees" then the payments are allowable under Section 302 of the LMRA).

75. *Compare Titan Tire Corp.*, 734 F.3d at 731 (Wood, J., dissenting) (arguing specifically that the union members were employees of Titan and were receiving money from Titan in the form of salaries and fringe benefits that were by reason of their services as former employees, yet the majority does not see these fringe benefits as "something of value" as required under Section 302 of the LMRA), *and* 29 U.S.C. § 186(c) (1994) (reviewing the exceptions listed within the statute deal with employer-paid payments, employer-backed trust funds, payments to satisfy judgments, payments of union dues, payments to labor management committees, and payments involving the sale of goods and services at the market price), *with* 93 CONG. REC. 4678 (1947) (arguing the only form of payments that were expressly outlawed by the legislature involved payments from an employer to an employee that were used to coerce or bribe the employee, yet the exceptions to the statute were drafted broadly).

76. *See, e.g.*, *Titan Tire Corp.*, 734 F.3d at 730 (Wood, J., dissenting) (eluding to the fact that Congress expressly included the exceptions clause of Section 302 to take other payments into consideration).

disregarded by the majority in their decision in *Titan Tire*.[77] The majority's disapproval of the arbitrator's award is cloaked behind an analysis that finds that arbitrators cannot legally order the parties to commit an illegal act.[78] There is still much debate about whether the salaries of full-time union representatives are lawful under the LMRA and have left employers to review any arrangements due to the fact that *Titan Tire* is considering controlling law in some jurisdictions.[79]

Next, this Comment introduces a hypothetical scenario with two possible approaches with regard to the compensation of on-leave union representatives. One analysis will allow the union representative's compensation as lawful under the LMRA and the other analysis considers the payment unlawful under the statute. The consequences of each interpretation is analyzed with regard to the effect that is placed on both employers and employees.

While the cases analyzed in this Comment do have similar fact patterns, each individual case seems to come to a different outcome with varying analyses.[80] There are a number of basic conditions that must be included,

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77. *Compare id.* at 731 (explaining that the majority's decision is improper and the case should be set aside before an en banc court), *and* Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064, 2068 (2013) (arguing that an arbitral award must be upheld even if a court is in disagreement with the outcome), *with* Brentwood Med. Assocs. v. United Mine Workers of Am., 396 F.3d 237, 243 (3d Cir. 1989) (explaining that the task of an arbitrator is to interpret the issue at hand and to enforce a contract. When he makes a good faith attempt to do so, even serious errors or omissions of law or specific facts will not subject his award to being vacated).

78. *Compare* EEOC v. Ind. Bell Tel. Co., 256 F.3d 516, 524 (7th Cir. 2001) (en banc) (embracing that an arbitrator cannot bind the parties to a decision that is in direct violation with a positively treated law), *and* Stolt-Nielsen v. AnimalFeeds Int'l. Corp., 559 U.S. 662, 671 (2010) (concluding a court cannot overrule an arbitral award even if the court feels the arbitrator has made an improper interpretation of the law), *with* 9 U.S.C. § 10 (2012) (explaining that Section 10(a)(4) of the Federal Arbitration Act states that, "[T]he United States court in and for the district wherein the award was made may make an order vacating the award upon application of any party to the arbitration . . . where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made").

79. *See* Courtney Kleshinski, *Employer Payment of Union Officials' Salaries Held Unlawful*, LAVELLE LAW, LTD. (Dec. 16, 2013), http://lavellelaw.com/employment/employer-payment-of-union-officials-salaries-held-unlawful (clarifying an appeal could change Titan's current control over the law, but until then, states within the Seventh Circuit's jurisdiction such as Illinois, Indiana, and Wisconsin could be affected by this decision).

80. *Compare* Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1053 (3d Cir. 1997) (allowing union representatives to take part time leave and to receive compensation under the LMRA), *and* Int'l. Ass'n of Machinists & Aerospace Workers v. BF Goodrich Aerospace Aerostructures Grp., 387 F.3d 1046 (9th Cir. 2004) (allowing compensation to a union representative because the duties he serves provide a direct benefit to his former employer). *But see Titan Tire Corp.*, 734 F.3d at 708 (denying

which could give rise to a claim between the union and the employer and includes: (1) some form of collective bargaining agreement between the two parties that dictate the roles and scope of the relationship between the employer (or management) and the union,[81] (2) the employer must initially compensate the union representative,[82] and (3) some form of causation where the employer ultimately refuses to pay the union representative for the services they have performed.[83] When these three elements are fulfilled, the union representative will be allowed to file a grievance with the union under Section 302 of the LMRA.

Consider the following hypothetical situation that could lead to a claim brought by a union against an employer refusing to pay the salaries of on-leave full-time union representatives as it is in direct violation of Section 302 of the LMRA: On December 20, 2010 Smith Corporation, a manufacturer of widgets and cogs, purchased a manufacturing plant in Middleburg, Michigan. In January 2011, Smith Corp. entered into a series of labor agreements with Local 113, a union that represented the Smith Corp. workers. The agreements between Smith Corp and the union consisted of a collective bargaining agreement between the two parties. Originally, the bargaining agreement between the two parties contained a "no-docking" agreement allowing the employees who were union stewards to work a portion of their workday on processing employee union grievances without losing pay, benefits, or full-time status.[84] The other half

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full-time compensation to representatives on leave as being unlawful under the LMRA when these individuals serve different groups of workers in different workplaces).

81. *See, e.g., Caterpillar, Inc.*, 107 F.3d at 1053 (reasoning that a collective bargaining agreement had been in place for nearly twenty years without conflict); *see also Collective Bargaining*, AFL-CIO, http://www.aflcio.org/Learn-About-Unions/Collective-Bargaining (last visited Feb. 22, 2015) (demonstrating the collective bargaining process involves working people acting through their unions as a means to negotiate labor contracts with the employers in order to determine specific conditions of their employment such as pay, benefits, hours, leave, fringe benefits, as well as developing a work-life balance).

82. *See, e.g., Titan Tire Corp.*, 734 F.3d 708, 710 (7th Cir 2013) (extrapolating Titan Tire purchased the tire manufacturing facility in 2005, entered into labor agreements with Local 745 the following year, and then proceeded to pay the union representation for three consecutive years before refusing to pay the salaries of the representatives).

83. *See, e.g.*, BASF Wyandotte Corp. v. Local 227, 791 F.2d 1046, 1047 (2d Cir. 1986) (observing the union in question was the sole collective bargaining representative from the mid 1940's until 1982 when the company refused to compensate union members while on leave); *see also* Toth v. USX Corp., 883 F.2d 1297, 1298–99 (7th Cir 1989) (permitting USX employees to accrue pension-benefits rights while they were on a leave of absence from active employment for years prior to making changes to the policy in 1984 stating that such policies were in violation of the LMRA).

84. *See Caterpillar, Inc.*, 107 F.3d at 1053 (establishing that no-docking

of their day was devoted to normal manufacturing work. This arrangement was successful for the parties for a number of years.

In April 2013, the bargaining agreement was expanded to allow the union's president, a full-time employee, to devote his or her entire workday to union business without pay or full-time employment status by Smith Corp.[85] The union representative, who is elected by a majority of the union members, receives a pay increase of $10,000 for his services and is placed on a leave of absence during his one-year commitment to the union. Furthermore, the president also represents a local bargaining unit of firefighters in the district. While working as the union president the representative conducts only union business, performs no manufacturing duties for Smith Corp., and is not under control of Smith Corp. The president spends four days per week at the Smith Corp. office and one day per week at the Middleburg Fire Station to address union grievances.[86]

Things went smoothly for several months, but in December 2013, Smith Corp. informed the union that it would no longer pay the salaries of the full-time union representatives. Smith Corp. claimed it was in direct violation of the LMRA because the union president did not solely represent Smith Corp's workers and claimed the union president did not work full-time at the Smith Corp. facility.[87]

In the above scenario, the three required elements are met. The collective bargaining agreement between Smith Corp. and Local 113 governs the scope and representation of the two parties. The agreement is violated when Smith Corp. refuses to compensate the full-time union

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provisions such as this are a typical provision of collective bargaining agreements in unionized workplaces); *see also* Phillip Landau, *Can an Employer Dock My Pay?*, THE GUARDIAN WORK BLOG (Aug. 10, 2013), http://www.theguardian.com/money/work-blog/2012/aug/10/can-employer-dock-pay (discussing that wages can be deducted when employees arrive late, for instance, but no extra penalties or deductions should be made to an employee unless there are specific provisions for any deductions in one's employment contract or else the additional docking of pay would amount to unlawful deductions protected against under the Employment Rights Act of 1996).

85. *E.g.*, *Caterpillar, Inc.*, 107 F.3d at 1053 (repeating the workers on leave are not docked for the work they are missing while conducting union business); *see also* Gilbert E. Dwyer, *Employer-Paid "Union Time" Under the Federal Labor Laws*, 12 LAB. L.J. 236, 236 (1961) (extrapolating the results of a survey of collective bargaining agreements showing it has been a common practice for decades for employers to allow former employees fulfill roles of union representatives by gradually performing less work and spending more and more times on filing union grievances).

86. *See, e.g.*, *Titan Tire Corp.*, 734 F.3d at 715 (acknowledging that the union representative spends hours at multiple work sites in order to file grievances for employees from both workplaces).

87. *E.g.*, *id.* at 710 (implying the union representative receives a full-time salary because of the work he provides for representing the union, but not from his previous employment at Smith Corporation).

president and gives rise to a grievance on behalf of the union. Using facts from this scenario, this Comment will now apply two different tests. One will allow compensation of the union president and the other will be similar to that of the Seventh Circuit's ruling in *Titan Tire*.

B. Under a Caterpillar Analysis, a Full-time Union Representative's Compensation is Allowable Under Section 302(c) of the LMRA

Section 302(c) of the LMRA allows payments when union members receive compensation "by reason of" their current or former services provided as employees.[88] The compensation of the union president should be allowed under Section 302 because Smith Corp is receiving a benefit from the union representative's service. Furthermore, "no-docking" provisions are lawful under the LMRA and it is beneficial for the corporation to have a union representative in the long-term.[89]

The union president, while on leave, is still an employee of Smith Corp. He is providing a service to Smith Corp, which provides the company with a benefit, and thus, he should be compensated for the services provided. This is a requirement under the collective bargaining agreement between both Smith Corp. and its union representatives.[90] Additionally, the president was being compensated for his role and services provided to Smith Corp., hence why it continued to pay him while he assumed the role and filed union grievances on behalf of Smith Corp. workers.[91] This analysis aligns with the Third Circuit's rejection of its prior precedent in *Trailways Lines, Inc. v. Trailways, Inc., Joint Council of Amalgamated Transit Union*,[92] which stated that the Section 302(c)

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88. *See Caterpillar, Inc.*, 107 F.3d at 1054 (maintaining payments for services "by reason of" ones former employment are allowed under Section 302 the LMRA); *see also BASF Wyandotte Corp.*, 791 F.2d at 1046–47 (holding that a collective bargaining agreement allowing chemical workers time off with pay for the purpose of conducting business related to union matters other than direct meetings with management are allowable under Section 302(c) of the LMRA).

89. *E.g.*, BERTRAM R. CRANE & ROGER M. HOFFMAN, SUCCESSFUL HANDLING OF LABOR GRIEVANCES 3–5 (1956) (arguing when management allowing union representatives to take a leave of absence for either a part of the day or on a full time basis to conduct union grievances for fellow employees, the employer will mutually receive benefits such as harmonious relations between employees and efficiencies in workplace productions).

90. *See, e.g., id.* at 110–14 (1956) (examining typical clauses used when drafting a provision for compensation to union representatives for filing grievances on during the regular workday).

91. *See Caterpillar, Inc.*, 107 F.3d at 1054 (observing Section 302 of the LMRA says union officials are representatives under terms of their employment).

92. 785 F.2d 101 (3d Cir. 1986).

exception does not apply to union representatives who are not under direct control of their employer and goes against the legislative intent of the statute.[93] Section 302 of the LMRA does not designate or differentiate the status of employees when it discusses the legality of payments to current or former employees, but instead focuses on the services provided by employees.[94] The union is representing Smith Corp. workers on union grievances, meeting with management to facilitate discussions between the two parties, and filling out grievance paperwork. All of these actions directly benefitted Smith Corp and its employees.[95]

Collective bargaining agreements, like the one between Smith Corp. and Local 113 will almost exclusively contain "no docking" provisions or allow a full-time union representative to take leave to represent aggrieved workers on behalf of the employer.[96] The initial collective bargaining agreement between Smith Corp. and its employees contained a no- docking provision, which was later amended to allow the president to work full-time while conducting the union's business.[97] Agreements between parties are not entered into without full consideration by both sides. Therefore, it seems likely that the two sides would have discussed all of the terms and conditions of the agreement when it made the amendment in April 2013, including any clauses discussing leaves of absences and compensation.[98] Given the fact that Smith Corp. agreed to allow the president to work full-time as a union representative and receive compensation for these services, it seems unethical and unfair to allow Smith Corp. to back out of their side of the bargain. Additionally, no-docking provisions and paid union leave provisions have been historically covered under Section 302 of the

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93. *See id.* at 106–07 (3d Cir. 1986) (reasoning that employers who lack control but receive a benefit from the representative must compensate the union representative).

94. *See Caterpillar, Inc.*, 107 F.3d at 1055 (declaring these men provide services such as handling grievances and other labor matters).

95. *E.g.*, BASF Wyandotte Corp. v. Local 227, 791 F.2d 1046, 1047 (2d Cir. 1986) (emphasizing that no-docking provisions allow representatives of the union to attend meetings and conduct union business during scheduled working hours).

96. *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, BULL. NO. 1425-19, MAJOR COLLECTIVE BARGAINING AGREEMENTS: EMPLOYER PAY AND LEAVE FOR UNION BUSINESS 6 (1980) (distinguishing that more than 80% of collective bargaining agreements contain no- docking provisions that allow employees to conduct union business during the workday).

97. *E.g.*, Titan Tire Corp. of Freeport v. United Steelworkers, 734 F.3d 708, 718 (7th Cir. 2013) (assessing the trend that many unionized workplaces started with a no-docking provision and then slowly progressed into allowing union representatives to take a leave of absence in order to fulfill employee grievances on a full-time basis).

98. *See* COLOSI & BERKELEY, *supra* note 7, at 1 (defining collective bargaining as a process that affords the parties the opportunity to exchange promises and commitments in order to reach agreement).

LMRA.[99] Provisions such as these are beneficial to both management and to union representatives and are a vital part of the collective bargaining agreement between the parties.[100]

Finally, it is beneficial for management to have a liaison between the aggrieved worker and itself, which is the president's role in this hypothetical.[101] Union representatives are involved in the initial steps of filing a complaint, all the way through resolution of grievances, and contract negotiations.[102] Having one individual taking part throughout the entire process will not only ease the grieving worker, but also may bring a resolution quicker than if only management was involved in a dispute with an employee.[103] Union representatives will disseminate valuable information and guidance, and will be a vast resource for the workers.[104] Furthermore, management will save money in the long run by resolving the

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99. *E.g.*, 29 U.S.C. § 186(c)(1) (1994) (indicating the specific language in the Labor Management Relations Act includes current or former employees).

100. *Compare* CRANE & HOFFMAN, *supra* note 89, at 92 (arguing that management learns of the concerns of their employees and allows union representatives to advocate for their client), *with* Teresa J. Tsuchida, *Unions and Management: A Blissful Marriage?*, GALLUP BUS. J. (Mar. 9, 2006), http://businessjournal.gallup.com/content/21727/unions-management-blissful-marriage.aspx#1 (when management and union members work together the partnership that develops between the groups improve the environment of the workplace and allows both sides to feel as if they have "won."), *and* ALLYNE BEACH & LINDA KABOOLIAN, WORKING FOR AM. INST., WORKING TOGETHER: A PRACTICAL GUIDE FOR UNION LEADERS, ELECTED OFFICIALS, AND MANAGERS TO IMPROVE PUBLIC SERVICES 5 (2005), *available at* http://www.law.harvard.edu/programs/lwp/Working%20Better%20Together.pdf (articulating that when union representatives and management work together in a collaborative way they will yield important results and will lead to more creative and empowered work forces as well as higher quality and efficiency).

101. *See* Garofalo, *supra* note 17 at 778–79 (expanding how the employee acting as a union representative acquires knowledge of workers' concerns and problems which is beneficial to both parties involved, including the employer).

102. *E.g.*, Garofalo, *supra* note 17 at 780–81 (expanding on the idea that union representatives are one of the main sources in which employees receive information regarding labor rights and other union affairs); *see also The Steward's Role*, THE PROF. INST. OF THE PUB. SERV. OF CAN., http://www.pipsc.ca/portal/page/portal/website/slc/sdev/role (last visited Feb. 22, 2015) (indicating the role of union grievance representatives is to facilitate communication of policies, advise employees of their rights under bargaining agreements, and attend consultation meetings with management to promote healthy relationships between the parties involved in labor disputes).

103. *See, e.g.*, HERMAN ERICKSON, THE STEWARD'S ROLE IN THE UNION AND A HISTORY OF AMERICAN UNIONS 82 (1971) (highlighting that workers look to the representatives for information and direction).

104. *See* Garofalo, *supra* note 17, at 781 (noting union representatives use their knowledge and past experience with workers and management to help resolve grievances); *see also* CRANE AND HOFFMAN, *supra* note 89, at 225 (explaining that one of the main roles of the union representative is to file grievances on behalf of the employees its represents, which includes determining the legitimacy of an employee's claims).

issues earlier and avoiding litigation.[105] It is also an industry standard of many organizations involved in settlement negotiations that all members of management receive additional compensation in order to acknowledge their contribution to the success.[106] If the industry standard allows additional compensation for management based on the efficiency of negotiated union settlements, it seems unethical to deny compensation to a union representative for bringing about a quick settlement.[107] Thus, the union president should be recognized as both an advocate for his client and an effective negotiator with management.[108] These dual roles will ultimately save Smith Corp. from litigation, will provide a service and a benefit to the company, and should prompt compensation from Smith Corp. for the beneficial services provided by the union representative.[109]

C. Under a Titan Tire Analysis, a Full-time Union Representative's Compensation is Unlawful Under Section 302(c) of the LMRA

Congress enacted Section 302 of the LMRA in order to prevent bribes and conflicts of interest in the workplace.[110] This statute allows payments "by reason of" services provided to one's employer under Section 302's exceptions provision, but does not allow compensation when an individual: (1) represents more than one group of employees, (2) does not work out of the employer's main place of business, and (3) is not under direct control of the employer on a daily basis.[111] Thus, using the same logic as the Seventh

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105. *See, e.g.*, TERRY L. LEAP, COLLECTIVE BARGAINING AND LABOR RELATIONS 200 (2d ed. 1995) (observing most grievances can be quickly resolved through conversations between union members and a member of management thus preventing drawn out disputes).

106. *See* COLOSI & BERKELEY, *supra* note 7, at 8 (establishing how this common practice will serve as an incentive to settle disputes between the parties).

107. *See* CRANE AND HOFFMAN, *supra* note 89, at 223–25; *see also* WALT BAER, LABOR UNION REPRESENTATIVES: ALLOWED AND PROHIBITED PRACTICES, 43 (1992) (discussing the underlying purpose of grievance procedures is for a prompt and expeditious resolution between the parties).

108. *See* Garofalo, *supra* note 17, at 780 (reasoning that union representatives fill the vital role of investigating an employee's claim and attempting to produce an informal resolution to the problem by bringing it to management).

109. *See* Garofalo, *supra* note 17, at 779–80 (explaining that allowing a former employee to fill the role of union representative benefits both the other employees by fulfilling their grievances and represents an efficient means to settle disputes for his employer).

110. *See, e.g.*, Garofalo, *supra* note 17, at 789. (listing specific examples that are prohibited by the statute); *see also* Arroyo v. United States, 359 U.S. 419 (1959) (articulating the primary concerns that led Congress to enact the LMRA was corruption within workplace collective bargaining agreements involving both the bribery of employees by management as well as the abuse of union funds by union officials).

111. *E.g.*, Titan Tire Corp. of Freeport v. United Steelworkers, 734 F.3d 708, 712 (7th Cir. 2013) (announcing a discrepancy that an employee cannot be compensated

Circuit's majority, the union representatives would not be compensated under the LMRA because the union representatives represent both the local Fire Department and the Smith Corp. employees. In addition, they do not work on Smith Corp.'s property on a full-time basis and are not under the direct control of Smith Corp. on a full-time basis, which means they cannot be lawfully paid under Section 302 of the LMRA.[112]

Applying a plain meaning approach to Section 302(c)'s statutory language, "by reason of" simply recognizes that both current and former employees have a right to payment from their employers arising from services performed, as they have a right to obtain what is rightfully theirs.[113] Furthermore, this language stresses that the union representative is not entitled to receive payments because of the services provided, but rather the payment should be made in spite of the services they perform as an acting union representative.[114] Therefore, under this line of analysis, payments made "by reason of" a union president's service do not apply to Section 302 of the LMRA because the payments relate to the services provided to the union, which is comprised of both Smith Corp. employees and local fire fighters.[115]

Relying on the hypothetical scenario above, the union president is an acting member of the union that represents Local 113, which is comprised of both Smith Corp. workers and local fire fighters.[116] Because the services provided by the president directly benefit the union, as his position requires meeting with workers and filing union grievances, Smith Corp. should not be compensating this individual because they are not receiving any benefit from this work.[117] Additionally, the union president is on leave while performing these duties and is not a current employee of Smith Corp. As

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under Section 302 of the LMRA when the represent more than one company's employees and work out of multiple locations on a regular basis).

112. *E.g.*, *id.* at 713 (commenting on the limited hours the union representatives were available to Titan employees at their workplace).

113. *See id.* at 720 (citing to the dissent in *Caterpillar, Inc.*,107 F.3d 1052, 1058 (3d Cir. 1997) (Mansmann, J., dissenting)) (articulating the Section 302 exception relies on the notion that an employee should receive what is rightfully theirs).

114. *See id.* (alluding to the notion that the union representatives compensation should come from the person they represent and not the organization that formerly employed them).

115. *Id.* at 720 (suggesting the salaries of the union representatives do not fall under Section 302's exception because the union workers salaries are not "by reason of" their service as former employees of Titan, but rather are because of their services provided to union members from both Titan and the local school district).

116. *See id.* at 711 (noting a factual similarity between union president representing two different groups).

117. *See, e.g.*, *id.* at 725 (thinking there is no connection between the previous employment and this).

such, paying a former employee a salary to perform a job for another organization is not a requirement under the LMRA.[118]

In addition to the lack of benefit received by Smith Corp for the services the union representative performs, the rate of pay includes a pay increase of $10,000 while the president assumes his union duties.[119] Under Section 302 of the LMRA, salaries of the full-time representatives are illegal if the terms of compensation are disproportionate with the former employee's previous rate of pay.[120] Both the statutory provisions of the LMRA and collective bargaining agreements require that payments between an employer and a union representative are lawful and uncoercive.[121] Furthermore, there must be a "firm connection" between the bargained-for term as well as the prior terms of employment within the bargaining agreement.[122] Consequently, a bargaining agreement deal between an employer and the union may be in direct violation of Section 302 of the LMRA, and therefore, illegal if the payment terms were found to be disproportionate with the employee's previous terms of employment.[123]

D. Unions Beware: Titan Tire's Ripple Effect to Unions Throughout the United States.

If adopted by the Supreme Court, the Seventh Circuit's narrow interpretation of Section 302(c)'s exceptions clause could drastically affect union representatives across the nation. This interpretation is controlling in several jurisdictions and does not allow the compensation of full-time union representatives who take a leave of absence in order to fill roles of union representatives.[124] There are a number of implications that this

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118. *E.g.*, *id.* at 722. (reasoning this is different from paying fringe benefits to a former employee).

119. *See id.* at 723 (noting a factual similarity of pay increase of union president).

120. *E.g.*, Toth v. USX Corp., 883 F.2d 1297, 1305 (7th Cir. 1989) (finding that these payments cannot be "by reason of" payments because of their disproportional nature to their previous rate of pay).

121. *See, e.g.*, *id.* at 1301 (emphasizing payments that are "by reason of" ones employment could qualify under Section 302's exception clause so long as there is no coercive intent behind the compensation).

122. *See, e.g.*, *id.* at 1305 (rationalizing these payments skirt a fine line and could easily become unlawful depending on the reason for which one is paid).

123. *See id.* at 1305 (suggesting when a union representative receives compensation that is incomparable with their previous pay rate, this may be found unlawful under Section 302 because it violates the bargaining agreement).

124. *See, e.g.*, John F. Ring, *Employer Payment of Union Officials' Salaries Deemed Unlawful*, MORGAN LEWIS (Nov. 11, 2013) http://www.morganlewis.com/pubs/LEPG_LF_EmployerPaymentofUnionOfficialSalariesUnlawful_11nov13 (observing the case at hand is controlling law in some jurisdictions and persuasive in others).

decision has created including an increased enforcement of other labor law provisions for improper behavior involving payments by management to union representation.[125]

Unionized workplaces within the Third Circuit could be placed in the dilemma as to which standard to apply.[126] By adopting *Titan Tire*, Management could argue that any form of payment to union representatives is unlawful under Section 302(c).[127] Conversely, unions would argue that the Third Circuit's decision in *Caterpillar* should control, which allows such payments to union representatives under the LMRA.[128] Furthermore, employers with active will be forced to review any collective bargaining agreements or any other labor forms to assess whether any current practices are lawful under the Seventh Circuit's interpretation of the LMRA.[129] Employers that have potentially unlawful workplace agreements may consider this interpretation as a basis for refusing to make additional payments to union representatives.[130] In the future, employers could refuse to compensate employees who are acting as full-time union representatives for fear of violating the law.[131] This effect could ripple out to the unions themselves, who would then be forced to find alternative ways to compensate displaced unionized employees when management pulls the

125. *See id.* (examining recent attention given to the Labor-Management Reporting and Disclosure Act of 1959 involving "persuading" activity in these payments).

126. *See id.* (observing the Seventh Circuit's opinion to outlaw the payments was the first of its kind and has the ability to affect mature collective bargaining agreements between employers and unionized employees in the workplace).

127. *E.g.*, Titan Tire Corp. of Freeport v. United Steelworkers, 734 F.3d 708, 710 (7th Cir. 2013) (voicing that employees who take leaves of absence to work for an union will not be paid salaries because these forms of payments are unlawful under Section 302 of the LMRA).

128. *See, e.g.*, Caterpillar, Inc. v. UAW, 107 F.3d 1052, 1057 (3d Cir. 1997) (concluding this decision allowed an employee to take a leave of absence in order to fulfill his or her duties as a union representative and still receive a salary under Section 302 of the LMRA).

129. *E.g.*, *LMRA Bars Employer from Paying Salaries to Non-working Union Officials: Seventh Circuit*, PRAC. L. (Nov. 14, 2013), http://us.practicallaw.com/0-548-2545?q=&qp=&qo=&qe= (voicing that unionized workplaces with past practices allowing these types of payments could follow the analysis used in Titan Tire to prohibit employers from making any additional compensation to union members on leave in accordance with the law).

130. *See* Ring, *supra* note 124 (discussing that any bargaining agreements or contractual obligations will no longer be honored based on the Seventh Circuit's decision in Titan Tire).

131. *See* Brenda J. Linert, *Labor's Pain: Union Numbers Decline, but Many Say Their Role is Still Vital*, TRIB. CHRON, (Jan 26, 2014), http://www.tribtoday.com/page/content.detail/id/598636/Labor-s-pain.html?nav=5021 (examining a trend that fewer unions exist due to anti-union campaigning by companies who refuse to pay them).

plug on their wages.[132] This Comment argues that businesses receive a benefit from the services of the union representatives and thus should be legally required to pay for their salaries. Therefore, the Seventh Circuit's decision has a ripple effect that could severely harm union organizations across the nation, as they would have to either compensate the union representatives or come up with an alternative solution, such as voluntary representatives.

III. *TITAN TIRE* CREATES A PRESUMPTION OF DEPRIVATION THAT SHIFTS THE BURDEN ONTO UNIONS

This Comment recommends that the Seventh Circuit's analysis in *Titan Tire* should be rejected by other jurisdictions. Union representatives provide a great service to their employer and their fellow employees by filing grievances, settling disputes in an efficient manner, and maintaining compliance with the applicable laws and agreements. Companies should not refuse to compensate union representatives who provide services to their company. These payments fall under the exceptions of Section 302 of the LMRA. Following the Seventh Circuit's overreaching analysis in *Titan Tire* has led to inconsistency and undermines the role of arbitrators.

A. Businesses Should Compensate Union Representatives Because a Refusal Would be Unjust.

The Seventh Circuit's ruling in *Titan Tire* is in directly conflicts with prior precedent and creates a circuit split with regards to the proper interpretation of Section 302 of the LMRA. The ruling in *Titan Tire* is overly broad and states that the "by reason of" exception only recognizes that salaries of current or former workers are not guaranteed under this provision. These employees may have a right to receive payments arising from the services they perform, but the majority's analysis does not take into consideration that Section 302 does not explicitly state this specific limitation.[133] The statutory language provided within the LMRA uses the broad language, and if it was the legislature's intent to include such conclusory statements, it would have explicitly done so.[134]

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132. *See, e.g.*, David G. Branchflower & Richard B. Freeman, *Unionism in the United States and Other Advanced OECD Countries*, 31 INDUS. REL. 56, 70–72 (1992) (recognizing the trend that employers will start to oppose unions and union compensation when their costs start increasing).

133. *See* Titan Tire Corp. of Freeport v. United Steelworkers, 734 F.3d 708, 731 (7th Cir. 2013) (Wood, J., dissenting) (explaining that Section 302 of the LMRA's use of the language "by reason of" does not expressly state that union representatives' compensation should come from the services they perform for their employer, but this interpretation can be inferred).

134. *E.g.*, 29 U.S.C. § 186(a) (1994) (quoting the use of such language as "any

Moreover, the analysis used by the Seventh Circuit fails to adequately recognize the importance of the former relationship between the employer and the employee, which may justify the payment of the salaries of certain union representatives. Collective bargaining agreements avoid conflicts between management and unions by utilizing grievance protocols and procedures that are binding on all parties.[135] The union representative plays a vital role during labor dispute negotiations between management and its employees and possesses the required knowledge of industry standards, the bargaining agreement, as well as other procedures involved.[136] Additionally, the statutory language does not require that the exception be available to only part-time union representatives or it would have explicitly stated so in Section 302. Therefore, the Seventh Circuit's interpretation denying the payment of full-time, on-leave, union representatives is unjust, arbitrary and will lead to inconsistent results.

B. Overturning an Arbitral Award Sets a Dangerous Precedent and is Over-reaching.

As pointed out in Justice Wood's dissent in *Titan Tire*, the majority decided the case based on how they would have come to the result rather than determining whether the arbitrator's decision was in violation of the bargaining agreement.[137] This line of reasoning is not the correct standard of review regarding the award. The Seventh Circuit's reversal of the award sets a standard that allows courts to overturn arbitration awards if it disagrees with the outcome or if its feels a mistake has been made.[138]

The majority's narrow analysis focuses on the reviewing court's ability to overturn awards that go against public policy.[139] The union

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money or other thing of value").

135. *See* JOHN P. SANDERSON, THE ART OF COLLECTIVE BARGAINING 1 (1979) (explaining that a specific list of covenants that both parties within the collective bargaining agreement should abide by).

136. *See Titan Tire Corp.*, 734 F.3d at 732 (Wood, J., dissenting); *see also* ERICKSON, *supra* note 103, at 21 (voicing the success of unions rely greatly on the representatives who are filing grievances on behalf of the employees).

137. *See Titan Tire Corp.*, 734 F.3d at 730 (focusing on the fact that majority's de novo review may have attempted to interject their own analysis saying that an arbitrator cannot make decisions that are illegal and thus concluding that the award was unjust and void against public policy).

138. *See, e.g.*, Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064, 2068 (2013); *see also* Stolt-Nielsen v. AnimalFeeds Int'l. Corp., 559 U.S. 662, 671 (2010) (stating that only evidence showing a grave error has been made is sufficient to vacate an arbitral decision).

139. *See* W.R. Grace & Co. v. Local Union 759, 461 U.S. 757, 766 (1983); *see also* Hurd v. Hodge, 334 U.S. 24, 35 (1948) (asserting "[T]he terms of private agreements is at all times exercised subject to the restrictions and limitations of the public policy of the United States as manifested in the Constitution, treaties, federal statutes, and

representatives received a pay increase for the services they performed for the union that was disproportional to their previous rate of pay. This pay increase was specified in the bargaining agreement between the two parties and the representatives also received fringe benefits such as health care and pensions. Both parties agreed to these terms, otherwise such provisions would not have been listed in the agreement. Also, salaries and fringe benefits are considered "things of value" as listed in Section 302 of the LMRA. Therefore, they should have been covered. The Seventh Circuit, however, disagreed and concluded that these payments were illegal.[140]

Allowing the Seventh Circuit to overturn an arbitrator's award will give other courts the notion that awards such as these do not need to be followed. As a result, other courts will utilize the same type of policy analysis to overturn awards they feel have been decided improperly. This gives the judiciary unfettered discretion and power regarding arbitration awards, allowing them to overturn awards as they see fit. Arbitration decisions should be followed, unless clear and convincing evidence shows extreme bias or a blatant disregard for the truth.

C. *Future Implications of the Seventh Circuit's Interpretation of the LMRA*

The Seventh Circuit's split from the Third Circuit provides an interpretation of the LMRA that is both broad and narrow with respect to different clauses of the statute. Section 302(a)'s prohibition of payments is broadly interpreted whereas Section 302(c)'s exceptions clause is narrowly interpreted. Under the Seventh Circuit's interpretation of 302(c), payments not specifically prohibited in 302(a) will be scrutinized more closely and may not be considered an exception under the statute's "by reason of" language. In addition to both the narrow and broad construction of Section 302 of LMRA, other implications within unions could potentially arise from the current analysis in *Titan Tire*, including what constitutes "a thing of value" under the statute.

CONCLUSION

This Comment argues that further clarifications in legislation are needed to prevent further ambiguities within the law. It seeks to point out that there will continue to be opposing viewpoints until the proper authorities give further clarification as to which analysis is preferred to maintain the legislative intent of the LMRA in preventing bribery and coercion within the workplace, as governed by the LMRA. The Seventh Circuit's ruling in

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applicable legal precedents").

140. *See Titan Tire Corp.*, 734 F.3d at 713.

Titan Tire directly conflicts with previous rulings by the Second, Third, and Ninth Circuits allowing the payment of full-time union representative under Section 302 of the LMRA. This split amongst the circuits has already led to increased scrutiny regarding the interpretation of Section 302 in *Unite Here Local 355 v. Mulhall.*[141] *Mullhall* was initially granted certiorari and oral argument was heard before the U.S. Supreme Court, but the case was ultimately dismissed as being improperly granted.[142] Although the decision is not expected until the end of the current term of the Court, it seems that further scrutiny of the interpretation of the LMRA will continue on a regular basis until a proper interpretation is adopted by the Supreme Court. Until a proper interpretation of the statute is decided, there will continue to be differences of opinion. Furthermore, this decision will lead to an increase in litigation where the judiciary will have to decide whether payments to full-time union representatives on leave are against the law.

141. 134 S. Ct. 594 (2013).

142. *See* Faman, *supra* note 5 (observing that ambiguity still exists within the statute); *see also Unite Here Local 355*, 135 S. Ct. at 594 (2013) (Breyer, J., dissenting) (indicating that the opposing views of the LMRA among the Court of Appeals not only affect the collective bargaining process, but could impose strict punishments for employers of union representatives found guilty of corrupt practices).

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