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ARTICLES

THE RESCISSION DOCTRINE: EVERYTHING OLD IS NEW AGAIN

ALLEN SPARKMAN*

This Article considers rescissions—attempts by parties to undo a transaction and have that undoing respected for federal tax purposes. Some commentators have questioned the legal basis for the rescission doctrine as applied by the Internal Revenue Service, and others have argued for expansion or restriction of the doctrine. This Article traces the development of the rescission doctrine, examines a critical article that argues that there is no legal precedent that truly supports the rescission doctrine as it is currently applied by the Internal Revenue Service, considers whether there exists sufficient legal authority for the doctrine as applied by the Internal Revenue Service, and briefly considers alternatives.

*The author expresses deep appreciation to Robert Keatinge for his helpful comments on this paper and his substantial contributions to previous versions that were co-authored with the author for several joint CLE presentations.

I. CURRENT INTERNAL REVENUE SERVICE POSITION

Since 1980, the Internal Revenue Service ("IRS") has approved rescission treatment for certain transactions that unwind earlier transactions. Revenue Ruling 80-58[1] considers two situations.

In Situation 1, in February 1978, A, a calendar year taxpayer, sells a tract of land to B and receives cash for the entire purchase price. The contract of sale obligated A, at the request of B, to accept reconveyance of the land from B if at any time within nine months of the date of sale, B is unable to have the land rezoned. In October 1978, B determines that it is not possible to have the land rezoned and notifies A of its intention to reconvey the land pursuant to the terms of the contract of sale. B reconveys the land to A during October 1978, and B receives back all amounts that B expended[2] in connection with the transaction.

Situation 2 is the same as Situation 1 except that the period within which B could reconvey the land to A is one year. In January 1979, B determines that it is not possible to have the land rezoned and notifies A of its intention to reconvey the land pursuant to the terms of the contract of sale. B reconveys the land to A during February 1979, and A returns all amounts to B that B expended in connection with the transaction.

Revenue Ruling 80-58 explained its holdings as follows:

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.
>
> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes. *See Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 88 L. Ed. 725, 64 S. Ct. 596, 1944-1 C.B. 526 (1944), Ct. D. 1603, 1944 C.B. 526.

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1. *See* Rev. Rul. 80-58, 1980-1 C. B 181.

2. This is the language used in Revenue Ruling 80-58. B may have expended various amounts in connection with the land from A, for example, attorney fees, realtor commissions, documentary fees, title company fees, etc. Presumably, Revenue Ruling 80-58 requires only that B receive back what he paid to A for the land.

In *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940), the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without the approval of the shareholders. Under the plan the taxpayer was credited with earnings from the fund for the years 1930 and 1931. In 1931, as a result of suits filed by a shareholder, the directors of the company passed a resolution whereby the plan would be rescinded as to all participants in the plan who agreed to relinquish their previous credits and rights. The United States Court of Appeals held that although the plan was rescinded for 1930, the annual accounting period principle required the determination of income at the close of the taxable year without regard to subsequent events. That is, the rescission in 1931 was disregarded for purposes of determining 1930 taxable income. With regard to whether the 1931 income should be taxed, the Court of Appeals said in the *Penn* case that the rescission in 1931 extinguished what otherwise would have been taxable income for that year.

The facts of the *Penn* case are similar to those in *Situation 1* and *Situation 2.* In *Penn,* earnings were credited in 1930 and 1931 and there was a rescission in 1931 (that was intended to affect both years). *Situation 1* relates to the earnings credited in 1931, the year of the rescission; and *Situation 2* relates to the earnings credited in 1930, that is, a year different from the year of the rescission.
In *Situation 1* the rescission of the sale during 1978 placed *A* and *B* at the end of the taxable year in the same positions as they were prior to the sale. Thus, in light of the *Penn* case, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction. See Rev. Rul. 74-501, 1974-2 C.B. 98, which holds that there is no adjustment to the basis of the old stock where a shareholder exercised stock rights and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued because the market price of the stock had depreciated to a price below the subscription offer.

In *Situation 2,* as in *Situation 1,* there was a completed sale in 1978. However, unlike *Situation 1,* because only the sale and not the rescission occurred in 1978, at the end of 1978 *A* and *B* were not in the same positions as they were prior to the sale. Again, in light of the *Penn* case, the rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.

In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.[3]

More recently, the IRS restated its view of rescissions in Private Letter Ruling ("PLR") 200923010[4]:

> The Service recognizes that a rescission may be given full effect in abrogating a transaction under certain conditions. When these conditions are met, the transaction is disregarded for federal income tax purposes. In this connection, Rev. Rul. 80-58, 1980-1 C.B. 181, states the general legal principles pertaining to the doctrine of rescission in the following terms:
>
>> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.[5]

The PLR states that there are at least two conditions that must be satisfied for the remedy of rescission to apply to disregard a transaction for federal income tax purposes. First, the parties to the transaction must return to the status quo ante; that is, they must be restored to "the relative positions they would have occupied had no contract been made."[6] Second, this restoration must be achieved within the taxable year of the transaction.[7]

The IRS applies the two stated conditions somewhat differently. The first, that the parties be restored to the relative positions they would have occupied had no contract been made, appears to be satisfied upon material compliance.[8] The second condition, that the restoration be achieved within

3. *Id.*

4. *See* I.R.S. Priv. Ltr. Rul. 200923010 (2009).

5. *Id.*

6. *Id.*

7. *Id.*

8. *See* I.R.S. Priv. Ltr. Rul. 200613027 (2006) (holding that a valid rescission of the conversion of a partnership to a corporation occurred even though corporate employees who received stock and were redeemed before the rescission were not parties to the ruling and presumably were not required to pay back the redemption proceeds); *see also* I.R.S. Priv. Ltr. Rul. 2009520036 (2009) (discussing a situation where a partnership converted to a corporation and, upon learning that the business purpose it had thought it would achieve if it were a corporation would not be realized, the corporation converted to a limited liability company. The corporation converted to a limited liability company because of a change in the state's franchise tax that caused partnerships no longer to enjoy an advantage over limited liability companies. Both conversions occurred in the same taxable year, and the IRS ruled that a valid rescission had taken place even though the former general and limited partners of the partnership were members of a limited liability company).

the taxable year of the transaction, appears to be an either/or proposition; that is, either the condition is satisfied or it is not. If the multiple parties to a contract have different taxable years, the original transaction and the rescission apparently have to occur in the same taxable year with respect to each party. For example, if A purchases Blackacre on March 31, 2014, from Fiscal Year Corp, which has a taxable year ending March 31, it does not appear that this sale could be rescinded effective for federal tax purposes other than on the day of closing because otherwise the rescission would be in a different taxable year for Fiscal Year Corp.[9] Interestingly, in Revenue Ruling 80-58, the IRS stated that taxpayer A was a calendar year taxpayer, but made no statement about the tax year of taxpayer B.[10]

Note that Revenue Ruling 80-58 states that "rescission refers to . . . voiding of a *contract*."[11] The IRS apparently does not apply the rescission doctrine to transactions that do not involve the reversing or undoing of a contract. Consider, for example, PLR 200925044.[12] A taxpayer was receiving distributions from an Individual Retirement Account ("IRA") that were intended to be a series of substantially equal periodic payments per I.R.C. Section 72(t)(2)(A)(iv), in order to avoid a 10% penalty on early distributions. The taxpayer converted part of the IRA to cash and had it transferred to a new IRA via a trustee-to-trustee transfer. The IRS concluded that the partial conversion and transfer of the IRA constituted a modification of the payment stream, making the penalty applicable.[13] PLR 200925044 held, without any discussion of rescission theory or whether the retransfer had occurred in the same taxable year, that the consequences of the modification could not be avoided by causing the transferred amount to be transferred back to the original IRA.[14] Where there is a contract, such as a subscription agreement that is cancelled, the IRS has granted rescission treatment without a formal rescission designation in the cancellation.[15] In PLR 2009520036,[16] the IRS required the taxpayer to represent that "under the laws of State A the Plan of Conversion constituted a contract between and among the parties thereto."[17]

More recently, for 2012 and 2013, "whether a completed transaction can

9. *See* I.R.S. Priv. Ltr. Rul. 201211009 (2012); I.R.S. Priv. Ltr. Rul. 201021002 (2010)

10. *See* Rev. Rul. 80-58, *supra* note 1.

11. *Id.* (emphasis added).

12. *See generally* I.R.S. Priv. Ltr. Rul. 200925044 (2009).

13. *Id.*

14. *Id.*

15. *See* Rev. Rul. 74-501, 1974-2 C. B. 98, Situation 2.

16. Priv. Ltr. Rul. 2009520036, *supra* note 8.

17. *Id.*

be rescinded for Federal income tax purposes" was listed as one of the issues under study for which rulings would not be issued until the IRS resolved the issue through publication of a revenue ruling, a revenue procedure, regulations or otherwise.[18] Rescissions are not so listed in Revenue Procedure 2014-3, but in late June 2013, William Alexander, IRS Associate Chief Counsel, Corporate, announced that the IRS was abandoning the guidance project *and* that the no-ruling policy would stay in place:

> We've put a lot of time, effort, thought into looking at all sorts of aspects of the rescission doctrine—its history, its fingerprints, its scope, its relationship to other similar phenomena in the [C]ode . . . . And at the end of this, it appears that where we're going to wind up is where we are now. And so I would expect that Rev. Rul. 80-58 [1980-1 C. B. 181] will be the Service's guidance on the subject for the indefinite future, that rescission will remain a no-rule area for the indefinite future, and that next year's guidance plan will not show a project on the topic.[19]

II. DEVELOPMENT OF THE ANNUAL ACCOUNTING CONCEPT

Revenue Ruling 80-58's rationale included its statement that "the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year."[20] The annual accounting concept developed after the adoption of the Sixteenth Amendment to the U.S. Constitution in 1913.[21]In *Burnet v. Sanford & Brooks Co.*,[22] the taxpayer operated a dredging business and from 1913 to 1915, acted as a subcontractor for another company that had a contract with the United States for dredging the Delaware River.[23] On its income tax returns for 1913-1916, the taxpayer included for each year the payments received under its subcontract and deducted the expenses it paid each year for performing under the subcontract. The taxpayer reported net income for 1914, but the other returns reported net losses.[24]

Difficulties arose in the dredging work, and the prime contractor successfully sued the United States for breach of warranty of the character of the material to be dredged. From the prime contractor's recovery, the

18. Rev. Proc. 2012-3, 2012-01 I.R.B 113; Rev. Proc. 2013-3, 2013-01 I.R.B 113.

19. IRS Ends Rescission Study, Leaving No-Rule in Effect, 2013 TNT 127-1 (July 2, 2013).

20. Rev. Rul. 80-58, *supra* note 1.

21. U.S. CONST. amend XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.").

22. 282 U.S. 359 (1931).

23. *Id.* at 361.

24. *See id.* at 361.

taxpayer in 1920 received $192,577.59, representing the $176,271.88 by which the taxpayer's expenses under the contract had exceeded its receipts, plus $16,305.71 of accrued interest. The taxpayer did not report the $192,577.59 it received in 1920 for tax purposes, and in its argument before the Court asserted that the Sixteenth Amendment and the Revenue Act of 1918 plainly contemplated taxes only on net income or profits and could not be applied to tax a transaction from which the taxpayer realized no profit.[25]

The Court noted that even if the taxpayer's contention was accepted:

> [T]he question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.[26]

The Court rejected the taxpayer's contention with observations that have become part of tax lore:

> All revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt.[27]
>
> A taxpayer may be in receipt of net income in one year and not in another. . . . The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.[28]
>
> The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.[29]

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25. *See id.* at 361–62.
26. *Id.* at 362–63.
27. *Id.* at 363.
28. *Id.* at 365.
29. *Id.*

In *Security Flour Mills Co. v. Commissioner*,[30] the Court cited and quoted from *Burnet v. Sanford & Brooks Co.* in holding that Security Flour Mills could not deduct on its income tax return for 1935 payments made by it in 1936, 1937, and 1938.[31] In 1953, the Court again cited *Burnet v. Sanford & Brooks Co.* in holding that an individual taxpayer was not entitled to reduce his salary compensation received in one year because of repayment of a portion of the salary in a later year.[32]

The Internal Revenue Code now contains exceptions to the annual accounting concept, such as installment sale treatment,[33] and the percentage of completion method of reporting for certain contracts that will not be completed during the year that they were entered into.[34] In addition, the Internal Revenue Code affords other relief, such as deductions for carrybacks and carryovers of net operating losses,[35] averaging income from farming and fishing operations,[36]mitigation of limitations,[37] and special computation of tax when a taxpayer restores more than $3,000 held under a claim of right.[38] Apart from special rules like these, the annual accounting concept remains fundamental to the income tax system in the United States.[39]

III. SUGGESTIONS FOR IMPROVEMENT AND ALTERNATIVES

Commentators and the Tax Section of the New York State Bar Association ("NYSBA") have looked at the rescission doctrine as it has developed and been applied by the courts and the IRS. On August 11, 2010, the NYSBA Tax Section submitted a report (the "NYSBA Report"),[40] urging greater certainty with respect to rescission, and specifically making the following four recommendations:

30. 321 U.S. 281 (1944).

31. *See id.* at 286, n. 9.

32. *See* Healy v. Commissioner, 345 U.S. 278, 284 (1953) (stating "Congress has enacted an annual accounting system under which income is counted up at the end of each year").

33. *See* I.R.C. § 453 (2012) (Allowing reporting of income as payments are received under qualifying installment sales).

34. *See* I.R.C. § 460 (2012).

35. *See* I.R.C. § 172 (2012).

36. *See* I.R.C § 1301 (2012).

37. *See* I.R.C. §§ 1311-14 (2012).

38. I.R.C. § 1341 (2012).

39. *See* Treas. Reg. § 1.441-1(b)(3) (2002): "Annual accounting period means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books."

40. New York State Bar Association Tax Section Report No. 1216 (August 11, 2010) available at http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=43022.

1. We recommend that Treasury and Service clarify the elements of a valid rescission for federal tax purposes by, for example, confirming the practical approach the Service has taken in private letter rulings that the status quo ante requirement is met where parties are restored to their prior positions "in all material respects"; addressing the effect that the making or receiving of additional payments in the course of an "unwind" might have in this regard; defining the same taxable year requirement in the event that the parties involved have different tax years; and detailing whether and to what extent a rescission must be identified as such by the parties at the time it is undertaken.
2. We believe that, in providing guidance concerning the elements and effects of a valid rescission, Treasury and the Service should be especially attentive to the doctrine's application in the context of related party transactions, unilateral actions or transactions, "partial" rescissions and cases where the underlying transaction is later "done over."
3. We also believe that the rescission doctrine generally should not be available to skirt explicit Congressional or Treasury pronouncements limiting a taxpayer's ability to unwind an election, action or transaction. At the same time, however, we ask that the Service consider adopting a more flexible approach in providing administrative relief to correct oversights, mistakes and execution errors in connection with various elective regimes, including entity classification elections and Section 83(b) elections.
4. Finally, we recommend that the Service clarify the scope of the rescission doctrine in the compensation context, identifying in particular the extent to which common law remedies may be available to supplement the specific corrections procedures provided in various administrative pronouncements to correct plan document or operation "failures" under Section 409A of the Code.[41]

In addition to the clarifying recommendations made by the NYSBA Report,[42] notwithstanding the annual accounting principle, it has been argued that rescission should be allowed (if otherwise proper) so long as the statute of limitations for the taxable year of the original transaction remains open. In addition, and sometimes in the alternative, commentators have argued that the validity of a rescission should not depend on whether it falls within the same taxable year as the original transaction, or some other period, but rather on whether the rescission is entered into because of, for example, the failure of the parties' expectations for the original transaction. For example, Donald Hasen commented:[43]

[I]f unwinding is viewed as an appropriate remedy, there is no reason to

41. *Id.*
42. *Id.*
43. *See generally* Donald Hasen, *Unwinding Unwinding*, 57 EMORY L.J. 871 (2008).

> limit it in the ways that it is limited under current law. [Allowing] unwinding relief along the lines available under the claim of right doctrine and the [tax benefit rule] would seem to do no more violence to the annual accounting principle or to tax administration more generally than it does in these areas. Thus, one would hope for both a narrowing of the rule that permits unwinds for rescissions no matter what the reason as long as the rescission occurs in the same taxable year, and relaxation of the rule that limits any unwind to the same taxable year. Any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified. When the error is justified, however, it does not seem that the same-year rule should limit the relief, though it might modify it. Thus, unwinding presumably could extend both to reversals that constitute modifications and to reversals in donative situations or other non-arm's length arrangements under the income tax, such as tax elections; it would not be limited *a priori* to rescissions. The same-year rule might continue to have an effect, however, on the nature of the relief. Under this partly narrower and partly broader standard, a same-year reversal that merits unwind treatment could simply result in complete disregard of both transactions, as under current law. A later-year reversal meriting unwind treatment could be treated much as a deduction under the claim of right doctrine or an inclusion under the [tax benefit rule].[44]

However one views the policy merits of this argument, in light of the Court cases discussed *supra* in Part II, relaxation of the same-year rule for rescission treatment would appear to require congressional action. On the other hand, restricting rescission treatment to unwindings that are carried out because "the mistake or error giving rise to it is justified" would likely be at least as fact-driven as are determinations whether, for example, compensation is reasonable. As explained below, this Article takes the position that the annual accounting concept provides ample legal justification for the rescission doctrine as articulated by Revenue Ruling 80-58. The annual accounting concept promotes simplicity by providing a bright-line limitation on rescission treatment.

IV. RECENT CRITIQUE OF RESCISSION DOCTRINE

A. Introduction

In Revenue Ruling 80-58, the IRS based its analysis in part on *Penn v. Robertson*,[45] stating that "the facts of the *Penn* case are similar to those in

44. *Id.* at 943–44 (footnote omitted).

45. *See* 115 F.2d 167 (4th Cir. 1940); *see also* Sheldon I. Banoff, *Unwinding or Rescinding A Transaction: Good Tax Planning or Tax Fraud?*, 62 TAXES 942, 960 (Dec. 1984) (discussing Rev. Rul. 80-58 and *Penn v. Robertson*).

Situation 1 and *Situation 2*."[46] Two commentators have mounted an attack on Revenue Ruling 80-58 and the rescission doctrine it articulates in The Fabricated Unwind Doctrine: The True Meaning of *Penn v. Robertson* (hereinafter, "*Fabricated Doctrine*").[47] John Prebble and Chye-Ching Huang assert that the entire rescission analysis in Revenue Ruling 80-58 lacks any real basis in precedent, that the rescission doctrine is a "fabrication" by the IRS, that the IRS, practitioners, and academic commentators have all misunderstood *Penn v. Robertson*, and that the case, as analyzed by them, provides no authority for Revenue Ruling 80-58.[48] Prebble and Huang[49] take the position that the court in *Penn v. Robertson*, far from holding that the taxpayer was entitled to treat the benefit received from his employer's stock benefit fund in 1931 as "extinguished" when the establishment of the fund was rescinded in 1931, actually articulated a rationale based on allowing the taxpayer's return in 1931 to treat the repayment of the benefit received from the fund as a deductible payment offsetting the receipt of a taxable benefit from the fund earlier in 1931. *Fabricated Doctrine* recommends that Revenue Ruling 80-58 be revoked and offers scant comfort to taxpayers who might be disadvantaged as a result.[50]

This Article demonstrates that the authors of *Fabricated Doctrine* have completely misread *Penn v. Robertson*, and their conclusions should be ignored on that basis alone. *Penn v. Robertson* in fact provides ample legal support for the rescission doctrine as announced in Rev. Rul. 80-58. Moreover, this Article argues that, even if *Penn v. Robertson* had never been decided, the annual accounting concept provides an ample legal and policy basis for Revenue Ruling 80-58. The annual accounting concept is a fundamental principle of United States income tax law established by the Supreme Court in the cases discussed *supra* in Part II. Revenue Ruling 80-58 cites the annual accounting concept as one of the two grounds (*Penn v. Robertson* being the other) for its holdings.[51]

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46. Rev. Rul. 80-58, *supra*, note 1.

47. John Prebble and Chye-Ching Huang, *The Fabricated Unwind Doctrine: The True Meaning of* Penn v. Robertson, VICTORIA U. OF WELLINGTON LEGAL RES. PAPERS, No. 17/2011 (Sept., 2011), *available at* http://ssrn.com/abstract=1781269.

48. *Id.* at 121.

49. Professor Prebble and Ms.Huang have also written a shorter piece, based in part on an earlier version of *Fabricated Doctrine.* John Prebble and Chye-Ching Huang, *The Rescission Doctrine: Clothes Without an Emperor?*, TAX ANALYSTS TAX NOTES TODAY (May 16, 2011) (hereafter "*Tax Notes Paper*"). Some of the material in the *Tax Notes Paper* now appears in the current version of *Fabricated Doctrine.* This Article discusses only the current version of *Fabricated Doctrine.*

50. *Fabricated Doctrine, supra* note 47, at 163.

51. Rev. Rul. 80-58, *supra*, note 1.

Fabricated Doctrine begins its analysis by making the following statements:

> Taxpayers routinely rely on the unwind doctrine found in Internal Revenue Service Revenue Ruling 80-58 when they discover that their transactions have unwanted tax consequences. Nowadays, "unwinding" has become a "common if not ubiquitous feature of tax practice." This article finds that the unwind doctrine has no firm basis in case law. Instead, the unwind doctrine is an Internal Revenue Service (IRS) fabrication based on the IRS' misinterpretation of the case *Penn v. Robertson*.
>
> Also referred to as the "rescission doctrine," a tax "do-over," or a "tax mulligan," the effect of the unwind doctrine is that if you change your mind about a transaction, you can avoid its income tax consequences by returning to the economic status quo ante, so long as you do so by the end of the tax year.
>
> . . .
>
> The Internal Revenue Code, Treasury Regulations, case law, and IRS rulings do not refer to any unwind doctrine or rescission doctrine by name.[52] The IRS has allowed taxpayers to use unwind treatment to erase from tax history not only tax effects, such as the derivation of income from a sale of property but also tax effects such as changes in entity status, the liquidation of a company, and a company's exit from a consolidated group. It has allowed unwind treatment when the economic reversal was motivated by changes in business conditions, and also in circumstances where the reversal was motivated by tax outcomes that the parties later came to regret. It has allowed unwind treatment not only when the unwind was legally connected with the original transaction, such as a contractual payment rescinded for mistake, but also where the two transactions were legally independent, such as when two parties voluntarily reached a fresh agreement to reverse the economic effects of a completed and legally independent transaction.[53]
>
> The unwind doctrine is attractive to taxpayers because they can use it to achieve better tax results than would otherwise be possible. Transactions that cancel each other's economic effects will not necessarily—absent the unwind doctrine— have tax effects that also cancel each other. For example, a taxpayer might derive taxable income, but then pay that amount back later in the year. Without the unwind doctrine, the outgoing

52. *Fabricated Doctrine*, *supra* note 47, at 117–18. (footnotes omitted)
53. *Id.* at 118.

> in the second transaction will offset the tax effect of the first *only if* it is deductible in its own right. If the outgoing is not deductible in its own right, the taxpayer will owe tax as a result of the two transactions, even though she has economically returned to the status quo ante. By contrast, under the unwind doctrine, both transactions would be treated as if they had never occurred, regardless of whether the second outgoing is deductible.[54]

Just in these few statements, *Fabricated Doctrine* advances questionable positions. Although this author has not tried to undertake (or to even see if it is possible) to determine the frequency of taxpayers' use of rescission, a Westlaw search disclosed only two private letter rulings since 2012 dealing with rescissions.[55] Thus, it appears questionable whether Prebble and Huang had objective evidence that the use of rescissions is routine, common, or ubiquitous. On the other hand, anecdotal evidence suggests that taxpayers and their advisors are comfortable enough with the rescission doctrine that they are willing to undertake uncomplicated rescissions without seeking a private letter ruling. For example, if one party has sold real estate to another party within the same taxable year and the parties unwind the transaction, either because a condition in the contract has not been satisfied, or by mutual agreement because of economic changes, with the buyer conveying the real estate back to the seller and the seller returning the purchase price to the buyer, many if not most experienced tax practitioners would be comfortable advising the parties that it would be appropriate to take a return position that this was a valid rescission, i.e., the transaction would not be reported on either party's return for the applicable year.

Fabricated Doctrine also implies that these "routine" rescission transactions are undertaken only when taxpayers "discover that their transactions have unwanted tax consequences[,]"[56] and that the effect of the availability of rescissions is that "if you change your mind about a transaction, you can avoid its income tax consequences by returning to the status quo ante, so long as you do so by the end of the tax year."[57] Contrary to *Fabricated Doctrine*, many private letter rulings[58] describe situations where the parties entered into a rescission transaction for what appeared to be substantial business reasons. Moreover, saying that one can rescind a transaction for tax purposes upon a change of mind about a transaction[59] is

54. *Id.* at 118–19.

55. This is unsurprising in light of the developments discussed earlier at notes 18-19, *supra*, and accompanying text.

56. *Fabricated Doctrine*, *supra* note 47, at 117.

57. *Id.* at 117–18.

58. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2009520036, *supra* note 8.

59. *Fabricated Doctrine*, *supra* note 47, at 117–18.

a correct statement only if the authors of *Fabricated Doctrine* are using the word "you" as a plural noun; the situations described in Revenue Ruling 80-58 involve a sale by one party to another pursuant to a contract that allowed the buyer to rescind if desired zoning was not achieved. The sales were rescinded only because both parties had agreed to do so in their original contracts. However, Revenue Ruling 80-58 states that another way in which a valid rescission may occur is by mutual agreement.[60] Presumably, this mutual agreement to rescind may occur after the initial sale and does not have to be included in the original contract. If A sells Blackacre to B in January 2014, and B decides in July 2014 that he doesn't like Blackacre and wishes he'd never bought it, there's nothing he can do if A responds negatively to B's request to rescind the sale. If B has grounds for alleging that A defrauded him, he might bring a suit for rescission, but even if he is successful and obtains a judgment that the sale, was void because it was fraudulently induced, he may not receive rescission treatment for federal tax purposes if the court-ordered rescission does not occur in 2014.[61]

As discussed above,[62] Revenue Ruling 80-58 contains this statement: "The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made".[63]

So far as the authors of *Fabricated Doctrine* are concerned, this statement does not amount to a reference to the "rescission doctrine" by name.[64] Would they have thought differently if the ruling had stated "The legal concept of the rescission doctrine . . ."? Perhaps not, as they assert, without citing any authority, that "commentators coined the appellation."[65] Is not Revenue Ruling 80-58, in fact, a statement of the rescission doctrine, at least as to Situation 1, in which the rescission took place in the same taxable year as the original sale?

Fabricated Doctrine's litany of situations in which the IRS has approved rescission treatment[66] is apparently an attempt to show, from a policy

60. Rev. Rul. 80-58, *supra*, note 1.

61. *See, e.g.*, Banoff, *supra* note 45 at 967–68 (discussing the rare instances, all involving adversarial court action, in which an original transaction has been declared void *ab initio* and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year).

62. Rev. Rul. 80-58, *supra*, note 1.

63. *Id.*

64. *Fabricated Doctrine*, *supra* note 47, at 118.

65. *Id.*

66. *Id.*

standpoint, that the rescission treatment allowed by Rev. Rul. 80-58 is overbroad. It is difficult to be sure what the point is, because *Fabricated Doctrine* does not offer any analysis other than its statements quoted above,[67] which conclude, in part, with the statement that, absent the rescission treatment allowed by Rev. Rul. 80-58, "transactions that cancel each other's economic effects will not necessarily . . . have tax effects that also cancel each other."[68] Saying that taxpayers have better results under Revenue Ruling 80-58 than they would have in its absence does not seem to an argument against the validity of the ruling. To illustrate its point, *Fabricated Doctrine* states: "For example, a taxpayer might derive taxable income, but then pay that amount back later in the year. Without the unwind doctrine, the outgoing in the second transaction will offset the tax effect of the first *only if* it is deductible in its own right."[69] This statement by *Fabricated Doctrine* ignores authorities discussed below[70] that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer's reportable taxable income—authorities that do not rely on Revenue Ruling 80-58.

More importantly, the authors of *Fabricated Doctrine* do not recognize the importance of the annual accounting concept in federal tax law. The annual accounting concept supports, from a policy perspective, allowing rescission treatment for tax purposes if the unwinding transaction takes place in the same taxable year as the original transaction. The annual accounting concept also acts as a brake on rescission treatment for tax purposes by disallowing such treatment if the unwinding transaction takes place in a taxable year subsequent to the taxable year of the original transaction.

The Supreme Court explained the annual accounting concept as follows:

> Congress has enacted an annual accounting system under which *income is counted up at the end of each year.* It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the accounting is made.[71]

Revenue Ruling 80-58 states a similar view in explaining the rationale for its holdings: "The annual accounting concept requires that one look at the transaction on an annual basis *using the facts as they exist at the end of*

67. *Id.* at 118–19.

68. *Id.* at 118.

69. *Id.* at 118 (emphasis in original).

70. *See infra* Part IV Subsection C Fabricated Doctrine's Examination of TARP Bonuses.

71. Healy v. Commissioner, 345 U. S. 278, 284–85 (1953) (emphasis added).

the year."[72]

If a taxpayer's income is to be determined each year by "counting [it] up at the end of the year" and "using the facts as they exist at the end of the year," then why would one not think that rescission treatment is appropriate for tax purposes if the original transaction and the unwinding transaction both take place in the same year?

Fabricated Doctrine does not analyze the applicability of the annual accounting concept or, indeed, even mention it.[73] Nowhere do Prebble and Huang note that the annual accounting concept was one of the two grounds (*Penn v. Robertson* being the other) cited by the IRS for its holdings in Revenue Ruling 80-58. *Fabricated Doctrine*'s failure to analyze the applicability of the annual accounting concept may explain why it ignored authorities discussed *infra* in Part IV Subsection C[74] that would allow a taxpayer who receives income and repays later in the same year to exclude the repaid amount from the taxpayer's reportable taxable income—authorities that do not rely on Revenue Ruling 80-58.

Fabricated Doctrine analyzes *Penn v. Robertson* by attempting to show that the court applied only a deduction rationale in the analysis that led to its holding.[75] *Fabricated Doctrine* then takes a detour to examine the potential tax results of voluntary repayment of a bonus in the same year as its receipt, but its analysis is flawed because it assumes deductibility of the bonus and fails to discuss relevant authorities suggesting that the taxpayer would get to exclude (not deduct) the bonus from income if the taxpayer were to repay the bonus in the year of receipt.[76] *Fabricated Doctrine* then applies this flawed analysis to argue that the taxpayer might be afforded rescission treatment under Rev. Rul. 80-58 because of the repayment, even though it is unlikely that Rev. Rul. 80-58 would be applicable.[77] This is another instance in *Fabricated Doctrine* where the authors describe supposedly likely or possible results of the rescission doctrine of Revenue Ruling 80-58 in apparent attempts to demonstrate that Revenue Ruling 80-

72. Rev. Rul. 80-58, *supra* note 1 (emphasis added).

73. *Fabricated Doctrine, supra* note 47 at 164 refers to the "tax year accounting principle in *Saunders v. Commissioner.*" The reference is to Saunders v. Commissioner, 101 F.2d 407 (10th Cir. 1939). *Saunders* is a very short opinion in a claim of right case and does not mention a "tax year accounting principle" or any other accounting principle or concept.

74. *See infra* Part IV Subsection C *Fabricated Doctrine's Examination of TARP Bonuses.*

75. *See infra* Part IV Subsection B Fabricated Doctrine's Analysis of Penn v. Robertson.

76. *See infra* Part IV Subsection C Fabricated Doctrine's Examination of TARP Bonuses.

77. *See Fabricated Doctrine, supra* note 47, at 122; *infra* Part IV Subsection C.

58 leads to inappropriate results.[78]

B. Fabricated Doctrine's Analysis of Penn v. Robertson

Fabricated Doctrine states that it has undertaken a close reading of *Penn v. Robertson*, and found no support in that case for the unwind doctrine ascribed to it:[79]

> This article examines *Penn v. Robertson* closely in order to determine its ratio. We find that *Penn v. Robertson* is not in fact authority for the unwind doctrine. The IRS in Rev. Rul. 80-58 made two mistakes in interpreting *Penn v. Robertson.*[80]
>
> First, the IRS mistakenly understood *Penn* as treating two transactions within the same tax year, which returned the parties to the economic status quo, as having never occurred. In fact, *Penn v. Robertson* simply allowed taxable income derived in a year to be offset by a deduction generated later in the same tax year. *Penn v. Robertson* does not sanction ignoring two economically canceling transactions, nor does it transform an outgoing that is not deductible in its own right, into a deductible expense.[81]
>
> The second mistake that the IRS made in Rev. Rul. 80-58 was to appear to extend unwind treatment to cases where the second (unwind) transaction has no legal connection to the first, rather than restricting it to cases of true rescissions, that is where the second transaction is legally connected to the first.[82]
>
> . . .
>
> These mistakes came about because Revenue Ruling 80-57[sic] and subsequent private letter rulings made the classic error of confusing the timing question of *when* a particular outgoing is deductible with the substantive question of whether the outgoing is deductible at all.[83] *Penn v. Robertson* was a "when" case. The issue was whether a certain outgoing, undeniably deductible in its own right if incurred by the

78. *Fabricated Doctrine supra* note 47 at 118 (". . . if A sells 100 shares of stock to B for $100 and, during the same taxable yeat and before any dividends have been declared on the stock, the transaction is rescinded such that A receives the stock back from B and B receives the $100 back from A. A and B will generally be taxed as though A held the stock for the entire time.").

79. *Fabricated Doctrine, supra* note 47, at 127–28.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Fabricated Doctrine, supra* note 47 at 119–20.

taxpayer, should be taken into account for tax purposes in period one (when the taxpayer Penn was alive) or in period two (after Penn's death). *Penn v. Robertson* is authority for the ordinary proposition that an allowable deduction can offset a taxable gain when both the gain and deduction occur in the same tax year. It is authority that such an offset can occur even when the (deceased) taxpayer's executor undertakes the transaction that gives rise to the deductible outgoing. However, it is not authority that two economically self-cancelling transactions should be treated as extinguishing each other for tax purposes, as if for income tax purposes neither transaction had occurred.[84] Nor is it authority that a transaction should be treated as deductible solely on the basis that it reverses the economic effect of an earlier transaction in which taxable income was derived.[85]

The IRS' misinterpretation of *Penn v. Robertson* does not generally matter for practical purposes (although it is incorrect in law) in cases where the unwind transaction is also a true rescission. At least in most cases, when a taxpayer derives taxable income under a contract, then rescinds the contract, that rescission will inevitably give rise to an allowable deduction in its own right. The outgoing (repayment) in the second transaction is legally related to the first outgoing, so the repayment will necessarily relate to the taxpayer's income-earning process, which is a touchstone of deductibility. Ordinary principles of tax law operate to allow the deduction to offset the taxable gain if the two transactions occur in the same tax year. The result will be no net tax to pay on the rescinded contract, the same outcome reached under the unwind doctrine that treats the two transactions as having never occurred.[86]

Fabricated Doctrine defines "true rescissions" as:

> that category of unwinds [(any transaction that places the parties in the economic status quo ante economically)] [sic] in which the unwind transaction has some legal connection to the original transaction of which it undoes the economic effect. True rescissions include both judicially imposed rescissions and unwinds conducted to vindicate a legal claim embedded in the original agreement between the parties.[87]
>
> . . .
>
> Any "transactions that simply reverse the economic effect of an earlier transaction, but which are not legally connected to the relevant earlier

84. Actually, that's not exactly what Revenue Ruling 80-58 says happens. As to Situation 1, Revenue Ruling 80-58 states that "the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction." *See* Rev. Rul. 80-58, *supra* note 1.

85. *Fabricated Doctrine*, *supra* note 47, at 120.

86. *Id.*

87. *Id.* at 141.

transaction" are referred to by *Fabricated Doctrine* as "reversals."[88]

As noted above, *Fabricated Doctrine* asserts that in its view, Revenue Ruling 80-58's incorrectness generally does not matter practically in the case of a true rescission. *Fabricated Doctrine* also views Situation 1 in Revenue Ruling 80-58 as a "true rescission" because the unwinding was "conducted pursuant to a legal right embedded in the original agreement."[89] At several points, *Fabricated Doctrine* asserts that it does not matter whether a transaction like the one in Situation 1 of Revenue Ruling 80-58 is treated as a rescission because

> [a]t least in most cases, when a taxpayer derives taxable income under a contract, then rescinds the contract, that rescission will inevitably give rise to an allowable deduction in its own right. . . . Ordinary principles of tax law operate to allow the deduction to offset the taxable gain if the two transactions occur in the same year.[90]

If we examine *Fabricated Doctrine*'s assumptions in light of the income tax results that likely would apply to the parties in Situation 1 of Revenue Ruling 80-58 if that transaction were not treated as a rescission, we see that the "doesn't matter" approach is incorrect. In Situation 1, A sells a tract of land to B in February, 1978, and receives the full purchase price at closing. If we view this sale without regard to the later unwinding, A has a gain or loss equal to the amount by which the purchase price exceeds or is less than A's basis in the property sold. Unless A is considered a dealer in real estate, the gain or loss will be a capital gain or loss—a long or short-term gain depending on A's holding period. B has a basis in the land equal to the purchase price paid by B. If, in October, 1978, B conveys the property back to A, and the reconveyance is treated independently for tax purposes and does not cause the February sale to be disregarded for tax purposes, A gets the land back with a new basis equal to the purchase price A returns to B. B has no gain or loss because he has a basis in the land equal to the purchase price he paid to A in February, assuming that the tract of land was just land and did not include any depreciable or amortizable assets. If the conveyance back to A does not cause the sale in February to be disregarded for tax purposes, what is there in the conveyance back transaction that will give rise to a deduction for A to offset A's capital gain from the sale in February? There is nothing; accordingly, it matters greatly to A whether Revenue Ruling 80-58 is correct.

Fabricated Doctrine continues:

> The theme of the following sections is that the holdings in *Penn v. Robertson* were wholly concerned with matters of timing, not with

88. *Id.* at 143.

89. *Id.* at 142.

90. *Id.* at 120; *see also id.* at 142.

> matters of substantive deductibility. (In later sections, we explain how the IRS and commentators have erroneously misinterpreted *Penn v. Robertson* by taking the case to relate not only to timing but also to substantive deductibility.)[91]
>
> *All parties*, and the Court of Appeals, agreed, and proceeded on the assumption that the outgoings that were at issue were deductible in their own right as a matter of substance. The issue in the case related to timing: in which tax year were those outgoings deductible? And, in respect of one outgoing, incurred in 1931, was the outgoing deductible by Mr. Penn, the taxpayer (who died during 1931), or by his executors?[92]

Next, one must analyze the assertion that "all parties, and the Court of Appeals, agreed that the outgoings were deductible." The court in *Penn v. Robertson* framed the case as follows:

> The Government's present contention is (1) that all the credits on Penn's note, both for dividends and share of profits, were taxable income in the years in which they were respectively credited because received by him under a claim of right and without restriction as to their disposition, and (2) as the year 1931, the rescission of the transaction voluntarily made by Penn's executors after his death, although in 1931, could not properly affect Penn's individual income taxability. On the other hand the taxpayer's contention is that (with the exception of the 1931 item of $31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of $31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income. Thus two questions are presented for our determination; one, whether the credits on Penn's notes constituted income constructively received by him for both years, and if so, second, whether the rescission in 1931 extinguished what otherwise would have been income to Penn in that year.[93]

Where in the above quoted statement from the opinion in *Penn v. Robertson* is there any suggestion that the court was applying a deduction rationale? Judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like "whether the rescission in 1931 extinguished what otherwise would have been taxable income."[94] More typically, judges and practitioners would use language like "as an offset [or reduction] in taxable income" when discussing a possible deduction.

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91. *Id.* at 127.

92. *Id.* at 127–28 (emphasis added).

93. 115 F.2d 167, 172–73 (4th Cir. 1940).

94. *Id.* at 175.

Fabricated Doctrine continues to argue its assertion as follows:

> Only one of the deduction and conflation rationales is the ratio of *Penn v. Robertson*. The ratio of a case is the principle of law found in it that has the force of law as regards the world of [sic] large. The ratio of a case is not just any rationale that can be used to explain the case's outcome. Instead, as Goodhart's *Determining the Ratio Decidendi of a Case* explained, the principle of a case is found by taking account of the facts treated by the judge as material, and his or her decision as based on those material facts.
>
> Thus, it is important to examine closely how the judges in *Penn v. Robertson* both presented the material facts and reached their decision based on those facts. While the outcome of *Penn v. Robertson* may be consistent with the conflation rationale, the way that the judges presented the facts and their decision show the deduction rationale to in fact be the ratio of that case.[95]

The reference to Goodhart is to Arthur L. Goodhart's article entitled, Determining the *Ratio Decidendi* of a Case.[96] *Fabricated Doctrine* cites Goodhart as though his views establish the gospel for interpretation of case law. In fact, just a year after its publication, Karl Llewellyn described Goodhart's article as essentially an indiscretion.[97] Discussion and criticism of Goodhart's views has continued since Llewellyn's disapproval.[98] Llewellyn believed that Herman Oliphant failed to see enough guidance in precedent and that Goodhart saw too much.[99] Robert G. Scofield presents a persuasive argument that in many common fact patterns, "no matter which of the two theories of *ratio decidendi* one adopts, it does not appear that there is clearly one *ratio* that states the law. Given the vagueness, *ratio decidendi* is a metaphysical concept."[100]

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95. *Fabricated Doctrine*, *supra* note 47 at 130.

96. *See generally* Arthur L. Goodart, *Determining the* Ratio Decidendi *of a Case*, 40 YALE L.J. 161 (1930).

97. *See* Karl N. Llewellyn, *Legal Tradition and Social Science Method: A Realist's Critique*, in ESSAYS ON RES. IN THE SOCIAL SCI., THE BROOKINGS INST. 89, 98 (1931).

98. *See, e.g.*, Robert G. Scofield, *Goodhart's Concession: Defending* Ratio Decidendi *from Logical Positivism and Legal Realism in the First Half of the Twentieth Century*, 16 KING'S C. L.J. 311 (2005); H. K. Lücke, Ratio Decidendi: *Adjudicative Rationale and Source of Law*, 1 *Bond* L. REV. 36 (1989); Julius Stone, *The Ratio of the* Ratio Decidendi, 22 THE MODERN L. REV. 597 (1959); Arthur L. Goodhart, *The* Ratio Decidendi *of a Case*, 22 THE MODERN L. REV. 117 (1959). Before Goodhart's 1930 article was published, Herman Oliphant published an article taking a contrary position. Herman Oliphant, *A Return to Stare Decisis*, 14 AM. B. ASS'N J. 71 (1928).

99. Karl N. Llewellyn, THE COMMON LAW TRADITION: DECIDING APPEALS 14 n. 9 (1960).

100. Scofield, *supra* note 98, at 325.

It is beyond the scope of this Article to undertake an analysis of the best way to parse a court opinion. Suffice it to say that, even if Goodhart's views are applied, *Fabricated Doctrine*'s misreading of *Penn v. Robertson* is astonishing. *Fabricated Doctrine* asserts that "[f]or Judges Parker and Chestnut[101] it was material that the payment was deductible" and "in terms of the court's process of reasoning, deductibility of the repayment was a material fact."[102] These assertions are unsupportable in light of the court's actual use of the term "deduction."[103] *Fabricated Doctrine* attempts to explain its assertions as follows:

> Despite the lack of explicit clarity in the judgment, close reading reveals four indicators that their Honours implicitly, but nevertheless clearly, operated under the deduction rationale, the simple subtraction of a deduction from a gain.[104]
>
> First, the Commissioner assumed that the case was about a countervailing deduction, not about a conflation. As their Honours understood it, counsel for the Commissioner submitted that, "the loss to Penn by the rescission or re-sale could only serve as a deduction against income received by his executors after his death during the calendar year."[105]
>
> Secondly, had the question of conflation of transactions been at issue as an alternative argument (alternative, that is, to the receipt/deduction argument just addressed) the Commissioner would surely have submitted that *conflation* could not span two tax periods marked off from one another by Penn's death. After all, he certainly argued that a *deduction* could not jump back to the period when Penn was alive (and therefore could not be considered in Penn's tax position rather than the executor's).[106]

Yes, the Commissioner did argue that a deduction arising after Mr. Penn's death could not offset income realized while he was alive, but the court rejected this argument, stating, *inter alia*, that the Commissioner's

101. It is not apparent why *Fabricated Doctrine* claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in *Penn v. Robertson*, in which Judge Dobie joined. 115 F.2d 167, 169 (4th Cir. 1940). Judge Parker wrote a concurring opinion in which he stated he concurred with the result and "also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income." 115. F.2d at 177 (Parker, J., concurring).

102. *Fabricated Doctrine*, *supra* note 47, at 132.

103. Notes 106-114, *infra*, and accompanying text.

104. *Fabricated Doctrine*, *supra* note 47, at 131.

105. *Id.*

106. *Id.* at 132 (emphasis in original).

contention was "based on the erroneous assumption that Penn's tax accounting period ended with his death on October 22, 1931, and was not for the full calendar year."[107] Given the way appellate arguments are presented, the Commissioner may not have had the opportunity to present an alternative argument after the court rejected the argument that 1931 involved two tax years. If he had been able to, then why would the Commissioner have thought that an argument that a "conflation" could not "jump back" would have been any more successful? Surely, this tells us nothing.

Fabricated Doctrine continues:

> The court rejected this submission of the Commissioner by holding that Penn himself, though dead, could take advantage of the loss that emerged from the rescission. The judges did not explicitly address the question of whether the loss was a deduction or a cancellation that had to be conflated with the 1931 credit to make the credit a nullity. *Their Honours did however call the outgoing from the rescission, "a deduction" and "such deduction."* This indicates that the court was operating under the deduction rationale (the subtraction of an allowable deduction from a derived gain) because, under the conflation and extinction rationale, a deduction would not in fact arise, since the conflation rationale treats the two transactions together as a nullity.[108]

The court in *Penn v. Robertson* used the terms "deduction" and "such deduction" only in its discussion of the Commissioner's contention,[109] as those are the terms the Commissioner used in his argument. How this indicates the rationale of the court is not readily apparent. The court in *Penn v. Roberson* uses the term "deduction" only in the following paragraphs:

> A minor part of the tax controversy related to *deductions* from income made by the taxpayer in the amount of $14,725 for the year 1930, and $12,271 for 1931, for travel and entertainment expenses. The district judge determined that these items were properly allowable as *deductions* for the respective years, and the Collector does not now further question them.[110]
>
> . . .

107. Penn v. Robertson, 115 F.2d 167, 176 (4th Cir. 1940).

108. *Fabricated Doctrine*, *supra* note 47, at 131–32 (emphasis added).

109. *Robertson*, 115 F.2d at 176 (discussing the Commissioner's argument the court stated that the Commissioner contends that "the loss to Penn by the rescission or re-sale could only serve as a *deduction* against income received by his executors after his death during the calendar year") (emphasis added).

110. 115 F.2d at 167 (emphasis added).

> The market value of the stock on the date of the decedent's death was \$1,798,562.50; the amount then still due on the note amounted to \$1,347,631.48. The equity in Penn's favor at current market price was then \$451,931.02. It may also be noted that in subsequent income tax accounting the Tobacco Company claimed *deductions* for the amounts credited to Penn on the note which, however, were disallowed by the Commissioner and his ruling was acquiesced in by the Company.[111]
>
> . . .
>
> But in view of practical necessities, income tax accounting with the Government must be on an annual basis, *Burnet v. Sanford & Brooks Co.,* 282 U. S. 359, 51 S. Ct. 150, 75 L. Ed. 383; *Heiner v. Mellon,* 304 U.S. 271, 58 S. Ct. 926, 82 L. Ed. 1337; and, therefore, moneys received by a taxpayer as his own under a claim of right and without restriction as to their disposition are taxable for the year in which they are received and retained even though in a later year the taxpayer is obliged to refund them in whole or in part, in which event he would have a claim for *deduction* in the later year.[112]
>
> . . .
>
> The more serious contention made by counsel for the Collector on this point is that, although Penn's tax accounting was on the cash basis and for the calendar year, his taxable period ended with his death on October 22d, and what was subsequently done by his executors, even though done in the same calendar year, cannot affect the matter. To support this contention, reliance is placed on the provisions of the income tax law that an individual taxpayer and his estate are separate taxable entities; and it is argued therefrom that nothing can be done by executors to affect income chargeable to their decedent within his lifetime, and therefore the loss to Penn by the rescission or re-sale could only serve as a *deduction* against income received by his executors after his death during the calendar year. In the instant case the tax assessed by the Commissioner against Penn for 1931 was about \$80,000, while the tax payable by the executors for the balance of the calendar year without *such deduction* was only \$108.65. No authority is cited in support of the Commissioner's contention in this respect, and we do not consider it sound.[113]

As one can see, the first time the court in *Penn v. Roberson* uses the term

111. 115 F.2d at 171–72 (emphasis added).
112. 115 F.2d at 173 (emphasis added).
113. 115 F.2d at 176 (emphasis added).

"deduction," it is in the course of discussing an issue that is no longer in the case. The second time, the court discusses a disallowed deduction of the American Tobacco Company that had been conceded by the company. The third time, the court discusses the tax rules that apply when a taxpayer receives income in one year under a claim of right and is required to repay the income in a later year; this discussion is not applicable to the court's decision with regard to 1931 because in that year, which was considered one taxable year of Mr. Penn notwithstanding his death during the year, the receipt and repayment of the income happened in the same year. The fourth and final time the court uses the term "deduction" is in the sole context of describing the Commissioner's position. These four instances say nothing about the court's perspective; accordingly, it is not rationally possible to state that the court in *Penn v. Robertson* was operating "under the deduction rationale" on the basis of the court's use of the term "deduction" in its opinion.[114]

What the court in *Penn v. Robertson* did say was: "But we agree with the district judge that the rescission in 1931 before the close of the calendar year, *extinguished* what otherwise would have been taxable income to Penn for that year."[115]

The authors of *Fabricated Doctrine* acknowledge that the court in *Penn v. Robertson* did use rescission language, such as describing the repayment of the 1931 payment by the taxpayer as a rescission that "extinguished" the entire stock fund transaction for 1931. Moreover, the authors of *Fabricated Doctrine*, in a paragraph in which they characterize the actions of the American Tobacco Company and Penn's executors as creating a deduction, nevertheless state: "Therefore, the reversal in 1931, although undertaken by Penn's executors after Penn's death, was nevertheless Penn's. *This reasoning had the effect of cancelling the 1931 credit, both economically and for tax purposes*."[116] Explaining that the 1931 credit was cancelled, "economically and for tax purposes" sounds as though they are describing a rescission. However, *Fabricated Doctrine*, with no support at all, goes on to assert that:

> Rev. Rul. 80-58 uses the term "extinguished" to mean "ignore both transactions." But the judges in *Penn v. Robertson* were using "extinguished" to mean "completely set off." The outgoing on the rescission in *Penn* gave rise to a *deduction* that completely set off the income. That outgoing was taken into consideration in the tax year of the 1931 credit because the rescission happened before the taxable period closed at the end of that year, in short, in the same tax year. Rev. Rul.

114. *Fabricated Doctrine*, *supra* note 47, at 131–32.
115. 115 F.2d at 175 (emphasis added).
116. *Fabricated Doctrine*, *supra* note 47, at 128 (emphasis added).

80-58, subsequent IRS rulings, and commentaries reject this possible interpretation of *Penn v. Robertson* by ignoring it entirely.[117]

The Merriam-Webster online dictionary offers several definitions of "extinguish," including "to bring to an end," "to make an end of," "to cause to be void," and "to get rid of."[118] It seems likely that both Revenue Ruling 80-58 and *Penn v. Robertson* were using "extinguished" in its commonly-accepted meaning rather than a meaning conjured up to support *Fabricated Doctrine*'s argument. Moreover, Revenue Ruling 80-58 and subsequent rulings and commentaries had good reason to ignore Fabricated Doctrine's "possible interpretation." As discussed earlier, judges and practitioners who are discussing whether a transaction by a taxpayer results in a deduction for income tax purposes do not generally use words like "whether the rescission in 1931 extinguished what otherwise would have been [taxable] income to Penn in that year."[119] More typically, judges and practitioners would use language such as as an offset, or reduction, in taxable income when discussing a possible deduction. *Fabricated Doctrine*'s assertion that the court in *Penn v. Robertson* employed a deduction rationale is a fantasy based on imagined language not used by the court in the way asserted by *Fabricated Doctrine.* In addition, as discussed previously,[120] Revenue Ruling 80-58 did not use the term "extinguished" to mean "ignore both transactions." Revenue Ruling 80-58 states that "the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction."[121]

Moreover, if "the conflation rationale treats the two transactions as a nullity," is that not what the court in *Penn v. Robertson* did when it stated that "we agree with the district judge that the rescission in 1931 before the close of the calendar year, *extinguished* what otherwise would have been [taxable] income to Penn for that year"?[122] However, on facts like those in Situation 1 of Revenue Ruling 80-58, it is incorrect to assert that the "conflation rationale treats the two transactions together as a nullity". In Situation 1 of Revenue Ruling 80-58, the reconveyance of the property by B to A in October 1978 extinguishes the taxable gain to A from the sale by A to B in February 1978. The sale in February 1978 is disregarded for tax purposes, but the reconveyance is what makes the rescission work. The

117. *Id.* at 140. (emphasis added).

118. Merriam Webster Dictionary http://www.merriam-webster.com/dictionary/extinguish.

119. 115 F.2d at 173.

120. *Fabricated Doctrine*, *supra* note 47, at 119–20.

121. Rev. Rul. 80-58, *supra* note 1.

122. 115 F.2d at 175 (emphasis added).

reconveyance is not a nullity. Nor is the February 1978 sale a nullity for state law purposes. B may have some potential liability (for example under environmental laws) arising from his period of ownership.

Fabricated Doctrine also tells us that:

> [H]ad the Commissioner submitted that a conflation could not span two periods their Honours would have recorded their response in their judgment, but they did not. The reason is clearly that *counsel for Penn* did not argue that the case was one of conflation, but was satisfied to argue the case as one of a deduction offsetting an earlier receipt.[123]

Counsel for taxpayer in *Penn v. Robertson* made several arguments: (1) with the exception of $31,498.14 in 1931, Mr. Penn never actually received any money, or benefit from the credits, and should not be charged with constructive receipt;[124] (2) there was no constructive receipt of income by Mr. Penn because the stock allotment plan of 1929 was wholly invalid and void *ab initio*;[125] (3) with the exception of the $31,498.41 in cash in 1931, the whole plan remained executory until it was finally abandoned, and therefore, Mr. Penn didn't have constructive income;[126] and (4) a credit of $90,702.80 should be taxed, if at all, in 1929, not 1930, and a credit of $181,708.12 should be taxed, if at all, in 1930, not 1931.[127]

Based on the foregoing description from the opinion in *Penn v. Robertson* of the arguments made by the taxpayer's counsel, the assertion that the taxpayer's counsel "was satisfied to argue the case as one of a deduction offsetting an earlier receipt" is untenable. If possible, there is even less support for *Fabricated Doctrine*'s assertion than for the assertions that deductibility was material to the court, as the taxpayer's counsel did not use the term "deduction" at all in his arguments. Indeed, when the court framed the issues for decision, it reported the taxpayer's position as follows:

> [T]he taxpayer's contention is that (with the exception of the 1931 item of $31,498.14) Penn never actually received any money or benefit from the credits, and is not chargeable with their constructive receipt, in view of the invalid and executory nature of the transaction; and as the cash item of $31,498.14 was returned during the calendar year upon the rescission of the plan, it was not taxable as income.[128]

Where in this, or in the earlier quote of the court's summary of both

123. *Fabricated Doctrine*, *supra* note 47, at 132 (emphasis added).

124. 115 F.2d at 172–73.

125. *Id.* at 173.

126. *Id.* at 174.

127. *Id.* at 177.

128. *Id.* at 172–173.

parties' positions,[129] is there any word remotely suggesting that the court or taxpayer's counsel was operating under a deduction rationale?

Fabricated Doctrine offers additional arguments:

> The third reason for concluding that *Penn v. Robertson* did not involve the conflation rationale is that this interpretation would require accepting that the judges chose to make new law, even though they could have reached the same result via the established and perfectly ordinary route of subtracting a deduction from income.[130]
>
> There were two transactions relevant to this particular issue: the crediting transaction, the 1931 credit to Penn in his lifetime, and the repayment transaction, the outgoing that the executors incurred months later. Both events were relevant for income tax purposes. To treat the credit as a receipt and the repayment as a deduction requires no magic, no new law. That is how income tax works: on net results. Indeed, the court used the expression, "net profit."[131]
>
> . . .
>
> The court in *Penn v. Robertson* uses the term "net profit" as follows:
>
>> At the outset of the discussion it should be noted that the tax controversy exists only because the stock allotment plan was initiated in 1929 and abandoned in a subsequent tax year. If the plan had been terminated during Penn's lifetime in the same tax year that it originated, it is obvious that there would have been no tax, as there was no *net profit*. On the items in controversy the Commissioner has made tax assessments of about $90,000, which the taxpayers have paid, and the Government contends may not be recovered although the transaction resulted in no *net profit*.[132]

It is hard to see how the court's use of the term "net profit" in this context has any relevance to the argument asserted by *Fabricated Doctrine*. Moreover, in 1929, the value of the stock allotted to the directors of the American Tobacco Company exceeded the cost price to the recipients by close to $2,000.000.[133] If the plan terminated in 1929, saying that there would be "no net profit" sounds as though one would be describing a rescission. Moreover, *Fabricated Doctrine*'s assertion that income tax works on net results is correct only if it is understood to mean "net results

129. *Fabricated Doctrine, supra* note 47, at 127–28.
130. *Id.* at 132.
131. *Id.*
132. 115 F.2d at 173 (emphasis added).
133. *See* 115 F.2d at 173.

within a taxable year." The taxpayer in *Burnet v. Sanford & Brooks Co.*[134] argued that the Sixteenth Amendment prohibited taxation of a transaction on which there was no net profit, but the Court held that net profit must be computed on the basis of the annual accounting period, even if that produces a taxable profit in one or more tax years from a transaction that does not produce a profit overall.

Fabricated Doctrine continues:

> On the other hand, to conclude that the court adopted the conflation rationale one has to assume that for some reason their Honours believed that it was necessary for the court to hold innovatively that some alchemy had operated to conflate the two transactions and to leave them a fiscal nullity as well as being an economic nullity. This conclusion also requires one to believe that the court would have adopted this innovation without explicitly noting that it had done so.[135]

It appears likely that the court did not think it was adopting an innovation. The cases discussed *supra* in Part II support the proposition that taxable income for each tax year is determined by computing net results at the end of the year. Moreover, although *Fabricated Doctrine* ignores it, Revenue Ruling 80-58 included in its legal analysis the statement that "the annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes."[136]

Again, from *Fabricated Doctrine*:

> Fourthly, if the conflation rationale is correct it is an invention of tax law that has no counterpart in the general law. Ordinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out. For instance, Judges Parker and Chestnut took care to explain that Penn was taxable on the 1930 credit to him, and why this was so, even though the credit to him was void. They summarized the reason in these terms:
>
>> But while we regard the [share purchase] plan as void . . . [c]onstructively received income is taxable when the amount is definitely liquidated and available to the taxpayer without restriction. The circumstances under which the credits were made met these conditions. The credits were precise in amount and were absolutely made as reductions of the notes.
>
> It would have been much more radical for their Honours to say that for tax purposes a rescission makes a nondeductible expense deductible.

134. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 361–62, 365 (1931).

135. *Fabricated Doctrine*, *supra* note 47, at 132–33.

136. Rev. Rul 80-58, *supra* note 1 (citing Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944)).

> Considering how carefully they explained the constructive receipt rule that tests derivation for tax purposes, which had by then been established law for years, it is inconceivable that they would have laid down a completely fresh rule without explaining their reasons.[137]

It is entirely unclear what point the authors of *Fabricated Doctrine* are trying to make with some of their statements quoted above. What does it mean to say that "[o]rdinarily, tax law is part of and reflects the rest of the law. Where tax creates its own special rules the courts point this out."? Experienced practitioners have always believed that tax, securities, and corporate and alternative entity law all have their specific concerns, are not consistent, and in no sense can be said to be a part of one another. What can the authors of *Fabricated Doctrine* possibly mean by "if the conflation doctrine [i.e., rescission] is correct it is an invention of tax law that has no counterpart in the general law."? What is general law? Is not tax law part of whatever general law is? Moreover, rescission is recognized in other areas of the law.[138] If rescission is an invention of tax law, why has it been defined by *Black's Law Dictionary* and discussed by treatises such as *Corbin on Contracts* as though it is part of everyday contract and other areas of law?[139] The authors of *Fabricated Doctrine* know this because they discuss how leading contract treatises disagree about the precise definition of the term "rescission."[140]

Fabricated Doctrine attempts to buttress its argument by stating the following:

> Now, examine the issue in terms of Goodhart's analysis of ratio and material facts. For Judges Parker and Chestnut,[141] it was material that the repayment was deductible. ("That the repayment was deductible" appears on its face to be a conclusion of law, rather than the statement of a fact. However, in the context of the tax question at issue in *Penn v. Robertson* the deductibility of the repayment was a matter of fact on which the court built its conclusion of law). Taking it that the repayment was deductible, the court moved to the issue before it: could Penn's estate take advantage of the deduction notwithstanding that he had died

137. *Fabricated Doctrine*, *supra* note 47, at 133.

138. *See, e.g.*, 15 U.S.C. § 1635 (2012) (providing a right of rescission in certain credit transactions).

139. *See* Banoff, *supra* note 45, at 957.

140. *Fabricated Doctrine*, note 47, *supra*, at 141.

141. As noted earlier, at note 100, *supra*, and accompanying text, it is not apparent why *Fabricated Doctrine* claims knowledge of the state of mind of only Judges Parker and Chestnut. Judge Chestnut wrote the majority opinion in *Penn v. Robertson*, in which Judge Dobie joined. *Compare* Penn v. Robertson, 115 F.2d 167, 169 (1940) *with* 115 F.2d at 177 (Parker, J., concurring), where Judge Parker stated he concurred with the result and "also in the reasoning of the court, except with respect to grounds upon which the dividends credited in the year 1930 are taxable income."

> before the repayment was made? That is, in terms of the court's process of reasoning, deductibility of the repayment was a material fact. It follows that we cannot extract authority from *Penn v. Robertson* that in the circumstances of the case, and for tax purposes, the repayment was extinguished. Since extinguishment of the second of a pair of transactions is crucial to the unwind doctrine, it follows that *Penn v. Robertson* is not authority for that doctrine.[142]

As explained above,[143] nothing in the opinion in *Penn v. Robertson* supports *Fabricated Doctrine*'s assertions in the paragraph quoted immediately above. The opinion provides absolutely no indication that the court was acting under a deduction rationale or that the deductibility of the repayment was material. Moreover, to speak of the repayment being extinguished and that "extinguishment of the second of a pair of transactions is crucial to the unwind doctrine" is nonsense. As discussed earlier, the authors of *Fabricated Doctrine* do not appear to understand the meaning of "extinguished," and the rescission could not be extinguished or disregarded if it was to have the effect of causing the transaction to be disregarded for tax purposes.[144]

C. Fabricated Doctrine's Examination of TARP Bonuses

Having presented what can be seen as a Pollyannaish analysis of "true rescissions,"[145] and an egregious misreading of *Penn v. Robertson*,[146]*Fabricated Doctrine* then attempts to illustrate the policy short-comings of Revenue Ruling 80-58 by examining what it views as the possible income tax treatment available to Douglas Poling, who, in 2009, received a $6.4 million bonus from AIG, which AIG paid out of funds it had received from the Troubled Assets Relief Program ("TARP").[147] Following great public outcry and threatened federal legislation to impose punitive taxes on such "TARP bonuses," in March 2009, Poling announced that he would repay his bonus "because [he] thought it was the correct thing to do."[148] The authors of *Fabricated Doctrine* assume for purposes of their paper that Poling's repayment would not be deductible.[149] They state that, if Poling repaid his bonus in 2009 (the year of receipt) the preparer of Poling's tax return would have to determine the correct income tax

142. *Fabricated Doctrine, supra* note 47, at 132.

143. Notes 105-113, *supra*, and accompanying text.

144. *Id.*

145. *Fabricated Doctrine, supra* note 47 at 144.

146. *See supra* Part IV Subsection B Fabricated Doctrine's Analysis of Penn v. Robertson.

147. *See Fabricated Doctrine, supra* note 47, at 122.

148. *Id.* at 123–24.

149. *See id.*

treatment of the receipt of the bonus and its repayment, and that the answer to this would "depend[] on Rev. Rul. 80-58, and the correct meaning of the ruling's purported authority, *Penn v. Robertson*."[150]

Actually, Mr. Poling undoubtedly would have engaged a competent return preparer, who would not have spent any time worrying about Revenue Ruling 80-58 and whether it is in fact supported by *Penn v. Robertson* but instead would have excluded the bonus from Poling's reported taxable income pursuant to the authority of Revenue Ruling 79-311.[151] Revenue Ruling 79-311 holds that if an employee repays compensation in the year of receipt the amount repaid is "excludible from [the employee's] gross income in the year of repayment."[152] Although the repayments in Revenue Ruling 79-311 were required by the relevant employment contract, the IRS views Revenue Ruling 79-311 as extending to voluntary repayments.[153] In addition, IRS Publication 525: Taxable and Nontaxable Income, also states that "if you repay unearned commissions or other amounts in the same year you receive them, reduce the amount included in your income by the repayment." IRS Publication 525 does not treat a repayment in the year of receipt as a deduction. Moreover, Mr. Poling would be able to exclude from income any portion of his TARP bonus repaid in the year of receipt under *Fender Sales, Inc. v. Commissioner*,[154] where the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent he voluntarily returned such bonuses to his employer in the year of receipt. Specifically, the court stated:

> This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.[155]

Fabricated Doctrine does not discuss *Fender Sales* in connection with its consideration of Mr. Poling's tax situation, but it does discuss it with the cases discussed below.[156] *Fabricated Doctrine* asserts that the result in that

150. *Id.* at 124.

151. Rev. Rul. 79-311, 1979-2 C. B. 25.

152. *Id.* (citing Couch v. Commissioner, 1 B.T.A. 102 (1925)).

153. *See* Treasury Information Letter 2005-0146 (September 30, 2005), (stating: "The repayment results in a reduction in gross income and wages rather than a deduction. *See* Couch v. Commissioner, 1 B.T.A. 103 (1924), acq., IV-1 C. B. 1 (1925)").

154. 22 TCM (CCH) 550 (1963), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964).

155. *See id.* at 560-61.

156. *See infra*, Part IV Subsection D Fabricated Doctrine's Discussion of Other

case "seems superficially consistent with the mistaken interpretation of *Penn v. Robertson*," but that "it is not . . . compelling." *Fabricated Doctrine* also states that "the court in *Fender* cites, but does not rely on, *Penn v. Robertson*," instead appearing to create "a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee."[157]

The court in *Fender Sales* cited previous decisions of the U.S. Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites *Penn v. Robertson* in a citation of opinions that are described by the court as "adher[ing] to a similar position." It would seem at least arguable that this is demonstrative of "reliance" on *Penn v. Robertson*. The court in *Fender Sales* certainly gave no indication in its opinion that it thought it was creating a special rule, particularly one that would apply only where the taxpayer in effect was on both sides of the unwinding.[158]

Cases.

157. *Fabricated Doctrine*, *supra* note 47, at 149.

158. *See* John W. Lee, *Tax TARP Needed for Year One and Year Two Returns of Executive Bonuses to TARP Recipient: A Case Study of Year One Rescission/Exclusion from Income and Year Two Deduction Under Section 1341* 1 WM. & MARY L. REV. 323, 376–77 (2010); there Mr. Lee states:

> By the 1940s the Tax Court had come to flatly stating the rule as follows:
>
> > [C]ompensation for services of officers of corporations for any period is subject to modification either by corporate action or by agreement at any time and from time to time during the taxable year and the amount at which compensation is finally adjusted at the close of the taxable year is the amount which the officer must report as compensation or the corporation may deduct as ordinary and necessary business expense. [citing, at note 245, *McEwen v. Commissioner*, 6 T. C. 1018, 1025 (1946).]
>
> The Tax Court has applied this exception to modifications where the payment of compensation was neither in error nor subject to conditions subsequent.[citing, at note 246, *Fender Sales*.]
>
> Similarly, the Service often flatly states the rule to be that a taxpayer's gross income includes the amount of compensation set forth in a renegotiated employment contract rather than the amount of compensation set forth in an original employment contract where the renegotiated employment contract is bona fide and legally binding on the parties. Furthermore, the Board of Tax Appeals, the Tax Court, and the Service are generally in agreement that the renegotiated employment contract must be executed and the resulting salary adjustments must be implemented prior to the close of the taxpayer's taxable year.[citing, at note 247, I. R. S. Field Serv. Adv. Mem., 1994 FSA LEXIS 5 (Oct. 18, 1994.)
>
> The Service reasoned that:
>
> > [w]here both the initial receipt of funds and the repayment of some portion

In addition, Mr. Poling's tax return preparer could rely on *Bishop v. Commissioner*.[159] In that case, the petitioner was a shareholder of Pendleton Woolen Mills. Another shareholder had asserted a claim against the petitioner and other shareholders who were diverting business from the corporation and using its name in partnerships that the petitioner and the other shareholders had formed. The shareholder's claims against petitioner and the other shareholders involved in the partnership were settled in an agreement entered into on December 31, 1946 and approved by the corporation's board of directors on the same day. Also, on December 31, 1946, pursuant to the agreement, the partnerships were terminated and all of their 1946 income was transferred to the corporation. The Tax Court held for the petitioner, agreeing that all of the partnerships' 1946 income was taxable to the corporation, stating:

> We recently considered the application of the claim of right doctrine in Michael Phillips, 25 T. C. 767. Briefly, the petitioners assert that the directors of a corporation cannot retain income gained personally from a deal with the assets of the corporation, citing *Enyart v. Merrick,* 148 Ore. 321, 34 P.2d 629, and that under the facts here Pendleton was entitled to this partnership income. The next step in petitioner's argument is that where the alleged income is restored to the rightful owner in the same taxable year it is received, then the income is not taxable to the original recipient.
>
> The petitioners' contention is supported by authorities. The 'claim of right' doctrine had its origin in *North American Oil Consolidated v. Burnet,* 286 U.S. 417. In general, it charges the recipient with the receipt of income when he asserts a claim it is his even though his claim later proves to be invalid. There is no need to go into a general discussion of the claim of right doctrine for actually here the question is as to the tax consequences when in the year of receipt the claim of right is renounced and the income repaid to its rightful owner. The applicable rule was recently stated in the following quotation from *United States v. Merrill,* 211 F.2d 297:
>
>> We are not aware that the rule has ever been applied where, as here, in the same year that the funds are mistakenly received, the taxpayer discovers and admits the mistake, renounces his claim to the funds, and recognizes his obligation to repay them. Cf. *Carey Van Fleet,* 2 B. T. A. 825; *Curran Realty Co. v. Commissioner,* 15 T. C. 341. We

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thereof take place in the same year, there cannot very well be a serious question about the overall propriety of excluding the amount so repaid from the taxable income of the party who has thus effectively relinquished or disavowed any claim thereto.[citing, at note 248, I. R. S. Gen. Couns. Mem. 33,602 (Aug. 25, 1967.]

159. 25 T.C. 969 (1956).

> think there is no warrant for extending the harsh claim of right doctrine to such a situation. In such case the Internal Revenue Bureau is not faced with the problem of deciding the merits of the claim to the funds received, for the question has been resolved by the interested parties.[160]

Returning to *Fabricated Doctrine*, the authors tell us that Poling's situation drives them to examine whether Rev. Rul. 80-58 would allow Poling to exclude his TARP bonus from income if he repays it. They state that they will now:

> [E]xplain what *Penn v. Robertson* does and does not stand for, and show how Rev. Rul. 80-58 misinterprets *Penn v. Robertson*. On a correct interpretation of the law, taxpayers like Mr. Poling would owe tax on a bonus even if they had returned it. The bonus receipt would be taxable, the repayment we assume is not deductible, and no special tax rule would apply to allow the transactions to nullify each other for tax purposes.[161]

Fabricated Doctrine is probably correct in its assumption that Poling's repayment of his bonus would not be deductible, because, as explained above,[162] the amount repaid in the year of receipt would be excluded from his income on the basis of authorities other than Rev. Rul. 80-58, authorities either not discussed at all by *Fabricated Doctrine* or not discussed in connection with Mr. Poling's situation.

In its discussion of the potential tax treatment of Douglas Poling, *Fabricated Doctrine* assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above[163]that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Polling would likely be entitled to treat repayment as a rescission under Revenue Ruling 80-58. *Fabricated Doctrine* states that "[i]t has been asserted that the unwind doctrine in Rev. Rul. 80-58 saves Poling from a net tax impost in respect of his returned bonus, even if under ordinary tax principles the receipt of the bonus is taxable and its return not deductible."[164]For its statement that "it has been asserted that . . . Rev. Rul. 80-58 saves Poling," *Fabricated Doctrine* states "The authors again thank unnamed United States colleagues[165]who suggested that reliance on revenue rulings would

160. *Id.* at 974.

161. *Fabricated Doctrine, supra* note 47, at 127.

162. Note 153, *supra*, and accompanying text.

163. Note 153, *supra*, and accompanying text.

164. *Fabricated Doctrine, supra* note 47, at 127.

165. *Fabricated Doctrine* did thank certain colleagues by name for reviewing the article. *See id.* at 117, n. 1.

lead to the result that Poling would pay no net tax."[166] It is unfortunate that *Fabricated Doctrine* could not name these colleagues so that others could know just what revenue rulings they were referring to. As discussed earlier, there are cases and a published revenue ruling that are not rescission authorities, but are based on the annual accounting concept and indicate that Mr. Poling would be entitled to exclude his TARP bonus from income if he repaid it in the year of receipt.

Fabricated Doctrine states:

> If the IRS continues to follow and apply Rev. Rul. 80-58 as it has, both Poling's receipt of the bonus and his return of it to AIG would be treated for tax purposes as if they had not occurred. He would not have to acknowledge either transaction on his income tax returns. This is a far more attractive result for Poling than that reached under ordinary tax principles, which would require him to pay tax on a bonus that he does not keep.[167]

Despite *Fabricated Doctrine*'s concern that Revenue Ruling 80-58 would save Mr. Polling, this Article demonstrates that several authorities not discussed in *Fabricated Doctrine* would give Mr. Polling his desired tax treatment without application of Revenue Ruling 80-58.[168] Moreover, because Mr. Polling's repayment of his TARP bonus likely would not be considered the undoing of a contract, there exists considerable doubt whether the IRS would apply Revenue Ruling 80-58 to his situation because of the IRS requirement that rescission means the rescission of a *contract*.[169] *Fabricated Doctrine* apparently goes on at such length about Mr. Poling's situation because the authors viewed Mr. Poling as the poster child for, what they believed to be, inappropriate relief that Revenue Ruling 80-58 would afford him when "ordinary tax principles" would not save him. Of course, as this Article explains, ordinary tax principles other than Revenue Ruling 80-58 would very likely have provided Mr. Poling with the tax treatment he presumably desired.[170]

D. Fabricated Doctrine's Examination of Other Cases

From its misanalysis of Douglas Poling's tax situation, *Fabricated Doctrine* moves on to a discussion of other cases and makes much of the point that they could find no subsequent case that the authors believed clearly cited *Penn v. Robertson* or relied on it to treat an unwinding as a rescission. In the minds of the authors of *Fabricated Doctrine*, this

166. *Id.* at 127, n. 50.

167. *Fabricated Doctrine*, *supra* note 47, at 148 (footnotes omitted).

168. *See* Note 153, *supra*, and accompanying text.

169. *See* Note 11, *supra*.

170. *See* Note 153, *supra*, and accompanying text.

indicates that *Penn v. Robertson* is not really a rescission case. They fail to discuss the possibility that there are no such cases because the IRS didn't challenge cases that involved unwindings in the same tax year. Cases involving a taxpayer's attempts to reduce income in one year because of events in a later year are decided as claim of right cases, not rescission cases. Prebble and Huang discuss the following cases, apparently on the theory that it demonstrates that the later cases did not directly rely on *Penn v. Robertson*, that bolsters their argument that *Penn v. Robertson* is not a rescission case.

This Article has already discussed *Fender Sales, Inc. v. Commissioner.*[171] There, the court held that petitioner C. Leo Fender was not taxable on bonus payments received in 1956 and 1957 to the extent that he returned such bonuses to his employer in the year of receipt. The court stated:

> This Court has adopted and consistently followed the legal proposition that where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of such adjusted amount.[172]

Although certainly not a literal rescission case, *Fender Sales*, nevertheless is completely consistent with the rescission doctrine that has developed since *Penn v. Robertson*. *Fabricated Doctrine* discusses *Fender Sales* by stating that the result in that case "seems superficially consistent with the mistaken interpretation of *Penn v. Robertson*." *Fabricated Doctrine* then asserts that "it is not . . . compelling." *Fabricated Doctrine* states that "the court in *Fender* cites, but does not rely on, *Penn v. Robertson*," and appears to "create a special rule when a reversal transaction will be considered deductible in its own right: namely in circumstances where both transactions involve a company and a principal shareholder in that company who is also an employee."[173] The court in *Fender Sales* cited previous decisions of the U.S. Tax Court and its predecessor, the Board of Tax Appeals, as direct authority for its statement quoted above. The court cites *Penn v. Robertson* in a citation of opinions that are described by the court as "adher[ing] to a similar position." It would seem at least arguable that this is "reliance" on *Penn v. Robertson*. The court in *Fender Sales* certainly gave no indication in its opinion that it thought it was creating a special rule, particularly one that would apply

171. 22 TCM (CCH) 550 (1963), *rev'd on other grounds*, 338 F.2d 924 (9th Cir. 1964). *See* note 157, *supra*, and accompanying text.

172. 22 TCM (CCH) at 560.

173. *Fabricated Doctrine*, *supra* note 47, at 149.

only where the taxpayer was in effect on both sides of the unwinding.[174]

Fabricated Doctrine discusses three opinions that were reversed by the Supreme Court in *United States v. Lewis*,[175] a claim of right case that unsurprisingly held that a taxpayer who received a $22,000 bonus in 1944 was taxable on the full amount in 1944, even though he was required to pay back $11,000 of the bonus in 1946. The taxpayer's repayment in 1946 was deductible in 1946. Inasmuch as there exists no legal authority holding that an unwinding that spans two or more taxable years can normally be treated as a rescission for federal income tax purposes, *Lewis* hardly represents a case that rejects the rescission doctrine, and is consistent with the holding of *Penn v. Robertson* as to the tax year 1930.[176]

Fabricated Doctrine discusses three lower court opinions, *Gargaro v. United States*,[177] *Lewis v. United States*,[178] and *Haberkorn v. United States*.[179] All three cases involved employees who had received bonuses in one year and were required to return a portion of the bonus in a later year. The U.S. Court of Federal Claims in *Gargaro* and *Lewis* allowed the taxpayer to reopen his tax return for the year of receipt of the bonus. *Haberkorn*, following *North American Oil Consolidated v. Burnet*,[180] held that the taxpayer could only deduct the repayment in the year of the repayment. The Supreme Court, in its opinion in *United States v. Lewis*, reversed the U.S. Court of Federal Claims decisions and affirmed *Haberkorn*. None of this is remarkable—all of this flowed from the claim of right doctrine that was established by *North American Oil Consolidated* and was followed in several later cases, including *Penn v. Robertson* (as to the tax year 1930). As the Court stated in *United States v. Lewis*:

> In the *North American Oil* case we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."
>
> . . .

174. *See* Lee, *supra* note 157.

175. 340 U.S. 590 (1951).

176. Banoff, *supra* note 45, at 967–68 (discussing the rare instances, all involving adversarial court action, in which an original transaction has been declared void *ab initio* and rescission treatment allowed for an unwinding in one year of a transaction that occurred in a prior year).

177. 73 F. Supp. 973 (Ct. Cl. 1947).

178. 91 F. Supp. 1017 (Ct. Cl. 1950).

179. 173 F.2d 587 (6th Cir. 1949).

180. 286 U.S. 417 (1932).

> Income taxes must be paid on income received (or accrued) during an annual accounting period. [citation omitted] and see *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, § 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.[181]

The claim of right doctrine applies differently when the repayment occurs in the same taxable year as receipt.[182]

Fabricated Doctrine tells us that "the principles of general justice applied in cases such as *Gargaro* and *Lewis* discussed above do not extend to all cases to which the unwind doctrine has been applied."[183] It goes on to suggest that a court might be sympathetic to Mr. Poling (and other taxpayers similarly situated) because of the argument that he returned his bonus due to the strong public feeling that this was the correct moral action, and that as a result, he should not face a negative tax consequence. Further:

> [a]ppeals to general notions of justice are unlikely, however, to be sustained in other cases to which the unwind doctrine has applied, such as cases where the reversal has been precipitated by unwise management decisions or the taxpayer's regret about the tax consequences of the original transaction. Considerations of justice in *Gargaro* and *Lewis* would seem to allow unwind treatment only in cases only where the unwind has moral value.[184]

As discussed earlier,[185] the opinions referred to here by *Fabricated Doctrine* are opinions of the U.S. Court of Federal Claims in two cases that were reversed by the Supreme Court in *United States v. Lewis*—an unremarkable claim of right case.[186] It is not clear what value these U.S. Court of Federal Claims opinions have at all. Generally, lower court opinions that are reversed because they are in clear conflict with Supreme Court precedent would be considered minimally persuasive, if at all. *Fabricated Doctrine* appears to be suggesting that some pro-unwinding arguments might be beneficial if an appeal could be made to "justice" and it could be argued that the desired unwinding "had moral value."[187] As

181. 340 U.S. at 591–592.
182. *See* 25 T.C. 969 (1956).
183. *Fabricated Doctrine*, *supra* note 47, at 164.
184. *Id.*
185. *See* 173 F.2d 587 (6th Cir. 1949).
186. *See id.*
187. *Fabricated Doctrine*, *supra* note 47, at 164.

explained below,[188] this Article asserts that there is ample legal and policy support for the rescission doctrine as articulated by Revenue Ruling 80-58, and it is not believed that any appeal to abstract notions of justice or morality are necessary.

Fabricated Doctrine next considers two cases, *In re Trico Marine Services*[189] and *Scallen v. Commissioner*,[190] describing them as "cases that mention *Penn v. Robertson* in dicta, and at best provide weak dicta support for unwinding."[191] In *Trico Marine Services*, the court considered plaintiff's motion to set aside the confirmation order. In discussing the practical feasibility of unwinding the bankruptcy plan that had been confirmed and carried out, the court stated:

> Where property is sold or conveyed, and the transaction is then rescinded, the rescission does not undo the tax effect of the initial transaction unless two factors are present. First, the rescission must occur in the same tax year as the initial transaction. [citing Penn v. Robertson, 115 F.2d 167, 175 (4th Cir.1940); and Rev. Rul. 80-58; other citations omitted]. The rule is one of practicality, based on the annual accounting principle that "requires the determination of income at the close of the taxable year without regard to the effect of subsequent events." *Penn,* 115 F.2d at 175; *accord Security Flour Mills Co. v. C.I.R.*, 321 U.S. 281, 286, 64 S.Ct. 596, 88 L.Ed. 725 (1944). Second, the parties to the transaction must be returned to the *status quo ante.* [citations omitted].[192]

As one can see, the court in *Trico Marine Services* cited *Penn v. Robertson* as authority for one of the basic requirements for a valid rescission. However, the court in *Trico Marine Services* held that no rescission had occurred in that case because it was impossible to return the parties to the *status quo ante.*

In *Scallen*, a corporation controlled by the taxpayer, Blue Ridge Properties Corporation in, January 1979, sold a hotel and apartments (the "Property") to Gerald R. Hansen. The next day, Hansen sold the Property to Bradley A. Herman. On November 19, 1979, Herman sold the Property to Campus Realty Corporation, another corporation controlled by the taxpayer. The Commissioner argued that these transactions resulted in a rescission of the January sale, and that the taxpayer, therefore, had no capital gain or loss from that sale and had his historic basis in the Property. The court noted that no gain would:

> be recognized, however, if in the year of sale, the sale is rescinded and

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188. *See* Part V, *infra* The Rescission Doctrine as Currently Applied by the IRS is Correct and Would be Correct Even if Penn v. Robertson had Never Been Decided.

189. 343 B.R. 68 (Bankr. S.D.N.Y. 2006).

190. 54 T.C.M. (CCH) 177 (1987).

191. *Fabricated Doctrine*, *supra* note 47, at 148.

192. 343 B.R. at 73.

> the taxpayer accepts reconveyance of the property and returns the buyer's funds. *Penn v. Robertson,* 115 F.2d 167 (4th Cir. 1940). We agree with respondent's statement of the law, but we do not agree that a rescission occurred on these facts.[193]

The court disagreed with the Commissioner because it was unwilling to disregard the corporate form of Blue Ridge Properties Corporation or Campus Realty Corporation. The court also stated that there was no agreement for rescission characterizing the transactions as a rescission would require disregarding the sale on February 1, 1979 from Hansen to Herman, and the Commissioner had offered no argument that that should be done. Once again, the court in *Scallen* cited *Penn v. Robertson* as authority but held that no rescission had occurred on the facts before it.

In *Hutcheson v. Commissioner,*[194] the taxpayer sold Wal-Mart stock in January 1989 and repurchased an equivalent amount of stock in December, 1989. While the court applied the principles of Rev. Rul. 80-58, the court unremarkably held that no rescission had taken place because the stock acquired in December was not the same stock that was sold in January.

In *Estate of L. E. Crellin v. Commissioner,*[195] the directors of a California personal holding corporation received erroneous advice from the corporation's Certified Public Accountant ("CPA"). The CPA advised the directors that the corporation would be subject to the personal holding company surtax unless the directors declared and distributed to the corporation's shareholders a dividend approximately equal in amount to a capital gain the corporation had received earlier in the year the dividend was paid. Later, in the same year, the directors learned that the CPA's advice was erroneous and passed a resolution purporting to rescind the dividend and directing that a demand be sent to the shareholders for return of the amounts paid to them. All of the shareholders returned the dividends. All of these events—the dividend, the resolution rescinding the dividend, and the repayment of the dividends by the shareholders—occurred in the same year.[196] As Sheldon Banoff demonstrates in his seminal article on rescissions,[197] except in the case of dividends mistakenly paid because of a scrivener's error, taxpayers cannot avoid dividend income by *voluntarily* repaying the dividends. In this case, the corporation had no right to enforce its demand that the shareholders repay the dividends, and the court held for the Commissioner. However, in so holding, the court noted, by contrasting the case of a compelled repayment

193. 54 T.C.M. at 205.

194. 71 T.C.M. (CCH) 2425 (1996).

195. 203 F.2d 812 (1953).

196. 203 F.2d at 813.

197. Banoff, *supra* note 45, at 981.

of a dividend that "when payment and return of the dividend occur within the same taxable year, it is reasonable to view the transaction as involving no increment to gross income, rather than an increment to gross income plus a deduction." Although this statement is plainly dicta, it suggests that the court would not be unfriendly to a taxpayer arguing for rescission treatment on facts like those for 1931 in *Penn v. Robertson*, and that the court would not be applying a deduction rationale to a same-year unwinding.

In *Branum v. Campbell*,[198] pursuant to a contract effective April 1, 1948, the taxpayer sold a 50% interest in a brokerage business to C. T. Green for $15,000. The contract provided that the taxpayer and Green were to operate the business as a partnership for an indefinite term unless terminated by operation of law or by agreement of the parties. On September 30, 1948, the taxpayer and Green entered into a second contract providing for the dissolution of the partnership and the payment of $15,000 from the taxpayer to Green for Green's interest in the partnership.

The taxpayer contended that he had no gain or loss on the transaction. He claimed that he had initially sold the business with the understanding that, if the partnership arrangement proved unsatisfactory, he would reimburse Green, as he claimed to do. The IRS did not accept this explanation. In concluding that a completed sale, separate and distinct from the partnership dissolution, had occurred, the court reasoned:

> The words and the tenor of the contract are definite. There is no reservation of title and no indication of a conditional or provisional agreement between the parties . . . There is no mention of an oral agreement [to unwind] . . . in the contract. . . . We think the evidence amply supports the findings by the court below that there was a completed sale[.]

One wonders what the result in *Branum* would have been had the taxpayer and Green entered into a contract rescinding the sale of the taxpayer's 50% interest in his brokerage business to Green instead of, as they did, agreeing to dissolve the partnership. Indeed, the IRS views *Branum* as a case that "while on the facts not holding that a rescission has taken place, acknowledges the principle that rescission in the year of sale will extinguish otherwise taxable gain."[199]

Fabricated Doctrine has the following observation about *Branum*:

> Commentary has implied that the taxpayer's argument might have fared better had the unwind transaction been "styled as a rescission." However, *Crellin's Estate* above suggests that even if the taxpayer in *Branum v.*

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198. 211 F.2d 147 (5th Cir. 1954).

199. The author acknowledges relying on Banoff's description of *Branum* for the discussion above. Banoff, *supra* note 45, *supra*, at 961.

> *Campbell* had labeled the repurchase of his partnership interest a "rescission" of the original sale, the court would have looked beyond the label to the substance which in this case was not a true rescission but, as the court noted, "separate and distinct."[200]

What the court in *Branum* said were "separate and distinct" were the taxpayer's sale of one-half of his business and the later dissolution of his partnership with the purchaser. If, instead of dissolving their partnership, the taxpayer and Green had agreed that Green would return the one-half of the brokerage business to the taxpayer that Green had purchased and that the taxpayer would return Green's purchase price, the taxpayer might have been able to argue successfully for rescission. One issue, given the nature of the business, would have been whether the parties could have been put back in the status quo ante. Another potential issue is whether the applicable partnership law would have allowed the transaction to be a rescission of the sale of the brokerage business. In any event, such a recasting of the transaction would have been more than a different styling like that dismissed above by *Fabricated Doctrine.* Moreover, *Fabricated Doctrine*'s reference to *Crellin's Estate* is improvident; as discussed above, voluntary repayment of dividends is always ineffective to avoid taxation.[201] The rules are different for other types of voluntary unwindings, like the repayment of a bonus.[202]

E. Policy Analysis in Fabricated Doctrine

In its last four pages, *Fabricated Doctrine* states its conclusion and discusses some policy issues. First, it states:

> The IRS should revoke its mistaken ruling, or to the extent that any ambiguity in the ruling allows it to be applied in ways that are not legally correct, should correct that ambiguity. The Treasury Regulations state that "the purpose of publishing revenue rulings . . . is to promote correct and uniform application of the tax laws by Internal Revenue Service employees and to assist taxpayers in attaining maximum voluntary compliance." Rev. Rul. 80-58 currently violates this regulation because it promulgates an incorrect interpretation of the tax law set out in *Penn v. Robertson.*[203]

In the second sentence of the above quotation, *Fabricated Doctrine* cites Treasury Regulation Section 601.601(d)(2)(iii) correctly. However, *Fabricated Doctrine* should have also considered Treasury Regulation Section 601.601(d)(2)(i)(a), which states: "A Revenue Ruling is *an official*

200. *Fabricated Doctrine, supra* note 47, at 160.
201. *See* Note 196, *supra*, and accompanying text.
202. *See* Note 152, *supra*, and accompanying text.
203. *Fabricated Doctrine, supra* note 47, at 163 (footnotes omitted).

interpretation by the Service that has been published in the Internal Revenue Bulletin. Revenue Rulings are issued only by the National Office and are published for the information and guidance of taxpayers, Internal Revenue Service officials, and others concerned."[204] Therefore, the question isn't just whether Revenue Ruling 80-58 is a correct interpretation of *Penn v. Robertson*, although this Article submits that it is, the question is whether Revenue Ruling is a correct interpretation of the law. As this Article summarizes below,[205] there are other legal and policy bases for Revenue Ruling 80-58. In this regard, it should be noted that *Fabricated Doctrine* also makes an incorrect statement in its footnote to the last sentence of the above quote which states: "While section 7805(b) gives the I.R.S. some discretion in enforcing the code, Revenue Ruling 80-58 does not purport to rely on discretion."[206] It is elementary that an official need not refer to his or her grant of discretion to take action based on that grant. Moreover, if Revenue Ruling 80-58 is viewed as a statement by the IRS that it will not challenge taxpayers who take the position on facts substantially similar to those in Situation 1 of Revenue Ruling 80-58 that they have engaged in valid rescissions for tax purposes, Revenue Ruling 80-58 could be viewed as an agency non-enforcement decision that is not subject to judicial review.[207]

Momentarily, it appears that *Fabricated Doctrine* is on the right track when it states that:

> Perhaps the most promising principled basis for the unwind doctrine is the idea that tax law should follow economic substance, coupled with the tax year accounting principle in *Saunders v. Commissioner*. Perhaps tax law should strive, where possible, to base legal outcomes on the net change in taxpayers economic positions during the tax year, ignoring interim changes in legal and economic position. A uniform application of this principle however would have implications somewhat more radical than allowing taxpayers to claim unwind treatment at their discretion; it would require that treatment in every relevant case, and would further indicated a broader move towards reporting of net tax positions only at year end.[208]

Saunders is a very short opinion in a claim of right case and does not mention a "tax year accounting principle" or any other accounting principal or concept. The remainder of the quoted paragraph could only be written by persons who have no understanding of the annual accounting concept as

204. Treas. Reg. § 601.601(d)(2)(i)(a) (1987) (emphasis added).

205. *See* Part V, *infra* The Rescission Doctrine as Currently Applied by the IRS is Correct and Would be Correct Even if Penn v. Robertson had Never Been Decided.

206. *Fabricated Doctrine, supra,* note 47, n. 185.

207. *See* Heckler v. Chaney, 470 U.S. 821 (1985).

208. *Fabricated Doctrine*, note 47, *supra*, at 164–165.

it has developed in U.S. federal income tax law. Moreover, *Fabricated Doctrine* shows its misunderstanding of the federal tax system by stating that taxpayers are now allowed "to claim unwind treatment at their discretion." If a taxpayer's sale were rescinded on facts that would come within Situation 1 of Revenue Ruling 80-58, the taxpayer's failure to treat the sale as rescinded would no doubt be challenged by the IRS if the taxpayer were audited.[209] Also, when do the authors of *Fabricated Doctrine* think taxpayers report their taxable income if not at the end of each year? *Fabricated Doctrine* also proceeds immediately to undercut its own suggestion by discussing Hasen's comprehensive but highly theoretical article:[210] "Furthermore, it is not clear that an economic substance approach would necessarily support the unwind doctrine. Hasen, in *Unwinding Unwinding*, created a theoretical framework for analyzing 'unwind' cases. Hasen attempted to derive from the Haig-Simons economic income concept principles for whether and when unwinding should be allowed."[211]

Hasen's discussion of the Haig-Simons conception of income is, in part, as follows:

> The Haig-Simons conception of income, named after the two theorists who are credited with having articulated it, defines income as the net change in a taxpayer's wealth (including wealth spent on consumption) during the tax period. The occurrence or not of transactions is irrelevant to the amount of the taxpayer's income or loss and, therefore, to the amount of income tax liability the taxpayer has during the tax period. Thus, the Haig-Simons definition takes into account the net appreciation and depreciation of assets held during the tax period, without regard to whether the assets are retained or sold. For example, whether or not *A* sells *Blackacre* on December 31, her tax liability for the year ending on that date is the same, because the increase or decline in value of *Blackacre* is definitive of whether she has taxable income or loss.[212]

Most readers will note right away that our income tax system is not based on Haig-Simons, as Hasen notes:

> [T]he Haig-Simons concept does not, in fact, supply the normative definition of income under the actual income tax. For one thing, the actual tax has always incorporated a realization requirement for most forms of income, and likely always will. Moreover, the historical justification for the income tax has more to do with practical ability-to-pay concepts than with the ideal of taxing Haig-Simons income. Actual ability to pay hinges in some measure on liquidity and valuation, two problems for a Haig-Simons tax that a realization-based income tax

209. *See* Scallen v. Commissioner, 54 T.C.M. at 205.

210. *See Fabricated Doctrine*, *supra* note 47, at 165 (citing Hasen, *supra* note 43).

211. *Id.*

212. Hasen, *supra* note 43, at 897–98.

largely solves.[213]

And Hasen further notes: "[f]rom a Haig-Simons perspective, the non-taxation of accrued but unrealized gain or loss represents an accommodation of the income tax to other exigencies, principally the problems of valuation, liquidity, and political acceptability."[214]

Hasen points out that rescission would be irrelevant in a Haig-Simons system of taxation.[215] But, as Hasen also notes in the above-quoted portions of his article, we don't live in a Haig-Simons tax world. Accordingly, rescission's lack of importance in a Haig-Simons system is irrelevant to whether the current rescission doctrine of Revenue Ruling 80-58 is good policy.

Fabricated Doctrine also notes:

> Hasen argued that "the substantive case for unwinding treatment is comparatively weak" in situations where income tax consequences are being unwound, as compared to situations where transactional taxes are being unwound. The crux of his thesis is that:
>
> > the existence of the thing that is taxed—income—does not depend on the fact of a transaction. Rather, the transaction provides the occasion for imposing the tax now rather than at some other time; the income (or loss), however, will generally be taken into account eventually. Hence the availability of the unwind treatment should not depend, even in the abstract, on the mere return to the status quo ante, because such a return does not mean that nothing giving rise to a tax has occurred. Hasen concludes that "any reversal, to merit unwind treatment, ought to be allowed only if the mistake or error giving rise to it is justified."[216]

Hasen makes other interesting statements: The "rightness" of any given rule in the abstract, however, is not the only consideration relevant to shaping a well-conceived unwinding doctrine. A further and equally significant consideration is *consistency*."[217]

This Article submits that the annual accounting concept as applied in Revenue Ruling 80-58 and the claim of right cases bring consistency to tax law. Moreover, although *Fabricated Doctrine* is correct that Hasen views the justification for allowing rescission treatment in income tax cases as comparatively weaker than for transactional tax cases, he nowhere attempts to quantify the difference, and he concludes his article by stating that rescissions will very likely continue to be allowed on some basis in income

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213. *Id.* at 899.

214. *Id.* at 898.

215. *See id.*

216. *Fabricated Doctrine*, note 47, *supra*, at 165.

217. Hasen, *supra* note 43, at 904 (emphasis added).

tax cases.[218] However, Hasen also discusses tax benefit rule cases and claim of right cases in connection with rescission and makes the following observation:

> If the compulsory nature of a reversal is considered one of the necessary conditions of unwind treatment, then Revenue Ruling 80-58 is overbroad in permitting unwinds in the same taxable year as the original transaction, regardless of whether the reversal is a product of the taxpayer's choice. On the other hand, if the sanctity of the annual accounting principle provides the basis for according or denying unwinding relief, it is unclear why the principle does not also govern claim of right and TBR cases, at least where the error giving rise to the later-year adjustment concerns the taxpayer's knowledge of underlying facts that themselves have not changed.[219]

The tax benefit rule ("TBR") provides that if a taxpayer recovers an expense or loss that was written off against a previous year's income, the recovered amount must be included in income in the year of recovery. Frequently recurring tax benefit situations are the inclusion of a prior bad debt deduction upon the unexpected repayment of the debt, and the inclusion in income of amounts previously deducted as losses under Section 165 when the amounts have been unexpectedly recovered.[220] The claim of right cases hold that if a taxpayer receives income in one year without any restriction on the taxpayer's use of the income, the full amount of the income must be included in the year of receipt notwithstanding a possibility that the taxpayer might be required to repay some or all of the income in the future.[221]

It is unclear why application of the annual accounting concept should change the treatment of tax benefit cases or claim of right cases. The annual accounting concept provides that a taxpayer's income for a taxable year is computed on the basis of the facts at the end of the year.[222] If the facts existing at the end of a taxpayer's tax year support the taking of a loss deduction or require the inclusion of income received under a claim of right, then that is the mandated result, and a taxpayer is not permitted to

218. *Id.* at 942 ("These considerations do not imply that unwinding should be unavailable under an income tax. They only indicate that the case for income tax unwinding is weaker than the case for transactional taxes. The possibility of evasion or avoidance may be a cost worth bearing, especially if the contexts in which unwinding is deemed a permissible remedy are sufficiently salient to the tax authority that the worry about evasion is minimal, the options for avoidance are minimized, or both.").

219. *Id.* at 923.

220. *Id.* at 906. *See* Treas. Reg. § 1.165-1(d)(2)(iii) (1977). (specifying that the rule applies to unexpected recoveries of losses that were reasonably but erroneously deducted in a prior taxable year).

221. United States v. Lewis, 340 U.S. 590, 591-592.

222. Note 39, *supra*, and accompanying text.

reopen a prior year on the ground that the relevant facts have changed since the end of that year. On the other hand, the rescission treatment allowed by Rev. Rul. 80-58 is consistent with the annual accounting concept, in that the rescission must take place in the same tax year as the transaction that is being rescinded; thus, the facts at the end of the tax year include the fact of the rescission. In connection with his argument that the annual accounting principle, if applied to tax benefit cases and claim of right cases in the same way it is applied to rescissions, would change the treatment of those cases, Hasen states: "For example, it is not clear why a deduction should be tan item that she included in a prior year."[223] This statement seems incorrect. If the taxpayer in a prior year included as income an amount the taxpayer did not actually receive, the annual accounting principle would say that that amount should not have been included in income in the prior year and the taxpayer's remedy should be limited to filing an amended return that would report taxable income correctly for the prior year based on the facts existing at the end of that year (although misapprehended by the taxpayer).

Fabricated Doctrine then refers to another article by Banoff, in which he discusses policy arguments both for and against permitting retroactive unwinding, including the argument against, that "approval of retroactive unwindings that are tax motivated permits taxpayers to play the audit lottery: If you are audited, only then do you unwind to avoid adverse tax results."[224] With respect to Banoff, under the present state of authority on rescission, it is unclear how one could play the audit lottery. If a taxpayer waits until he or she is audited, it will be impossible to carry out an unwinding in the same year as the transaction desired to be unwound.

Fabricated Doctrine continues:

> The unwind doctrine may similarly dilute the deterrent effect of the codified economic substance doctrine in section 17709(o) [sic] by allowing taxpayers to undertake transactions that may risk falling foul of that doctrine knowing that they can be rescinded later in the tax year if they receive advice that it would certainly fall foul of section 17709(o) [sic].[225]

Fabricated Doctrine's references to "section 17709(o)" [sic] appear to be intended to be references to I.R.C. Section 7701(o), which defines the "economic substance doctrine" as "the common law doctrine under which tax benefits under Subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business

223. Hasen, note 43, *supra*, at 923, n. 213.

224. *Fabricated Doctrine*, *supra* note 47, at 165–66 (citing Sheldon I. Banoff, *New IRS Rulings Approve Rescission Transactions That Change an Entity's Status*, 105 J. TAX'N 5, 6 (2006)).

225. *Id.* at 166.

purpose."[226] I.R.C Section 7701(o) also states rules for determining if economic substance exists. I.R.C. Section 6662 imposes penalties. I.R.C. Section 6662(a) imposes a penalty of 20% of the portion of any underpayment attributable to any of various defined actions, including any disallowance because a transaction lacks economic substance "within the meaning of section 7701(o) or failing to meet the requirements of any similar rule of law."[227] If a transaction that does not have economic substance is not disclosed in the taxpayer's return, the penalty increases to 40%.[228] It is clear that almost all unwinding transactions will have economic substance because the very nature of an unwinding transaction that comes within Revenue Ruling 80-58 is that the parties will have changed their economic position in a meaningful way—either by undoing a sale of property or by giving up the right to income. Also, it appears unlikely that a taxpayer who enters into a transaction lacking economic substance would see the light, if at all, within the period during which a valid rescission can be undertaken in compliance with Revenue Ruling 80-58. In any case, the purpose of I.R.C. Sections 7701(o) and 6662 would appear to be to deter taxpayers from entering into transactions that lack economic substance. Accordingly, if a taxpayer were to rescind a transaction because the taxpayer feared that the transaction would be found to lack economic substance, it would seem that I.R.C. Sections 7701(o) and 6662 would have achieved their purpose.

Fabricated Doctrine continues its argument by stating:

> Hasen further notes that the ability to unwind transactions in the manner allowed by Rev. Rul. 80-58 facilitates the problem of government 'whipsaw,' when the property transferred subject to an "unwinding has depreciated or depreciated [sic] over the course of the tax year." Each of these effects may mean that unwinding is a drain on the revenue.[229]

Any potential whipsaw problem appears to be de minimus because taxpayers do not have that much time to decide whether to rescind a transaction. Moreover, if taxpayer A sells property to taxpayer B in January 2014, and the parties rescind the sale before the end of 2014, the sale in January 2014, is disregarded under Revenue Ruling 80-58, and taxpayer A is treated as having owned the property all the time after the disregarded sale. Accordingly, any deductions attributable to the property would belong to taxpayer A, and taxpayer B would not be entitled to claim them. How does one determine if rescissions or any other activity is "a drain on the revenue"? Is there some knowable level of revenue belonging

226. I.R.C. § 7701(o)(5)(A) (2012).

227. I.R.C. § 6662(b)(6) (2012).

228. I.R.C. § 6662(i) (2012).

229. *Fabricated Doctrine*, *supra* note 47, at 166.

to the federal government that may be drained? Further, although Hasen does note that some whipsaw may occur, for him the possible whipsaw arises because taxpayers may conduct their affairs so as to avoid Revenue Ruling 80-58 when it is advantageous to do so, and comply when it is favorable.[230] Hasen also notes that our self-reporting system contributes to whipsaw.[231] Both of these concerns apply to our tax system generally and not the peculiar disadvantages of the unwinding doctrine of Revenue Ruling 80-58. Indeed, in another part of his article, Hasen discusses that when a taxpayer successfully avoids having to report gain on a rescinded sale, the taxpayer often will have more taxable income in future years than would be the case if the rescission had not occurred.[232]

V. THE RESCISSION DOCTRINE AS CURRENTLY APPLIED BY THE IRS IS CORRECT AND WOULD BE CORRECT EVEN IF PENN V. ROBERTSON HAD NEVER BEEN DECIDED

This Article attempts to demonstrate that *Penn v. Robertson* in fact offers strong support for the rescission doctrine articulated by Revenue Ruling 80-58 and that the authors of *Fabricated Doctrine* have completely failed in their attempt to show that the IRS fabricated the rescission doctrine in Revenue Ruling 80-58 and that everyone else has misread *Penn v Robertson. Penn v. Robertson* clearly characterizes the income realized by Mr. Penn early in 1931 as having been extinguished by his executors' agreeing to return his credits later in 1931. *Fabricated Doctrine* attempts unsuccessfully to show that the court in *Penn v. Robertson* was operating under a deduction rationale, but those attempts, as this Article demonstrates, were based on an incredible misreading of the opinion.[233] Nowhere in its opinion does the court in *Penn v. Robertson* give any indication that when it said that it agreed with the district court "the rescission in 1931 before the close of the calendar year *extinguished* what otherwise would have been taxable income to Penn for that year"[234] that it was really saying that what would otherwise have been taxable income to Mr. Penn was extinguished because it had been reduced to zero by a deduction. In addition to their fundamentally flawed reading of the opinion in *Penn v. Robertson*, the authors of *Fabricated Doctrine* only attempted to analyze half of the problem. Revenue Ruling 80-58 cited two grounds for its holdings—one was *Penn v. Robertson* and the other (cited first in

230. Hasen, *supra* note 43, at 940–41.

231. *Id.*

232. *Id.* at 901.

233. *See supra* Part IV Subsection B Fabricated Doctrine's Analysis of Penn v. Robertson.

234. Penn v. Robertson 115 F.2d 167, 175 (4th Cir. 1940).

Revenue Ruling 80-58) was the annual accounting principle as established by the Supreme Court cases discussed above in Part II. Ultimately, however, even if the authors of *Fabricated Doctrine* were correct in their assertion that *Penn v. Robertson* provides no support for the rescission doctrine as currently applied by the IRS, that doctrine would be correct as a matter of policy and would be within the authority of the Treasury Department and the IRS. Section 7801 of the Internal Revenue Code authorizes and directs the Treasury Department to perform the "administration and enforcement" of the income and transfer tax provisions, and Section 7805 authorizes and directs the prescription "of all needful rules and regulations." The Treasury has delegated this authority to the Commissioner of Internal Revenue.[235]

In other words, assume that *Penn v. Robertson* had never been decided and that taxpayers were just now approaching the IRS with questions about the tax treatment of transactions that had been unwound. Can anyone doubt that Sections 7801 and 7805 provide ample authority for the IRS to look at the Supreme Court cases defining and discussing the annual accounting concept, and, on the basis of the annual accounting concept, promulgate a revenue ruling articulating the same rescission doctrine as Revenue Ruling 80-58?[236] The Court in *Burnet v. Sanford & Brooks Co.* observed that "all revenue acts . . . since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the *net* result of all the taxpayer's transactions during a fixed accounting period."[237] The Court quoted this statement approvingly in 1944,[238] and, in 1953, it stated that "Congress has enacted an annual accounting system under which *income is counted up at the end of each year.*"[239]

The annual accounting concept is the common policy thread running through *Penn v. Robertson*, Revenue Ruling 80-58, and the claim of right cases. As discussed earlier, the claim of right cases teach us that if a taxpayer receives income in the tax year 2014 with no restrictions of the taxpayer's right to retain or use the income, if the taxpayer is required to repay all or a portion of the income in a later tax year, the taxpayer cannot reopen the 2014 tax year to reduce the taxpayer's income in 2014, but rather is only allowed a deduction in the year of repayment. The claim of

235. Treas. Reg. § 301.7805-1.

236. *See* Note 1, *supra*, and accompanying text. In 2013, the Internal Revenue Service reaffirmed that Revenue Ruling 80-58 is its guidance on rescissions—see notes 18-19, *supra*, and accompanying text).

237. 282 U.S. at 363 (emphasis added).

238. Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 285 (1944).

239. Healy v. Commissioner, 345 U.S. 278, 284 (1953) (emphasis added).

right cases also teach us, however, that if the taxpayer in this example repays all or a portion of the income in the year of receipt, 2014, the repayment reduces the taxpayer's reportable taxable income in 2014, whether the repayment is voluntary or involuntary; it is a reduction in reportable taxable income, not the allowance of a deduction. *Fabricated Doctrine* does not offer any analysis of the annual accounting concept. Indeed, in its discussion of the potential tax treatment of Douglas Poling, without any consideration of how the annual accounting concept might apply, *Fabricated Doctrine* assumes away any potential deductibility of a repayment by Mr. Poling of his TARP bonus, fails to discuss the authorities discussed above[240] that show that if Mr. Poling did repay his TARP bonus in the year of receipt, he would be allowed to exclude the repaid bonus from his taxable income for that year, and wrongly states that Mr. Polling would likely be entitled to treat repayment as a rescission under Revenue Ruling 80-58.

A fundamental difference between this Article and *Fabricated Doctrine* is that this Article believes the annual accounting concept is an important policy concept that supports the rescission doctrine as developed by Revenue Ruling 80-58. *Fabricated Doctrine* does not discuss the annual accounting concept or even acknowledge that it was one ground cited by Revenue Ruling 80-58 as authority for its holdings.[241] Under the annual accounting concept, a deductible expense paid (if the taxpayer uses the cash basis of accounting) or incurred (if the taxpayer uses the accrual method of accounting) on December 31, 2014 may reduce taxable income realized on January 1 2014. What policy argument suggests that it is inappropriate to say that a sale closed in January, 2014 that is unwound in December 2014 does not have to reported on the taxpayer's return for 2014? Similarly, what policy is there that would state that it is inappropriate to say that a taxpayer who receives taxable compensation in January 2014 does not have to report the income to the extent the taxpayer repays the compensation to the employer before the end of 2014? As discussed in more detail above,[242] it is no answer, particularly in the case of an unwound sale of a capital asset, to assert that a deduction puts the taxpayer in the same position as an unwinding and that therefore a deduction rationale is just as likely or, as *Fabricated Doctrine* argues, more likely the basis for the holding with respect to the tax year 1931 in *Penn v. Robertson* as is the rescission doctrine.

240. See *supra* Part IV, Subsection C Fabricated Doctrine's Examination of TARP Bonuses.

241. Rev. Rul. 80-58, *supra* note 1.

242. *Fabricated Doctrine*, *supra* note 47 at 142; *see* note 90, *supra*, and accompanying text.

This Article has demonstrated that *Fabricated Doctrine*'s recommendation that Revenue Ruling 80-58 be revoked rests entirely on a fundamentally flawed analysis of *Penn v. Robertson*. *Penn v. Robertson* in fact provides ample legal support for Revenue Ruling 80-58. Moreover, Revenue Ruling 80-58 is supported by the U.S. Supreme Court cases establishing the annual accounting concept, and Revenue Ruling 80-58's permitting a rescission of a sale in the same taxable year is completely consistent with the annual accounting concept. Although the IRS confirmed in 2013 that Revenue Ruling 80-58 will continue indefinitely to be its position on rescissions,[243] it would be beneficial if the IRS would relax its current no-ruling policy on rescissions and provide guidance on questions like those raised in the NYSBA Report. If time and energy could be found, a wide-ranging discussion of the best policies to apply to rescissions, tax benefit cases, and claim of right cases, as Hasen attempted in his article, would also be beneficial. In an age when information abounds on the Internet and researchers face difficulties in assuring that they have thoroughly researched a topic, articles like *Fabricated Doctrine* that appear in facially creditable publications present a danger and do a disservice to scholarship in a complicated field that could benefit from thoughtful analysis.

243. Notes 18-19, *supra*, and accompanying text.

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CONDEMNING A RESIDENTIAL MORTGAGE LOAN: IS IT AN EXTRATERRITORIAL TAKING?

MICHAEL M. SANDEZ*

Government attempts to solve every problem under the sun are countless. The City of Richmond ("the City"), California's plan to condemn loans held by trustees of residential mortgage-backed securities trusts is one such attempt. The plan would seek to reduce the risk of blight of the kind created by the 2008 financial crisis when housing values decreased and resulted in underwater mortgages that the City believes will increase the incidents of default, foreclosure, and then blight. Richmond has adopted a resolution that declares its legislative intent to pursue a plan with third parties providing counsel and capital for the city. The plan involves condemning a limited number of mortgages, paying a price that is greatly discounted due to what is claimed to be a greater risk of default, restructuring the loans to reduce the principal and improve the terms, and reselling the loans in the secondary mortgage market to other lenders. Unprecedented and without statutory authority, the plan has caught the attention of the legal community. Legal commentary has mainly focused on the constitutional issues raised by the plan. Legitimate questions about public use, just compensation, the impairment of obligation of contract, and interference with interstate commerce are analyzed in the commentary. This Article discusses whether the plan is an extra-territorial taking. California law imposes the stringent requirements of "legal necessity" on a condemnor that targets property located outside its territorial jurisdiction. Since the loans are held by trusts located outside Richmond city limits, this Article concludes that the situs of the

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mortgage loans is the domicile of the creditor, as has been held in cases concerning the analogous governmental power to tax creditors. The creditor's domicile rule provides a check against and accountability for government's excessive use of eminent domain powers. Further, this rule provides a measure of protection for owners of property located outside city limits who are not represented by and cannot vote in elections for the local government.

INTRODUCTION

Two cities in California and one city in Nevada have considered exercising the power of eminent domain to condemn residential mortgage loans but not the real property that serves as security for the loans. Two cities have rejected the idea,[1] but the City of Richmond ("the City"), California in 2013 passed a resolution with guidelines for the condemnation of approximately 620 residential mortgages.[2] Due to the unprecedented taking of mortgages after the financial crisis of 2008, these cities have caught the attention of the legal community. Most articles on this topic address several constitutional issues, with public use and just compensation being the two primary issues covered due to the requirements of the Takings Clause of the Fifth Amendment to the U.S. Constitution. This Article, however, primarily focuses on the fact that the residential loan promissory notes are most likely located outside Richmond's city limits, raising the issue of the taking of extra-territorial property: does a local municipality have the authority to take intangible property such as residential mortgage loans that are located outside its jurisdictional boundary? The context for the taking of mortgages is broader than the 2008 financial crisis. It is fitting, therefore, to briefly consider

1. Jim Christie, *Nevada City Rejects Eminent Domain Plan For Mortgages*, REUTERS (Sept. 5, 2013, 1:28 AM), http://www.reuters.com/article/2013/09/05/us-northlasvegas-eminentdomain-idUSBRE98406B20130905; Alejandro Lazo, *San Bernardino County Abandons Eminent Domain Mortgage Plan*, L.A. TIMES (Jan. 24, 2013), http://articles.latimes.com/2013/jan/24/business/la-fi-mo-eminent-domain-20130124.

2. Res. No. 120-13, Richmond City Council (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf.

aspects of U.S. history and eminent domain law.

A. Background

Habitual deficit spending has led government officials of all levels within the United States to use every tactic available to acquire more revenue.[3] Civil magistrates threaten and then take private property virtually whenever and wherever they want, seemingly without consequence to their political life. Stand up to them, and watch your world turn upside down, which is often the case even if you win the battle, and certainly is the case if you lose. The courts have nearly neutered the Takings Clause of the Fifth Amendment to the U.S. Constitution by an inordinately high degree of judicial deference and a low degree of judicial scrutiny. Consequently, there is now minimal protection for property owners, notwithstanding the accepted understanding at the formation of the nation that government's central function is to protect its citizens' lives and property, and to do so in the context of a limited and decentralized federal system.[4] We have come to a far different time than when the emphasis—rhetorically and substantively—was placed on "life, liberty, and the pursuit of happiness."[5]

The national government of the United States was formed with enumerated powers. The Constitution, in Article I, section 8, delineates the power that the People granted to the newly formed government. The Founders, however, did not explicitly grant a federal power of eminent domain, it being understood as a self-evident matter that a government of enumerated powers needs property to establish itself and to carry out its functions.[6] The Takings Clause alludes to a power that enables the

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3. Maxim Lott, *Report: State Budgets Fudge Numbers to Hide Massive Debt*, FOXNEWS (Nov. 13, 2014), http://www.foxnews.com/politics/2014/11/13/report-state-budgets-fudge-numbers-projected-debt-worse-than-reported/ (reporting that State Budget Solutions, a think tank that analyzed "unfunded liabilities", issued a report that found that states under-report their debt, Illinois being the worst and California being another example in that California discloses an unfunded liability of $4,909 per person, but its actual debt is nearly $20,000 per person).

4. For the point about a limited national government, *see e.g.*, Legal Tender Cases, 79 U.S. 457, 492, 573–74 (1870).

5. THE DECLARATION OF INDEPENDENCE para. 2 (1776).

6. *See*, William Baude, *Rethinking the Federal Eminent Domain* Power, 122 YALE L.J. 1738 (2013).

> At the Founding, the federal government was not understood to have the power to exercise eminent domain inside a state's borders. This understanding was reflected in seventy-five years of subsequent practice and precedent. The federal government sometimes needed land—for roads, lighthouses, etc.—but it did not use eminent domain to get it. Instead, it repeatedly relied on the states to condemn the land it needed. During this period, federal practice, congressional debates, and even two Supreme Court opinions all indicated a

acquisition of property when, as a protective measure, the Clause requires the national government to take private property only for a public use and only when it pays just compensation to the owner.[7]

The People, as the sovereign, must have reasoned that the power of eminent domain can be implicitly extended, since the national government was to be ratified as a limited government with certain identified powers and with the obligation to exercise its express and implicit powers in accordance with the "Laws of Nature and of Nature's God."[8] The Founders understood the laws of nature and of nature's God to be transcendent principles that, among other things, were to guide government officials and hold them accountable to ensure that the exercise of implicit powers was not inconsistent with the express powers granted in the compact that initially formed the government.[9] Since the compact

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lack of any general federal power of eminent domain.

. . .

> The original view was that the federal government had eminent domain power only in the District of Columbia and the territories, where the Constitution expressly granted it plenary power. Eminent domain could not be inferred from Congress's enumerated powers or the Necessary and Proper Clause because it was a great power, too important to be left to implication. As mentioned above, this understanding was reflected in uniform, widespread practice. While there certainly were expressions of the contrary view, especially several decades after the Founding, those views were not actually reflected in any judicial holding or federal practice until the Civil War. Meanwhile, during this period the Supreme Court declared—in a surprisingly neglected decision—that outside of the District and the territories "the United States have no constitutional capacity to exercise . . . eminent domain.

Id. at 1741–42 (citations omitted).

Mr. Baude points out that the view of federal eminent domain changed in 1875 when the U.S. Supreme Court decided Kohl v. United States, 91 U.S. 367, 372 (1875). *Id.* at 1742-43; *see also*, Kelo v. City of New London, 545 U.S. 469, 496 (2005) (O'Connor, J., dissenting).

7. U.S. CONST. amend. V.

8. THE DECLARATION OF INDEPENDENCE para. 1 (1776); *see*, Baude, *supra* note 6, at 1800–01 (making the distinction between implicit powers, which follow from enumerated powers, and inherent powers, which "requires no constitutional recognition", citing Kohl v. U.S., 91 U.S. 367, 371–72 (1875), in the author's discussion of the dramatic shift in U.S. Supreme Court eminent domain jurisprudence).

9. The Declaration of Independence referenced a litany of the English monarch's abuses, which were considered by the Founders as tyrannical and, being such, violated God's higher law and thus were not law at all. *See* THE DECLARATION OF INDEPENDENCE para. 3, *et seq.* (U.S. 1776) (referencing a litany of the English monarch's abuses, which were considered tyrannical by the Founders and in violation of God's higher law). *See generally* Jeffrey C. Tuomala, *Marbury v. Madison and the Foundation of Law*, 4 LIBERTY U.L. REV. 297, 314 (2010) (stating that ". . . if a provision of a constitution conflicts with the law of nature, it is not law, and the courts are not to apply it because it is not law.").

expressly limits the jurisdiction and authority of the federal government through the delineation of enumerated powers, it follows that its unwritten implicit powers must be limited, as well. It would be illogical to methodically and deliberately form a limited government with the expectation that undeclared implicit powers are unlimited or ever expanding. There is an inextricable relationship between these implicit powers and the government *as it was formed*. The sovereign formed its government to achieve intended purposes and presupposed that such intended purposes would be advanced and reinforced by certain unexpressed implied powers. The power to condemn property is implied because government's very existence as the seat of representative authority must be housed; officials need places to carry out their duties to fulfill government's primary purpose of seeking justice for the protection of lives and property.[10] Beyond this, eminent domain can become a form of tyranny.

Unfortunately, this incredible system, so very different in many respects from what had been attempted in the Old World, has been taken over by elites who believe government knows best. Jurisprudential views that developed over the past century have accepted an ever-expanding view of governmental power.[11] As a result, governance, politics, and law have become a suffocating paternalism.[12] A paternalistic approach to nearly all problems by all levels of government is so widespread that now, nearly every turn of the economy justifies some type of official action, including the condemnation of real and personal property. The decision in *Kelo v. City of New London*, a leading U.S. Supreme Court eminent domain case, further entrenches governmental paternalism by a test so broad that it appears that local government will now use the common market cycle as the basis for more central planning.[13] This is not to say that the City of

10. *See*, Baude, *supra* note 6, at 1793–94; *see also* Miss. & Rum River Boom Co. v. Patterson, 98 U.S. 403, 406 (1879); United States v. Jones, 109 U.S. 513, 518 (1883) (citing *Patterson*, 98 U.S. at 406).

11. *See, e.g.*, Harry G. Hutchinson, *Lochner, Liberty of Contract, And Paternalism: Revising The Revisionists? Review Essay: David N. Mayer, Liberty of Contract: Rediscovering A Lost Constitutional Right*, 47 IND. L. REV. 421, 440, 443-44, 464-65 (2014) for a discussion of sociological jurisprudence and legal positivism as developed in U.S. Supreme Court cases and analyzed in legal commentary.

12. *Id.* at 463.

13. *Compare* Kelo v. New London, 545 U.S. 469, 483 (2005) (declaring that the city was "entitled" to the court's deference because the city had made the ". . .determination that the area at issue was sufficiently distressed to justify a program of economic rejuvenation[."), *with* Pa. Coal Co. v. Mahon, 260 U.S. 393, 415 (1922) ("When this seemingly absolute protection [of private property in the Fifth Amendment] is found to be qualified by the police power, *the natural tendency of human nature is to extend the qualification more and more until at last private property disappears*. But that cannot be accomplished in this way under the

New London was solely under the pressures of a *common* economic downturn. Apparently, the city was in a bad financial status as a result of decisions that had been made over many years, and certainly was subject to the standard effects of the common economic cycle. The point here is that the *Kelo* ruling declared that public use encompasses economic development and thus provides the basis for a governmental taking of private property, which most likely will be interpreted to justify condemnation in municipalities with far fewer economic problems than those within New London. The problem is that local magistrates are now the arbiters of what is a "sufficiently distressed" area. Exposed to abuse, however, is the private property owner, who owns fee title subject to the whims of local officials' notions of how to reverse economic distress and to the risks of an economic bust that results from the speculative nature of the local officials' economic development plan and reliance on private actors that are free to withdraw from the project.

Unfortunately, economic development, supported with plans drawn up by handy experts at the behest of municipal officials, generally will be upheld by the courts[14] where the local government has carefully considered "a comprehensive development plan" and has "complied with elaborate procedural requirements that facilitate review of the record and inquiry into the city's purposes."[15] Given the Court's broad expansion of public use to include economic development, it probably does not matter that the New London plan was a bust;[16] however, it should. One can expect that future economic development plans will pass constitutional muster under the current jurisprudence that extends a great deal of deference so long as it *appears* to be comprehensive, written in a manner that seeks to solve the effects of rough economic waters, and carefully considered in an adequate procedural context, regardless of the speculative nature of the plan.[17] The

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Constitution of the United States. The general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.") (emphasis added).

14. *Kelo*, 545 U.S. at 484. The *Kelo* majority also recognized that "[p]romoting economic development is a traditional and long-accepted function of government[.]" *Id.* (citing Berman v. Parker, 348 U.S. 26, 33 (1954) and other cases).

15. *Id.* at 493 (Kennedy, J., concurring).

16. Jeff Jacoby, *Eminent Disaster, Homeowners in Connecticut Town were Dispossessed for Nothing*, BOS. GLOBE (Mar. 12, 2014, 7:12 PM), http://www.bostonglobe.com/opinion/2014/03/12/the-devastation-caused-eminent-domain-abuse/yWsy0MNEZ91TM94PYQIh0L/story.html.

17. For a fairly thorough criticism of the *Kelo* decision that includes discussion of economics, *see generally* Ilya Somin, *Controlling the Grasping Hand: Economic Development Takings After Kelo*, 15 SUP. CT. ECON. REV. 183 (2007). Economics is not an exact science in large part because assumptions are made on human subjective decisions and valuation, which will necessarily infuse speculation in any municipality's economic development plan. *See* George Steven Swan, *The Law And Economics Of*

lack of a guaranteed commitment by private entities central to the entire enterprise is of no apparent concern.[18]

B. The City of Richmond

An example of such extensive paternalism is found in the City of Richmond, California, where the city council passed a resolution that sets out its legislative intent and guidelines for the condemnation of approximately 624 mostly performing residential mortgages, so that the city can rewrite and resell the loans to new lenders while those borrowers remain in their homes and receive the windfall of better loan terms with a lower principal.[19] As some City councilmembers acknowledged economic improvement in the City, the Richmond city council majority passed the resolution on the basis that home values are underwater, which the majority believed creates the *probability* that borrowers will default and vacate their homes, lenders will foreclose, and blight will ensue.[20] Undaunted by the prospect of significant legal hurdles, the City has not retreated from its resolution. Serious questions regarding public use, just compensation, and impairment of obligation of contract are briefly described in this Article, while the question of the extra-territoriality of the condemnation is more closely considered.

This Article considers the City's plan for mortgage condemnation as an example of the government's excessive use of its power to condemn property. The City must have a fair degree of certainty that the implementation of its regulation would be upheld, as it surveys the predominant jurisprudential landscape that removed property rights from the highly-protected category of fundamental rights and extended a degree

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Fiduciary Duty: Womack v. Orchids Paper Products Co. 401(K) Savings Plan, 37 OKLA. CITY U. L. REV. 17, 34–9, 44, 48–49 (2012) (lengthy discussion about the lessons that economists learned and have yet to learn about their discipline after the financial crisis of 2008). Professor Swan commented, "The economist's knowledge is imperfect because no fully predetermined model adequately represents (by whatever yardstick) the causal mechanism that underpins outcomes at every interval (past, present, and future)." Swan, at 43.

18. *Kelo*, 545 U.S. at 469, 504 (2005) (O'Connor, J., dissenting); *see also* Somin, *supra* note 17, at 228.

19. *See* Res. No. 120-13, Richmond City Council (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf.; *see also* Joel M. Langdon, *The Importance of a Promise: Underwater Mortgages and a Municipal Rescue Attempt Through Eminent Domain*, 45 URB. LAW. 571, 604–06 (2013) (explaining how mortgagees can remain in their homes if they qualify under certain mortgage reduction programs such as the Home Affordable Modification Program Principal Reduction Alternative).

20. *See* Res. No. 120-13, Richmond City Council ¶¶ 3–4 (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf.

of judicial deference that presumes the validity of regulations notwithstanding their crippling effects upon private property rights and the gross expansion of government. While case law generally supports governmental condemnation of personal property,[21] there is no case that directly rules on the condemnation of a residential mortgage.[22] Before a court rules on this precise question, it is beneficial to review whether local government has the authority to condemn mortgages so that it can restructure and resell them. The literature on the topic typically covers—to one degree or another—the issues raised by the Takings Clause of the Fifth Amendment and the No Impairment of Contract Clause of Section 10 of Article I of the U.S. Constitution.[23] There is less attention given to the extra-territorial nature of the City's condemnation of mortgages that are likely to be located outside City limits.[24]

C. Local Government's Power to Condemn Personal Property is Limited.

The federal Takings Clause was eventually made applicable to the states and local governments by way of incorporation through the Fourteenth Amendment.[25] At the national level, the condemnation of property is considered an implicit power. In contrast, states are granted an express power to condemn property through their constitutions and statutes.

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21. Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, vol. 19 CURRENT ISSUES IN ECON. AND FIN., at 6, nn. 12–14 (2013). Professor Hockett provides citations to several cases wherein the condemnation of various types of personal property was in issue.

22. *See,* Leanne M. Welds, Note, *Giving Local Municipalities the Power to Affect the National Securities Market: Why the Use of Eminent Domain to Take Mortgages Should be Subject to Greater Regulation*, 79 BROOK. L. REV. 861, 873–74 (2014). Most cases have ruled on issues related to condemnation or dedication of real property and the direct impact on the property interest lenders hold in and through its mortgage or deed of trust; *see, e.g.*, W. Fertilizer & Cortage Co. v. City of Alliance, 504 N.W.2d 808 (1993) (dispute between a city's interest in dedicated land and a lender's security interest in the same land).

23. For the Takings Clause, *see, e.g.*, Christine J. De Leon, Note, *Eminent Domain: Richmond, California's Illusory Solution to the Mortgage Crisis*, 40 J. LEGIS. 191, 203–07 (2014); Andrew Peace, Comment, *Coming Up for Air: The Constitutionality of Using Eminent Domain to Condemn Under Water Mortgages*, 54 B.C. L. REV. 2167, 2197–98 (2013). For the Impairment of Contract Clause, *see, e.g.*, Clay A. Counts, Comment, *The Unskinnable Cat: Debt Reduction, Eminent Domain and the Contract Clause*, 33 ST. LOUIS U. PUB. L. REV. 459, 477 (2014); Katharine Roller, Note, *The Constitutionality of Using Eminent Domain to Condemn Underwater Mortgage Loans*, 112 MICH. L. REV. 139, 156 (2013).

24. Michael S. Moskowitz, Comment, *Treading Water: Can Municipal Efforts to Condemn Underwater Mortgages Prevail?*, 41 PEPP. L. REV. 633, 655–56, 665 (2014) (discussing briefly the location of a mortgage and extra-territorial jurisdiction of a municipality to condemn intangible property such as a mortgage and concluding that the City of Richmond would not prevail on this issue).

25. Chicago, B. & Q.R. Co. v. Chicago, 166 U.S. 226, 234–36 (1897).

Likewise, local governments and agencies, as political subdivisions of, for example, the state of California, must be granted the express power of eminent domain by the state constitution or a statute before such a power can be exercised.[26] Cutting against the presumption of validity of regulations, deference to local municipalities, and minimal protection for economic liberties, are state constitutions and statutes that provide various levels of restrictions to curb local government authority to condemn property.[27] One such restriction in California protects against a local government's effort to condemn property located outside its territorial jurisdiction.[28] A municipality's extra-territorial jurisdiction for purposes of condemnation is not necessarily coextensive with minimum contacts relative to a court's in personam jurisdiction.[29] Relatedly, the lack of extra-territorial jurisdiction to condemn may deprive a California trial court of jurisdiction to try the eminent domain proceeding.[30] Yet, the mortgages that are the target of eminent domain do create a lien on real properties that are located within the territorial limits of Richmond. Is this enough to give the municipality the jurisdiction to condemn the promissory notes? The City of Richmond will certainly need to take into account the extra-territorial nature of its taking of mortgage notes in its condemnation plan as it deliberates whether to proceed. Before an examination of the extra-territoriality issue, a description of the Richmond plan to condemn mortgage notes provides a helpful context.

I. DESCRIPTION OF THE CITY OF RICHMOND'S PLAN TO CONDEMN MORTGAGE NOTES

Of the three municipalities that have considered the condemnation of mortgage notes, Richmond remains the sole locale that still might move beyond resolution to actual implementation. San Bernardino County, California and Las Vegas, Nevada have abandoned further consideration. Rather than a broad review of all three proposals, an analysis of the particular aspects of Richmond's plan highlights the deficiencies of the plan and the underlying policy. A recent lawsuit filed in federal court

26. San Francisco v. Ross, 279 P.2d 529, 531 (Cal. 1955)..

27. Many states enacted legislation that limits the power of eminent domain in a backlash against the U.S. Supreme Court's holding in *Kelo*. The backlash, however, may have been inadequate to protect against government officials' constant (and perhaps obsessive) use of the power of condemnation. *See generally* Illya Somin, *The Limits of Backlash: Assessing the Political Response to Kelo*, 93 MINN. L. REV. 2100 (2009).

28. CAL. CIV. PROC. CODE § 1240.050 (West 2015).

29. Mayor of Balt. v. Balt. Football Club Inc., 624 F. Supp. 278, 284–85 (D. Md. 1986).

30. Harden v. Superior Court, 234 P.2d 9, 14 (Cal. 1944).

against the City provides a framework for the discussion that follows.

A. The Plan as Described in the Trustees' Recent Lawsuit

The City of Richmond was a defendant in a 2013 lawsuit[31] for injunctive and declaratory relief from its plan to condemn certain residential mortgages that satisfy criteria established by the City and Mortgage Relief Partners ("MRP"), a for-profit private investment company that consults and actively participates with the City in this endeavor. The lawsuit was filed after the Richmond City Council passed Resolution No. 120-13, which set out in general terms its legislative intent and the guidelines it would follow in its plan to condemn mortgage promissory notes.[32]

In a court motion that contains a favorable description of the program, the attorneys for the City and MRP stated that the City may "purchase underwater mortgage loans for their fair market value, using eminent domain powers if necessary, and then reduce the principal balances, keeping the current homeowners in their homes for the benefit of neighborhoods and the City as a whole."[33] Initially, the City sent letters[34] to the holders of approximately 624 mortgages[35] in an effort to negotiate the purchase of the mortgages, and the letters informed the lenders that the City might resort to eminent domain if negotiations were fruitless.

The details of the plan indicate why the residential mortgage-backed securities industry has been aggressive in opposing the plan, to the point that a group of trustees[36] filed the above-mentioned federal court complaint

31. Complaint for Declaratory and Injunctive Relief, Wells Fargo Bank, Nat'l Ass'n v.Richmond, No. CV-13-3663-CRB at 35 (N.D. Cal. Sept. 16, 2013) [hereinafter Complaint], *available at* http://docs.justia.com/cases/federal/district-courts/california/candce/3:2013cv03663/268907/1.

32. *See* Res. No. 120-13, Richmond City Council (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf.

33. Defendant Richmond's Notice of Motion and Motion to Dismiss for Lack of Subject Matter Jurisdiction; Memorandum of Points and Authorities in Support Thereof, at 1, Wells Fargo Bank, Nat'l Ass'n v. City of Richmond, No. CV-13-3663-CRB (N.D. Cal. Sept. 16, 2013) [hereinafter Def.'s Motion to Dismiss], *available at* http://docs.justia.com/cases/federal/district-courts/california/candce/3:2013cv03663/268907/38.

34. Defendants' Opposition To Motion for Preliminary Injunction, at 3, Wells Fargo Bank, Nat'l Ass'n v. Richmond, No. CV-13-3663-CRB (N.D. Cal. Sept. 16, 2013) [hereinafter Def.'s Opp'n to Pl.'s Mot. for Prelim. Inj.], *available at* http://docs.justia.com/cases/federal/district-courts/california/candce/3:2013cv03663/268907/32.

35. City of Richmond City Council Meeting Minutes, at 12 (Dec. 17, 2013) [hereinafter Meeting Minutes], *available at* http://www.ci.richmond.ca.us/ArchiveCenter/ViewFile/Item/5649.

36. The plaintiffs are trustees of hundreds of residential mortgage-backed securitization trusts that hold the mortgages. Trust beneficiaries include public and

against the City and MRP.[37] In one court document, the trustees describe the City's plan as follows:

> Under the guise of providing "mortgage relief" to Richmond homeowners, Richmond and [Mortgage Relief Partners ("MRP")] intend to use Richmond's eminent domain power to seize mostly performing mortgage loans hand-selected by MRP at steeply discounted prices (typically 80% of the current value of the home, but in many cases much less) and then allow MRP immediately to flip the loan to a new government-backed securitization pool trust for a much higher price (around 95% of the current value of the home). The substantial profit resulting from this eminent domain arbitrage would be shared by MRP, MRP's investors, and Richmond.[38]

Though the plan may not be implemented precisely as described by the trustees, their description reveals the issues that make the plan controversial and possibly unconstitutional.[39]

B. *State of the City*

There is good reason to expect that the City will not go forward with the condemnation plan, notwithstanding its successful defense of the federal action. About one year has passed and the City has yet to pass a resolution of necessity. California law requires such a resolution before an eminent domain proceeding may commence.[40] Contents of the resolution of necessity must include, among other things: (i) a statement of the public use for which the property is to be taken; (ii) the statute that authorizes the condemnation of the property; (iii) a general description of the property and its location; and (iv) a declaration that the public interest and necessity require the proposed project, the proposed project will be compatible with

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private pension plans, college savings plans, 401(k) savings plans, insurance companies, mutual funds, university endowments, and government-sponsored enterprises. Complaint, *supra* note 31, at 9.

37. Complaint, *supra* note 31.

38. Plaintiffs' Notice of Motion and Motion for Preliminary Injunction; Memorandum of Points and Authorities in Support Thereof, at i, Wells Fargo Bank, Nat'l Ass'n v. City of Richmond, Cal., No. CV-13-3663-CRB (N.D. Cal. Sept. 16, 2013) [hereinafter Pls' Mot. for Prelim. Inj.], *available at* http://docs.justia.com/cases/federal/district-courts/california/candce/3:2013cv03663/268907/8; *but see also* Langdon, *supra* note 19, at 590 ("The Plan contemplates that the amount the municipality will pay will be around 85% of the value of the real property that secures the mortgage.").

39. Various commentators have described and analyzed the plan. *See, e.g.*, Langdon, *supra* note 19, at 601; De Leon, *supra* note 23, at 212–218.

40. CAL. CIV. PROC. CODE §§ 1245.220, 1240.040 (West 2015) ("A public entity may not commence an eminent domain proceeding until its governing body has adopted a resolution of necessity that meets the requirements of this article.").

the greatest public good, and the property is necessary for the proposed project.[41] Current conditions in Richmond may not satisfy the criteria of a resolution of necessity.

The City's efforts to condemn mortgages appear to have begun in 2013, about five years *after* one of the worst years of the recent financial crisis. In the State of the City Address in January 2014, the Mayor of Richmond lauded the decline in crime and an increase in businesses and jobs in 2013.[42] At a meeting of the City Council on December 13, 2013 (when Resolution No. 120-13 was passed), an absent councilmember, who wanted to put the plan to a vote of the citizens and who opposed the pending resolution, had his letter read during the meeting. His letter noted that "[m]ost of the current foreclosure loans are no longer owned by the previous so-called Wall Street investors but by various labor unions, credit unions, retirement pension funds and individuals" and that the "value of homes throughout the nation as well as in Richmond are on a continuing sharp increase."[43] At the same meeting, a councilmember who was in attendance wanted clarification since the plan "proponents state[d] that of the 624 homes that received notices about one-third of those have had their mortgages successfully renegotiated."[44] If we assume those 624 homes were selected by the City and MRP because they were in the neighborhoods most impacted by the financial crisis, and that one-third of the loans were indeed renegotiated, the necessity for the exercise of eminent domain appears to be significantly minimized. If there has been a reduction in crime and an increase in business and jobs, it appears the project is unnecessary and does not advance the public good. Evidently, time has made a difference in Richmond, which by these accounts appears to be on its way to recovery.

C. Federal Constitutional Issues Raised by the Richmond Plan

Though the Richmond City Council has not proposed or voted on a resolution of necessity, the Richmond-MRP plan raises fundamental constitutional issues.

1. Public Use

An issue regarding the "public use" nature of the mortgage condemnation plan arises from the fact that the City has selected only

41. *See* CAL. CIV. PROC. CODE § 1245.230 (West 2015).

42. City of Richmond's State of the City, *Richmond Demonstrates 21st Century Leadership*, (Jan. 28, 2014), *available* at http://www.ci.richmond.ca.us/documentcenter/view/28194 (last visited Mar. 13, 2015).

43. Meeting Minutes, *supra* note 35, at 10–11.

44. *Id.* at 11.

certain mortgages to condemn, pursuant to its belief that the resultant metrics will demonstrate economic improvement in the municipality. When approximately 624 mortgages are being considered[45] in a city with a population of about 106,000 people,[46] among whom there are presumably thousands of mortgages, the accuracy of the claim that the plan is a "public use" should be called into question.[47] The plan targets mortgages that for the most part, are performing loans,[48] which makes it highly probable that the borrowers occupy the houses and presumably maintain their homes in satisfactory condition.[49] Instead of a public use that benefits the community, the plan is designed to benefit a small percentage of the borrowing population, MRP, and the City itself, the latter two for the sake of profit at the expense of the lenders.[50] Blight seems to be a distant threat.

Another issue concerns the interpretation of "public use" that now includes economic development. Democratic and Republican administrations at the federal and state levels, as well as "non-partisan" local municipalities, engage in habitual deficit spending for the sake of subsidies or entitlement program creation and expansion, only to strain government budgets on a daily basis.[51] Consequently, a majority of elected officials make revenue generation for government their highest priority, perhaps second only to raising funds for reelection. Nearly every decision turns on economics. With economic survival as a central focus of the day-to-day affairs of local, state, and federal government, economic

45. *See id.*

46. *See* CITY-DATA.COM, *Richmond, California*, http://www.city-data.com/city/Richmond-California.html (last visited Mar. 13, 2015).

47. A challenge to the claim of public use is particularly necessary because the City selected only 624 loans but claimed there were many underwater mortgages, which, in their minds, was the cause for the need to condemn mortgages. *See* Res. No. 120-13, Richmond City Council ¶ 2 (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf ("In addition to this basic standard [of public use], we will specifically restrict the use of eminent domain to the exceptional circumstances *when large numbers of households are underwater* and there are not other adequate measures to address the problem[.]" (emphasis added).

48. *See* Pls' Mot. for Prelim. Inj., *supra* note 38, at i; *see also* Langdon, *supra* note 19, at 578.

49. If the homes are not satisfactorily maintained, Richmond code enforcement officers can proceed with cease and desist letters and public nuisance enforcement against the owners-borrowers. *See* Steve J. Eagle, *Does Blight Really Justify Condemnation?*, 39 URB. LAW. 833, 836, 844–46 (2007) (arguing, among other points, that the alternatives of abatement, foreclosure, and private revitalization are more consistent with the Constitution and produce better outcomes).

50. Langdon, *supra* note 19, at 609–10; *see also* Alec Harris, Note, *Redemption and Return on Investment: Using Eminent Domain in the Underwater Mortgage Fight*, 8 HARV. L. & POL'Y REV. 437, 452–53, 464 (2014).

51. *See* Lott, *supra* note 3.

development can easily be made the justification for condemnation of any private property. As long as the procedural steps of thorough study and preparation, a comprehensive written plan, and notice to the public with public hearings are taken, no private owner's property is safe.[52] Public officials find broad legal authority under the *Kelo* decision, reinforcing their belief that economic development efforts are for the public good, and yet, ignoring the public's passionate reaction against *Kelo* and the implied rejection of eminent domain in certain instances.[53] Thus, lawsuits are probably useless because it would be quite difficult to find a pretext for the condemnation. Moreover, a political remedy is practically hopeless.[54]

2. Just Compensation

The deeply discounted prices the City expects to pay for the mortgages indicate there is a potential problem regarding just compensation.[55] What is the fair market value of a mortgage that is secured by real property with a value that is less than the loan principal balance? The City of Richmond and MRP are of the opinion that deep discounts are justified given the greater risk of borrower default when the collateral property's value is underwater. In their view, borrowers will not continue to make mortgage payments, and, despite investments of down payments and monthly payments (perhaps for years), will walk away when personal financial circumstances indicate that the borrowers will lose their homes by foreclosure. The borrowers lose motivation to stay current and the risk of default increases. Due to the higher risk of default and the cost of foreclosure, there is a decrease in the value of the loan. The City and MRP also claim that the trust beneficiaries are unable to recover the full loan balance through the foreclosure sale, either because values have fallen, or because foreclosure is a remedy that does not typically yield a sales price that provides full recovery for lenders. A steep discount in a mortgage's value is thus justified, according to the City and MRP.

The trustees and beneficiaries, on the other hand, contend that the

52. Kelo v. New London, 545 U.S. 469, 503-05 (2005) (O'Connor, J., dissenting).

53. *See* James W. Ely, Jr., *Post-*Kelo *Reform: Is the Glass Half Full or Half Empty?*, 17 SUP. CT. ECON. REV. 128 n. 1, 151 n. 109 (2009) (citing legal commentary and news article.that discuss public reaction to Kelo).

54. *See* Somin, *supra* note 17, at 218–221.

55. *See* Peace, *supra* note 23, at 2197–98 (explaining that rather than a traditional approach toward just compensation that is determined by the fair market value of the mortgage as agreed upon by a willing buyer and a willing seller in an arm's length transaction, the plan proponents claim the mortgages are underwater, subject to a higher degree of default, that result in lower foreclosure prices, and should thus be discounted, but that such claims include assumptions that may not occur, such as all mortgages will end in foreclosure, and therefore just compensation may be higher than what the City may want to pay).

underwater value of the collateral has little if any impact on the determination of the fair market value of the mortgage notes because home values are on the rise and lenders can sell the foreclosed properties at a later date when values are even higher. Lenders also contend that the reason why foreclosure sale prices typically do not yield a full recovery of the amount due is because of the lenders' voluntary choice to submit less than full credit bids at the foreclosure sale such that this argument should not be a factor.[56] Notably, the City and MRP have targeted mostly performing loans, which, of course, indicates that there is a lower risk that the targeted borrowers will default.[57] This fact alone greatly undermines the City's purported justification for its plan. The City and MRP's position is also weakened because they initially claim that the fair market value of the loans requires a steep discount, yet they turn around to claim the fair market value is higher in order for them to sell the loans (once restructured) at a higher price to new lenders.[58] In addition, there is a cost to lenders and to residential mortgage-backed securitization trusts when performing mortgages are condemned and thereby removed from the pool, which likely creates an uneven level of risk among the loans that remain within the portfolio.[59] On balance, it is likely that the actual fair market value will be found to be closer to the principal balances on the loans rather than the deep discounts the City and MRP claims.[60]

3. *Impairment of Obligation of Contract*

Another potential issue is that a political subdivision of a state will impair the obligation of a loan agreement arguably in contravention of the Impairment of Obligation of Contract Clause of the U.S. Constitution.[61] The City's and MRP's plan will use the mechanism of eminent domain for the purpose of actually rewriting the terms of certain mortgages, which provides a windfall to borrowers, a loss to trust beneficiaries, and a handsome profit to the City and MRP, its investment partner. Neither the

56. There are many reasons, legal and factual, why a lender submits less than full credit bids at a foreclosure sale, but this article does not delve in to this topic.

57. *See* Langdon, *supra* note 19, at 598.

58. The City and MRP will likely claim that the value would rise because the loan terms were changed to make it easier for the borrowers to make their payments and avoid default. There may be a difference in loan terms, but there does not appear to be a difference in the risk of default because borrowers already make their payments under current loan terms. Also, this ignores the indirect beneficial impact that the apparent upward trend of home values and the economy in general in Richmond have on the value of extant mortgages.

59. *See* Langdon, *supra* note 19, at 599.

60. *See id.* at 599–600

61. U.S. CONST. art. I, § 10, cl. 1; *see also* Roller, *supra* note 23, at 156; Counts, *supra* note 23, at 477.

technical procedures nor the substance of eminent domain law should overshadow the reality that the plan would impair the obligation of contract between borrower and lender.[62] According to the trustees, the plan may put the trusts, the trustees, and/or the beneficiaries in jeopardy of violating federal tax law.[63] Query whether the trustees would be at risk for or have a defense against claims of breach of the residential mortgage-backed securitization trust pool agreements or breach of fiduciary duties owed to the remaining pool beneficiaries because of the nonconsensual nature of the condemnation of certain mortgage loans, the condemnor's subsequent modification of the loan terms, and its resale of the newly restructured loans with better terms.

D. Status of the Trustees' Lawsuit Against the City of Richmond and MRP

The federal court in *Wells Fargo v. Richmond* did not decide these issues because the trustees' complaint was dismissed for lack of ripeness, since the City of Richmond had not passed a resolution of necessity to start the condemnation proceeding, and the trust beneficiaries had not yet suffered a loss.[64] Perhaps this and other related articles are solely academic exercises unless and until the City actually commences condemnation proceedings and the parties litigate the issues. Nonetheless, the fact that the City has taken the first step with its resolution of intent and general guidelines for the condemnation of mortgages should alert those who favor greater protection of private property. As the City considers its next step, it is worthwhile to review a local government's power to condemn personal property located outside its territorial boundaries.

II. CURRENT LAW REGARDING THE CONDEMNATION OF MORTGAGES BY EMINENT DOMAIN

An intriguing aspect of the condemnation of mortgages is that the proposal raises many issues. In fact, the range of issues spans the treatment of personal and real property rights by state and federal constitutions, statutes, and cases in the context of government's eminent domain power. In addition, the range of issues is framed by circumstances that have significantly impacted the lending and housing markets, and the economy in general. This Article cannot cover the entire span but does generally

62. *See* U.S. CONST. art. I, § 10, cl. 1. *See* Counts, *supra* note 23, at 485; *see also* Pls' Mot. for Prelim. Inj., *supra* note 38, at 15–16.

63. Pls' Mot. for Prelim. Inj., *supra* note 38, at 4.

64. Order Granting Defendants' Motion to Dismiss and Denying Plaintiffs' Motion for a Preliminary Injunction, at 1–2, Wells Fargo Bank, Nat'l Ass'n v. Richmond, No. CV-13-3663-CRB (N.D. Cal. Sept. 16, 2013) *available at* http://docs.justia.com/cases/federal/district-courts/california/candce/3:2013cv03663/268907/78 (last visited April 20, 2015).

address the law with regard to some issues and then specifically examines the law regarding the extra-territorial nature of the City's condemnation plan.

A. *Condemnation of Intangible Personal Property*

The City was not the first to develop the plan to condemn by eminent domain certain mortgages that were in private label securitized trusts as a policy strategy for local governments to deal with the effects of the recent financial crisis. MRP may have been the first, but based on the number of articles published on this topic, it appears that much of the credit for this idea goes to Professor Robert Hockett, a Professor of Law at Cornell Law School.[65] In one of his articles, Professor Hockett states:

> Because the law draws no distinctions between kinds of property that can be purchased in eminent domain, it is unsurprising that loans and liens in particular, as one form of contractual obligation among many, are themselves regularly purchased. Among these are mortgage loans and liens, as the Supreme Court and state courts have long recognized.[66]

Professor Hockett cites in his article cases that he contends support local government's power to condemn mortgages.[67] The cases involve rulings that relate to the condemnation of various types of intangible property.[68]

B. *Condemnation of Mortgages*

The cases cited by Professor Hockett include one case concerning the

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65. *See* Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, 19 CURRENT ISSUES IN ECON. AND FIN., 1, 9 (2013). A list of his articles is listed under the References section of the article. *See* Robert Hockett, *It Takes A Village: Municipal Condemnation Proceedings And Public/Private Partnerships For Mortgage Loan Modification, Value Preservation, and Local Economic Recovery*, 18 STAN. J.L. BUS. & FIN. 121, 123–24 nn. 3–6, 11, 126–27 nn. 22, 25, 133–35 nn. 53, 60, 62, 64, 137 n. 68, 157 n. 107 (2012). His articles are further cited therein.

66. Hockett, *supra* note 21, at 6 (footnotes omitted).

67. *See id.* at 6, nn. 12–13.

68. *See, e.g.*, Phillips v. Wash. Legal Found., 524 U.S. 156, 160, 172 (1998) (holding that the interest earned on funds held in a lawyer's trust account ("IOLTA") was the private property of the owner of the principal, *i.e.*, the client, and as such was subject to the Takings Clause of the 5th Amendment of the U.S. Constitution; *Phillips* did not answer the question as to whether the State of Texas statute that required banks to forward the interest earned on IOLTA accounts to the State for distribution to foundations to finance legal services for low-income persons was a taking); Armstrong v. United States, 364 U.S. 40, 41, 48 (1960) (a supplier of material to a shipbuilder pursuant to a contract was entitled to the property rights under a materialman's lien created by state law and the federal government's destruction of those property lien rights was held to be a taking of private property that required the payment of just compensation under the Fifth Amendment of the U.S. Constitution); *see also* Legal Tender Cases, 79 U.S. 457 (1870).

dedication of land to a local government for streets and alleys that led to an inverse condemnation action by a lender to protect its property interest created by a mortgage[69] and another that specifically concerns mortgages in the context of federal bankruptcy legislation.[70]

1. Municipal Ownership of Dedicated Land

A lender's inverse condemnation action to protect the priority of its property interest (based on its mortgage lien) over a local government interest in dedicated property does not directly address the outright condemnation of a mortgage by eminent domain.[71] In *Western Fertilizer & Cordage Co. Inc. v. City of Alliance*, developer BRG, Inc. purchased a particular parcel from Western and later the local city approved BRG's plat that contained dedications of certain portions of the parcel to the city for streets, alleys, and public land.[72] Later, when the balloon payment on the purchase price matured, BRG signed a note and mortgage in favor of seller-Western and the subject parcel became the collateral for the loan.[73] After the mortgage loan was created, BRG dedicated more land to the city.[74] When the developer defaulted, Western filed a complaint for foreclosure and eventually obtained title to the property under a sheriff's deed.[75] After the city insisted its rights to the dedicated land were superior to that of Western's property rights as a secured lender, Western filed an inverse condemnation action against the city.[76] Due to competing priority of interests, the discrepancies in the legal description of the collateral property in the mortgage and the legal description of the foreclosed property in the sheriff's deed, the Nebraska Supreme Court reversed the trial court's grant of summary judgment in favor of the city.[77] The court concluded that a mortgagee does not need to have title or possession of the subject property in order for a governmental taking of a property interest to occur.[78]

Thus, a local government could be required to pay just compensation when it accepts the dedication of land and then asserts an ownership interest in such land that it claims is superior to a lender's mortgage lien

69. W. Fertilizer & Cordage Co. v. Alliance, 504 N.W.2d 808, 810–11 (Neb. 1993).

70. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 572–73 (1935).

71. *W. Fertilizer*, 504 N.W.2d at 808.

72. *Id.* at 811.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* at 819–20.

78. *Id.* at 816, 819.

interest. Such a rule is markedly distinguishable from the locality's initiation of an eminent domain proceeding solely to condemn mortgage promissory notes located outside city limits.

The *Western* case is distinguishable from the City of Richmond plan. *Western* dealt with a municipality's assertion of ownership rights to dedicated land located within that city's territorial jurisdiction and claimed that it had priority over a lender's mortgage security interest in the same land. *Western* did not address a direct, forced taking of mortgage notes held by a lender located outside city limits.

2. *Bankruptcy Court Reduction of Mortgage Principal Balance*

Federal bankruptcy legislation and related cases have a direct impact on lenders' property interests through bankruptcy courts' authority to strip down or strip off a mortgage from bankrupt debtors' real property under certain circumstances.[79] In *Louisville Joint Stock Land Bank v. Radford*,[80] the U.S. Supreme Court struck down the Depression-era Frazier-Lemke Act (an amendment to the Bankruptcy Act)[81] after the debtor's lender successfully intervened in the bankruptcy case to assert a constitutional challenge against the Act under the Takings Clause of the Fifth Amendment to the U.S. Constitution. The Court concluded that:

> [since] the act as applied has [taken a property interest from the bank without compensation], we must hold it void; for the Fifth Amendment commands that, however great the nation's need, private property shall not be thus taken even for a wholly public use without just compensation. If the public interest requires, and permits, the taking of property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public.[82]

The Court recognized that the Act had the purpose "to preserve to the

79. This Article does not analyze the circumstances under which bankruptcy courts can or cannot strip down or strip off mortgages from the collateral real property. This topic remains an issue, as the U.S. Supreme Court on November 17, 2014 granted a writ of certiorari and on March 24, 2015 heard oral argument in the consolidated cases of Bank of America v. Caulkett, No. 13-1421, 2014 WL 2207208 (U.S. Nov. 17, 2014) and Bank of America v. Toledo-Cardona, No. 14-163, 2014 WL 3965212 (U.S. Nov. 17, 2014) to address the question: Does Section 506(d) of the Bankruptcy Code permit a chapter 7 debtor to "strip off" a junior mortgage lien in its entirety when the outstanding debt owed to a senior lienholder exceeds the current value of the collateral? *See Caulkett*, 2014 WL2207208, at *3 (outlining the question presented); *Toledo-Cardona*, 2014 WL3965212, at *3.

80. Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).

81. *See id.* at 572–73.

82. *Id.* at 601–02.

mortgagor the ownership and enjoyment of the farm property" and had an "*avowed object . . . to take from the mortgagee rights in the specific property held as security . . .* and . . . *'to scale down the indebtedness' to the present value of the property*."[83] To achieve these goals, the Act worked to take property rights from the bank.[84] In light of the substantive limitations on the character of the bank's mortgage that the Act imposed, the Court stated, "[i]f a part of the mortgaged property were taken by eminent domain, a mortgagee would receive payment on a similar basis."[85] Thus, the *Radford* Court recognized that if the underlying land were taken, the mortgagee's property interest would be impacted, as well, entitling it to compensation just as the landowner would receive payment.[86] As a result, *Radford* concluded that a bankruptcy law that significantly alters a mortgage lien such that essential property rights are all but destroyed is invalid.[87]

Inasmuch as the *Radford* opinion strongly defended private property rights, it is no wonder that the ruling has been criticized[88] and

83. *Id.* at 594 (emphasis added).

84. *Id.* at 594–95 ("As here applied it has taken from the Bank the following property rights recognized by the Law of Kentucky: (1) The right to retain the lien until the indebtedness thereby secured is paid. (2) The right to realize upon the security by a judicial public sale. (3) The right to determine when such sale shall be held, subject only to the discretion of the court. (4) The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself. (5) The right to control meanwhile the property during the period of default, subject only to the discretion of the court, and to have the rents and profits collected by a receiver for the satisfaction of the debt.").

85. *Id.* at 596 (referencing the taking of real property and not the mortgage itself as personal property).

86. However, in a condemnation proceeding when a municipality takes land with interests held by a fee owner-borrower and by a mortgage lender, there is an apportionment of the compensation paid. In California where there are divided interests in the property (e.g., the fee owner and a trust deed beneficiary), the condemnor in an eminent domain proceeding can require the trier of fact to determine the compensation to be paid to all defendants, who then can produce evidence as to their respective interests and right to all or a portion of the compensation, which the trier of fact shall apportion according to proof. CAL. CIV. PROC. CODE § 1260.220 (West 2015).

87. *Radford*, 295 U.S. at 601–602. The *Radford* court did not address the possible result if Congress had set out a mechanism within the Act to provide lenders with just compensation when debtors were granted mortgage relief under the Act.

88. In re Yi, 219 B.R. 394, 401 (E.D. Va. 1998) ("[L]ien avoidance under the federal bankruptcy power 'does not come within the traditional definitions of takings under the Fifth Amendment.'" (Citation omitted)); In re A.V.B.I., Inc., 143 B.R. 738, 746 (Bankr. C.D. Cal. 1992); Pillow v. Avco Fin. Servs., 8 B.R. 404, 411 (Bankr. D. Utah 1981). *Radford*, a 1935 case, was decided just prior to the U.S. Supreme Court's remarkable shift in the 1930s and 1940s toward greater deference to government and

distinguished.[89] Nevertheless, it remains viable and it has been relied upon in more recent opinions.[90] *Radford* provides a cautionary flag in that it acknowledges that private property rights ought to be protected when government asserts its enumerated bankruptcy power.[91] The line of cases that follow *Radford* hold to the principle that the Fifth Amendment's Takings Clause protects lenders' private property interests notwithstanding the bankruptcy setting.

The courts that criticize *Radford* conclude that the Takings Clause does not impede the authority of bankruptcy courts, though the secured mortgage and the related property interest may be directly affected by court orders. Such courts place an emphasis on the policy that Congress intended the bankruptcy statutes to grant relief so that debtors have a fresh start, and further reason that to achieve the policy goal, such statutes cannot be made vulnerable to a takings claim.[92] Though the treatment of debtors under the law has a checkered past, there is a longstanding regard for the principle that debtors often need to be unburdened by oppressive debt that goes at least as far back as the Old Testament in the Bible.[93] Since bankruptcy

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away from earlier closer scrutiny of legislation that impacted private contracts.

89. *See* Wright v. Vinton Branch of the Mountain Trust Bank of Roanoke, 300 U.S. 440, 455–56 (1937); *see, e.g.*, Kuehner v. Irving Trust Co., 299 U.S. 445, 450–53 (1937).

90. *See* Rodrock v. Sec. Indus. Bank, 642 F.2d 1193, 1197–98 (10th Cir. 1981) (" Counsel suggests that, with the passage of time, Radford has lost its steam and that later decisions of the Supreme Court cast doubt on the continuing vitality of that decision. We disagree. Such cases . . . may well refine the rule of Radford, but they do not destroy the fundamental teaching of Radford that Congress may not under the bankruptcy power completely take for the benefit of a debtor rights in specific property previously acquired by a creditor." Footnote 5 in *Rodrock* states, "We note that, not only has Radford never been overruled, either expressly or impliedly, but it has continued to be cited by the Supreme Court. *Rodrock*, 642 F.2d at 1197 n.5 (citing Armstrong v. United States, 364 U.S. 40, 44 (1960)); *see also*, In re A.V.B.I., Inc., 143 B.R. at 746 (citing United States v. Security Indus. Bank, 459 U.S. 70, 74 (1982) to acknowledge the U.S. Supreme Court's reliance on *Radford* "for the proposition that there are Fifth Amendment limitations on the extent to which the bankruptcy statutes can 'be used to defeat traditional property interests,' like lien rights").

91. *See* U.S. CONST. art. I, § 8, cl. 4.

92. *See, e.g.*, In re Pillow, 8 B.R. 404, 411, 420 (Bankr. D. Utah 1981) ("Furthermore, Congress recognized that 'one of the primary purposes of the bankruptcy act is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution that property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.'" (citing Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (emphasis and citations omitted)).

93. *Deuteronomy* 15:1–11.

mortgage relief is a direct challenge to a lender's property interests (by "'stripping down"' or "'stripping off"' the mortgage lien from the debtor's real property), the significance of the clash between the policy to give debtors a fresh start and the protection of private personal property interests cannot be underestimated. Bankruptcy courts have worked through the reasoning to balance these two competing interests, but this Article does not describe the dividing line in the bankruptcy context. Instead, this Article briefly examines the City's plan in light of the fresh start policy.

Both the bankruptcy statutes and the City's plan have the potential to directly deprive a lender of its personal property interest. Since there is a dearth of cases on point, the City will likely distinguish *Radford* and assert the general proposition that it can condemn mortgage notes outright, an act roughly analogous to the stripping off of the mortgage balance and lien. Accordingly, it is of value to examine the City's plan in light of the bankruptcy courts' fresh start policy. Bankruptcy courts rely on federal legislation based on a constitutionally enumerated power and the policy of a debtor's fresh start to enable a debtor to request a court to grant mortgage debt relief in the form of stripping down or stripping the loan principal. The City's plan, if implemented, would condemn mortgage notes without enabling legislation in order to directly force the lender, without its consent, to relinquish the entirety of its personal property interest through an eminent domain sale. What fresh start does the City and MRP provide for the borrower and for the City? After immediate protection pursuant to the bankruptcy court's automatic stay, a debtor-borrower can seek court approval of a loan repayment plan—the debtor enjoys a fresh start as he regains his financial footing over time and eventually the lender is made whole. The City's plan, however, does not require anything from the borrower and fails to make the lender whole. In fact, the lender's position is worse as it would be forced to sell at what appears to be below market price. Also, the City's form of a "fresh start" is actually a windfall because the borrower is given a new mortgage with a reduced loan principal and with better terms.[94] The borrower would clearly be in a much better position as a result of the strong-arm tactic of eminent domain that forces his lender to suffer a loss.

A bankruptcy court judge and an appointed bankruptcy trustee evaluate the details of a debtor's income, expenses, and debts before the decision to grant a fresh start is made. The City, on the other hand, has not made and most likely will not make an evaluation of a borrower's general financial circumstances or of the specific mortgage. The City simply has taken

94. *See* Res. No. 120-13, Richmond City Council ¶ 6 (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf

MRP's recommendation on which mortgages to condemn. The City and MRP primarily select borrowers who are current with their loan payments, unlike bankruptcy courts that have discharged the debts or equitably divided among creditors the assets of borrowers overwhelmed with debt. Under the City's and MRP's plan, approximately 624 mortgagors would receive a better loan, giving the term "relief" a new meaning. Moreover, there does not appear to be a current thought to provide a "fresh start" to the multitude of other borrowers who live within city limits.

Further, the City would not experience a fresh start. The restructuring of 624 targeted mortgages is too few to make a significant difference and it would be speculative to claim that blight conditions would be reduced (even if detectable). Even if defaults and foreclosures were to actually exist in such numbers as to pose a real threat, it would be far better to contain such a threat through public nuisance and other ordinances,[95] as well as background principles of state property law,[96] rather than to push the public use requirement into practical extinction.[97] Although the purchase and resale of mortgages may provide profits for the City and MRP, it is unlikely that the City's financial condition would be relieved of the pressure of long-term debts, subsidies, and entitlement programs.[98] As

95. *See e.g.*, RICHMOND MUN. CODE §§ 9.22.010-140 (2014); *see also* Eagle, *supra* note 49, at 836.

96. Lucas v. S.C. Coastal Comm'n., 505 U.S. 1003, 1027–28 (1992).

97. *See* Kelo v. New London, 545 U.S. 469, 494 (2005) (O'Connor, J., dissenting) (warning that the public use requirement may cease to exist after this decision); *see also* Steven J. Eagle, *A Resurgent "Public Use" Clause Is Consistent With Fairness*, 19 APR. PROB. & PROP. 18, 19 (2005) (a pre-*Kelo* article that draws attention to local government's use of condemnation as a "marketing tool" to draw business and to judicial conflation of "public use" and "public purpose." Further, the article comments on the then recent decision in County of Wayne v. Hathcock, 684 N.W.2d 765 (Mich. 2004), to say, "[a]lthough the *Hathcock* approach is hardly perfect, it does illustrate that only in rare instances does a town's economic survival depend on condemnation of a few specific parcels for resale").

98. Generally, recent history has shown that governmental officials at all levels have increased the number of programs and their budgets, and rarely if ever have terminated a program. This practice, as recounted on the daily news, has led the federal government and many state and local governments to accumulate a significant and perhaps irreversible amount of debt. In fact, municipal bankruptcies are apt to be more common in recent times, like that of the filing by the City of Detroit, Michigan. *See* Matt Helms, Nancy Kaffer & Stephen Henderson, *Detroit Files For Bankruptcy, Setting Off Battles With Creditors, Pensions, Unions*, DETROIT FREE PRESS (Jul. 19, 2013, 7:47 AM), http://www.freep.com/article/20130718/NEWS01/307180107/Detroit-bankruptcy-filing-Kevyn-Orr-emergency-manager. For an article regarding Detroit and other large cities with financial trouble, *see generally* Todd Spangler, *Detroit Not Alone Under Mountain Of Long-Term Debt*, DETROIT FREE PRESS (Jul. 22, 2013, 3:21 PM), http://www.freep.com/article/20130721/NEWS06/307210073/detroit-bankruptcy-pension-benefits-unfunded-liability.

a result, Richmond citizens would not see a fresh start but rather, would probably face higher taxes or a reduction in fundamental services so that officials' preferred programs are created, maintained, or expanded.[99]

Thus, a city council that puts itself in the lending business or in the secondary mortgage market does not create a fresh start. If the plan merely called upon the City to condemn existing loans and to serve as a one-time "broker" that sells the restructured loans, there would still not be a fresh start for the larger community, and consequently no public use. Whether as a long-term participant or a one-time broker in the private mortgage market, the City abrogates its fundamental role of protecting lives and property.

Let us suppose there is indeed a fresh start for the few as a result of the plan. The question becomes whether the plan is an excessive exercise of the power to condemn property. It is reasonable to conclude that municipal legislatures have not wisely used the power to condemn property if we were to gauge current practices in light of the historical understanding of eminent domain, the emphasis on paternalism, and the more frequent use of central economic planning. As a token gesture in recognition of James Madison's comment that if angels were to govern men there would be no need for internal or external controls of government,[100] state legislatures throughout the country have promulgated statutory measures to protect against municipal overreach through the taking of property.[101]

III. EXTRA-TERRITORIAL CONDEMNATION OF MORTGAGE NOTES

California, like many other states, uses its constitution[102] and legislation[103] to authorize its political subdivisions to condemn property

99. The author calls upon himself and his readers to be realistic about the methods of governance practiced by elected officials and bureaucrats. More importantly, the author and his readers must face the consequences of re-electing officials who continue current practices, and must bring about a robust revival of the political remedy of elections.

100. THE FEDERALIST No. 51, at 319 (James Madison) (Clinton Rossiter ed., 2003).

101. The men (or women) who are in office or serve as government employees make mere token gestures to be restrained under a system of checks and balances because, in the author's opinion, these same public servants appear to be in the constant pursuit of ways to circumvent the very statutory protective measures they draft and enact. To be fair, it is important to recall that it is often the judiciary's deference to legislative action and minimal scrutiny of regulation that impacts fundamental property rights that enable the circumvention.

102. CAL. CONST. art. I, § 19(a) ("Private property may be taken or damaged for a public use and only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner.").

103. CAL. CIV. PROC. CODE CIV. P. § 1230.020 (2015) ("Except as otherwise specifically provided by statute, the power of eminent domain may be exercised only as provided in this title."); *see* CAL. CIV. PROC. CODE § 1240.030 ("property" for a

through eminent domain. Without enabling law, local government cannot freely act to take property.[104] With enabling law, local municipalities can initiate eminent domain proceedings, but there are limits imposed on the power.[105] Most relevant to the City's plan is the statutory provision that concerns the location of the property to be taken. Generally, a local government or agency lacks the power to take property that is outside its territorial jurisdiction unless there is a specific statute that authorizes the taking[106] "or [the power is] necessarily implied as an incident of one of its other statutory powers."[107] Rather than review the issues of public use, just compensation, and impairment of contract raised by the Richmond plan, this Article takes a closer look at the California law that concerns extra-territorial condemnation.

A. *The California Constitution and the Power of Eminent Domain*

The California Constitution expressly prohibits state and local government from acquiring through eminent domain an owner-occupied residence so that it can transfer it to a private person.[108] This prohibition does not apply, however, if state or local government condemns property "for the purpose of protecting public health and safety; preventing serious, repeated, criminal activity; responding to an emergency; remedying environmental contamination that poses a threat to public health and safety[;]"[109] or "acquiring private property for a public work or improvement."[110] Thus, there is no express constitutional authority to condemn: i) a residential real estate loan promissory note; ii) an owner-occupied residence in order to transfer it to a private person; or, iii) property for economic revitalization. Unless the condemnation, restructuring, and reselling of a residential mortgage loan is construed to fall within one of the stated purposes, the City of Richmond must look for

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"proposed project"); CAL. PUB. RES. CODE § 5540 (2015) (real or personal property for exercise of powers by a regional park and other districts for such things as an open-space easement); CAL. GOV'T. CODE § 37353 (2015) (real property for parking and streets). *See generally* Harden v. Superior Court, 284 P.2d 9, 14–15 (Cal. 1955).

104. San Francisco v. Ross, 279 P.2d 529, 530–31 (Cal. 1955); *see also* CAL. CIV. PROC. CODE § 1230.020 (2015).

105. *Ross*, 279 P.2d at 531; *see also* CAL. CIV. PROC. CODE § 1230.020 (2015). Post *Kelo* cases outside of California have reinforced the point that under state law there are limits placed on the power of eminent domain. *See, e.g.*, Bd. of County Comm'rs v. Lowery, 136 P.3d 639, 646 (Okla. 2006) (citing *Kelo*, (O'Connor, J., dissenting)).

106. CAL. CIV. PROC. CODE CIV. P. § 1240.050 (West 2015).

107. *Id.*

108. CAL. CONST. art. I, § 19(b).

109. CAL. CONST. art. I, § 19(c).

110. CAL. CONST. art. I, § 19(d).

legal authority in a state statute.

B. *California Statutes and the Power of Eminent Domain*

California's eminent domain law establishes the procedures for eminent domain proceedings.[111] "A city may acquire by eminent domain any property necessary to carry out any of its powers or functions."[112] The extent of city powers or functions must be determined of course. Whether a city actually condemns property by eminent domain is a decision that is left to the city official's discretion.[113] The breadth of statutory condemnation authority expands to enable a city to acquire personal or real property located within *or beyond city limits*, and to convey such property, as well: "The legislative body may *purchase*, lease, exchange, or receive such personal property and real estate situated inside or *outside the city limits* as is necessary or proper for municipal purposes. It may control, dispose of, and convey such property for the benefit of the city."[114] An acquisition of a residential mortgage promissory note possessed outside of Richmond city limits must be shown by the City to be "necessary or proper for municipal purposes."[115] It has yet to be shown in California case law that a locality's condemnation of residential mortgage promissory notes is a municipal purpose, much less a necessary or proper one. Standard definitions of local government purposes do not involve the public entity's participation in the secondary mortgage market by condemning a mortgage loan in order to restructure the original loan terms and then selling the new loan.[116]

California Code of Civil Procedure Section 1240.050 declares that a local *public entity*[117] can acquire property only within its territorial limits,

111. CAL. CIV. PROC. CODE CIV. P. §§ 1230.010 *et seq* (West 2015).

112. CAL. GOV'T CODE § 37350.5 (2015).

113. CAL. CIV. PROC. CODE § 1230.030 (West 2015) ("Nothing in this title requires that the power of eminent domain be exercised to acquire property necessary for public use. Whether property necessary for public use is to be acquired by purchase or other means or by eminent domain is a decision left to the discretion of the person authorized to acquire the property.").

114. CAL. GOV'T CODE § 37351 (West 2015) (emphasis added).

115. *Id.*

116. The California Supreme Court has taken a strict construction approach to the interpretation of statues that concern the condemnation of extra-territorial property. *See* Harden v. Superior Court, 284 P.2d 9, 17 (Cal. 1955) (citing Madera v. Black, 184 P. 397, 400–01 (Cal. 1919), which stated that "It is the settled law of this state and the general rule everywhere that language purporting to define the powers of a municipal corporation is to be strictly construed, and that any fair, reasonable doubt concerning the existence of the power is resolved by the courts against the [municipal] corporation, and the power is denied") (internal quotation marks omitted).

117. CAL. CIV. PROC. CODE § 1235.190 (West 2015) ("Public entity" is defined to include "the state, a county, city, district, public authority, public agency, and any other

but can exceed its boundary if the entity shows that it has been given the power to condemn by express statutory authority, or if the power is necessarily implied from some other statutorily authorized power.[118] Express statutory authority is understandably granted to a public entity to go beyond its territorial limits for the purposes of water, gas, electrical supply, airports, drainage or sewer purposes if there is statutory authorization.[119] Such services are commonly understood to fall within core governmental functions because the services are fundamental infrastructure needs of a community.

C. *California Case Law and the Condemnation of Extra-Territorial Property*

There is a fairly bright line when the state enacts legislation that delineates the governmental purposes for which condemnation of extra-territorial property can be undertaken. Water, gas, electricity, airports, drainage, and sewerage purposes illustrate this point. As for the power to condemn extra-territorial property by eminent domain that is *necessarily implied*, California courts explain when a public entity may effectuate the extra-territorial taking.

1. *Court Jurisdiction Over an Eminent Domain Proceeding*

Initially, it is essential to point out that the California Supreme Court has held that a trial court does not have jurisdiction to try an eminent domain proceeding if the local municipality lacks extra-territorial jurisdiction to condemn property located outside its boundaries.[120] In *Harden v. Superior Court*, the Hardens, who owned land outside of the City of Hayward, California in June of 1954, obtained from the County of Alameda a building permit to erect a department store building.[121] In October 1954, the City of Hayward passed a resolution to condemn the Hardens' property, and other land, for the purpose of an off-street parking area.[122] The City

political subdivision in the state.").

118. CAL. CIV. PROC. CODE § 1240.050 (West 2015) ("A local public entity may acquire by eminent domain only property within its territorial limits except where the power to acquire by eminent domain property outside its limits is expressly granted by statute or necessarily implied as an incident of one of its other statutory powers.").

119. CAL. CIV. PROC. CODE § 1240.125 (West 2015) ("Except as otherwise expressly provided by statute and subject to any limitations imposed by statute, a local public entity may acquire property by eminent domain outside its territorial limits for water, gas, or electric supply purposes or for airports, drainage or sewer purposes if it is authorized to acquire property by eminent domain for the purposes for which the property is to be acquired.").

120. *Harden*, 284 P.2d at 14–15, 17.

121. *Id.* at 11–12.

122. *Id.*

filed a complaint to condemn the land by eminent domain.[123] When the Hardens' demurrer was overruled, they filed a writ of prohibition against the trial court.[124] The California Supreme Court held that the trial court exceeded its jurisdiction when it ruled on the demurrer and issued the writ of prohibition against the lower court.[125] The court concluded that the writ of prohibition was the appropriate remedy despite the lack of a final judgment, where it appeared that a "failure of justice would occur in a matter of public importance by a wrongful or excessive exercise of jurisdiction" and that the petitioner-landowners "do not have a speedy and adequate remedy by appeal under the circumstances [t]here presented."[126] The court found there to be a lack of jurisdiction because the City of Hayward did not have the express legal authority to condemn property beyond its boundaries because under precedent case law the term "purchase" in California Government Code Section 37351 must be strictly construed to prohibit extra-territorial condemnation of property.[127] Put briefly, since the municipality did not have jurisdiction to condemn property outside its boundaries, the trial court did not have jurisdiction to rule on the landowners' demurrer.[128] Condemning agencies would initiate eminent domain proceedings for naught.

2. *California's Statutory Scheme for the Condemnation of Extra-Territorial Property*

Based on City Resolution No. 120-13, it is fair to assume that the City believes that the metrics of the City's conditions regarding residential housing values, defaults, and foreclosures support a resolution of necessity for the mortgage condemnation plan, and that the plan satisfies the constitutional criteria of public use and just compensation. Nevertheless, its proposed plan cannot get very far since there is no statutory provision in state law that specifically permits the condemnation of residential mortgage loans. A broad provision such as Government Code Section 37351 will not suffice either,[129] which, pursuant to the holding in *Harden*, would leave a trial court without jurisdiction.

An alternative argument for the City requires it to claim that its power to

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123. *Id.*

124. *Id.*

125. *Id.* at 17.

126. *Id.* at 13–14.

127. *Id.* at 16–17.

128. *Id.* at 14 ("[W]hen it is shown that the court, in overruling the demurrer is proceeding without jurisdiction over the subject matter of the action, prohibition may issue."). *See generally*, CAL. CODE CIV. PROC. §§ 1102, 1103 (West 2015).

129. *See supra* notes 114 and 127 and accompanying text.

condemn residential mortgage notes is "necessarily implied as an incident of one of its other statutory powers."[130] This may prove difficult in that few agree that the handling of transactions in the secondary mortgage market is a local government function.[131] A review of California cases provides an analytical approach to the issue of a necessarily implied power to condemn property.

The opinion in *Kenneth Mebane Ranches v. Superior Court* (hereinafter "*Mebane*")[132] provides a good step-by-step analysis of California eminent domain law in the context of a local flood district's unsuccessful effort to condemn property outside its territorial limits for the purpose of environmental mitigation. Where a specific flood district is given express statutory authority to condemn property outside its boundaries "to construct, maintain, or operate a necessary 'water' or 'drainage' improvement," the district, nonetheless, lacks the authority to condemn extra-territorial property for a purpose that is not set out in statutes that generally speak of the power to condemn extra-territorial property.[133] "A statutory grant of eminent domain power must be indicated by express terms or by clear implication," and courts will strictly construe statutory language and resolve reasonable doubts against the municipality.[134] The court did not find a basis for an extra-territorial taking in the specific flood district regulation's express language or in a specific statute within California's eminent domain law.[135]

For the *Mebane* court to find that the flood district did not have express statutory authority for its condemnation effort, it engaged in a thorough analysis as to whether California law grants an implied power to a public agency to condemn property outside its limits. The court analyzed the alternative "necessarily implied" basis for such condemnation in Section 1240.050 of the California Code of Civil Procedure. The court's train of

130. CAL. CIV. PROC. CODE § 1240.050 (West 2015).

131. Here, secondary mortgage market activity is meant to include the purchase and resale of a residential mortgage loan that already exists, whether a chartered bank, licensed real estate mortgage broker, or a local municipality undertakes the activity.

132. Kenneth Mebane Ranches v. Superior Court, 12 Cal. Rptr. 2d 562 (Cal. Ct. App. 1992).

133. *Id.* at 566–67. The flood district in *Kenneth Mebane Ranches* sought to condemn extra-territorial property under its enabling statute in order to conduct environmental mitigation in an improvement within the district.

134. *Id.* at 565–66.

135. *Id.* at 566; *see*, CAL. CIV. PROC. CODE § 1240.125 (West 2015) ("Except as otherwise expressly provided by statute and subject to any limitations imposed by statute, a local public entity may acquire property by eminent domain outside its territorial limits for water, gas, or electric supply purposes or for airports, *drainage* or sewer purposes if it is authorized to acquire property by eminent domain for the purpose for which the property is to be acquired." (emphasis added)).

thought provides several elements that must be met before such an implied power is found. In *Mebane*, the question was whether the flood district had an implied power to condemn extra-territorial property for the purpose of environmental mitigation. The court said no. The question for the City of Richmond is whether California law enables it to exercise an implied power to condemn residential mortgage loans located outside city limits, since state law does not grant express statutory authority to a public entity to condemn loans regardless of the location.

a. The Standard to Establish an Implied Power to Condemn

The first element that is established under California's statutory scheme and prior case law requires a condemnor to demonstrate a "legal necessity" before it can proceed to take property outside its boundaries. The court in *Mebane* so concluded after it compared the "necessarily implied" phrase in Section 1240.050[136] and the "necessary for the project" phrase in Section 1240.030.[137]

The provisions in Section 1240.030, the *Mebane* court said, "require only a reasonable necessity under all the circumstances of the case and not an absolute or imperative necessity."[138] In contrast, Section 1240.050 "involves a jurisdictional issue, a question of law to be determined by the court[,]" and as the court noted, the Legislative Committee Comment stated that Section 1240.050 had codified prior law that had "applied a higher standard than reasonable or practical necessity."[139] The prior law that established the higher standard included *Carlsbad v. Wight*,[140] which held: "While the record disclosed that the city may have shown practical necessity, *there was no showing of 'urgency, or extreme expediency, or legal necessity, or that the proposed taking [was] indispensible.'*"[141] In

136. CAL. CIV. PROC. CODE § 1240.050 (West 2015) ("A local public entity may acquire by eminent domain only property within its territorial limits except where the power to acquire by eminent domain property outside its limits is expressly granted by statute *or necessarily implied as an incident of one of its other statutory powers*." (emphasis added)).

137. CAL. CIV. PROC. CODE § 1240.030 (West 2015) ("The power of eminent domain may be exercised to acquire property for a proposed project only if all of the following are established: (a) The public interest and necessity require the project. (b) The project is planned or located in the manner that will be most compatible with the greatest public good and the least private injury. (c) *The property sought to be acquired is necessary for the project*." (emphasis added)).

138. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 566–67.

139. *Id.* at 567–68.

140. 34 Cal. Rptr. 820, 825 (Cal. Ct. App. 1963).

141. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 568 (The Court in City of Carlsbad v. Wight, rejected the city's effort to condemn property outside its limits so that it could relocate a storm drainage canal on it.) (emphasis added).

another case, *Los Angeles v. Koyer*,[142] the court stated:

A grant of the power of eminent domain, which is one of the attributes of sovereignty most fraught with the possibility of abuse and injustice, will *never pass by implication, and when the power is granted, the extent to which it may be exercised is limited to the express terms or clear implication* of the statute in which the grant is contained.[143]

As if the quoted prior law had not done so, the court in *Mebane* emphasized the higher standard in Section 1240.050 when it stated:

Because the Legislature intended to codify prior law when it enacted section 1240.050, it must have incorporated the prevailing standard applicable to determine when the power of extraterritorial condemnation will be necessarily implied as an incident to a local public entity's other enumerated powers. That standard requires the power of extraterritorial condemnation to be a matter of "*urgency of extreme expediency or necessity*," or "*manifestly desirable*," or "*essential to the declared objects*" of the local public entity [citations omitted], or indicated by "*clear implication*" [citation omitted].[144]

The court went on to describe the higher standard as "legal necessity."[145] Despite the legislative comments that spoke of a local municipality's demonstration of a reasonable necessity, the *Mebane* court applied the more demanding "legal necessity" standard.[146] Thus, according to this appellate court, a local municipality must demonstrate more than reasonable necessity. As noted in the excerpt above from *Mebane*, to meet the "legal necessity" standard, a local public entity's resolution of necessity must describe the circumstances in which the exercise of the power of an extra-territorial taking is something of an "urgency of extreme expediency or necessity," is "manifestly desirable," is "essential to the declared objects" of the entity, or is "indicated by clear implication."[147] The requirements of a resolution of necessity and related presumptions are set out in California eminent domain law[148] and are discussed below in sub-

142. 192 P. 301, 302–03 (Cal. Ct. App. 1920).

143. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 568 (The Court in City of Los Angeles v. Koyer, reversed a judgment for the city, which sought to construct a public wharf for commerce and to condemn land that was several blocks from the wharf to construct public warehouses for the purpose of operating the wharf) (emphasis added) (internal quotation marks omitted).

144. *Id.* (emphasis added).

145. *Id.* at 567.

146. The *Mebane* court acknowledged that the last paragraph of the Legislative Committee Comment to Section 1240.050 referred to necessity as "only a reasonable necessity". However, the court distinguished the two cases cited in the Comment, and held that "legal necessity" was the appropriate standard. *Id.* at 568–70.

147. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 568.

148. For the mandate to enact a resolution of necessity, *see* CAL. CIV. PROC. CODE

part (i).

The *Mebane* court's comments regarding the contrast between Section 1240.050 and Section 1240.030 highlight the critical distinction in views between the City of Richmond and the trustees of the mortgage-backed securities trusts that filed the underlying lawsuit.[149] The opposing views turn on the threshold questions: (1) the location of the residential mortgage loans; and (2) whether location makes the City's plan an extra-territorial taking. Section 1240.030 does not address extra-territorial takings and requires a "reasonable necessity under all the circumstances of the case." This corresponds to the City's position that it does not need specific statutory authorization for a taking of property outside its boundaries since the residential mortgage loans are located within city limits under what it claims to be a "totality-of-the-circumstances test"[150] established by the California Supreme Court in *Oakland v. Oakland Raiders* (hereinafter *Oakland Raiders I*).[151] The City also relies on other U.S. Supreme Court and California case law that generally focuses on creditors' and residential mortgage lenders' remedies. The opposing trustees maintain that, pursuant to U.S. Supreme Court and California cases that resolved escheat and taxation issues, the applicable rule is that debts are owned by the creditors and are, thus, located wherever the creditors are domiciled.[152] The trustees also rely on the territorial limitations of Section 1240.050 to further support their position that the mortgage loans have an extra-territorial location.

No case has ruled on where a residential mortgage loan is located for the purpose of determining whether a public entity's exercise of eminent domain power seeks to take extra-territorial property. It is unclear how a California court would rule. The City and MRP rely on the California Supreme Court's factors in *Oakland Raiders I* to posit that the location of intangible property, such as mortgage loans, is within the territorial limits of the condemnor.[153]

Significantly, the California Supreme Court's opinion in *Oakland Raiders I* did not decide the question of the location of the partnership ownership interest in a National Football League franchise team targeted for condemnation. The court identified the City of Oakland as the principal

§§ 1245.220, 1240.040 (West 2015) ("A public entity may not commence an eminent domain proceeding until its governing body has adopted a resolution of necessity that meets the requirements of this article."). For the requisite information of a resolution of necessity, *see* CAL. CIV. PROC. CODE § 1240.030 (West 2015).

149. *See supra* note 29 and accompanying text.

150. Def.'s Opp'n to Pl.'s Mot. for Prelim. Inj., *supra* note 34, at 17–19.

151. 32 Cal. 3d 60 (previously published at 31 Cal. 3d 656) (1982) ("*Oakland Raiders I*").

152. Pls' Mot. for Prelim. Inj., *supra* note 38, at 6–7.

153. Def.'s Opp'n to Pl.'s Mot. for Prelim. Inj., *supra* note 34, at 18–19.

place of business of the partnership, the location of the team's home games, and the location of the team's tangible personal property.[154] The court then stated:

We readily acknowledge that there may be similar or additional factors which would be relevant in determining the appropriate scope of a city's power of condemnation. In fairness, that power must have reasonable limitations. Prima facie, however, *such territorial restrictions seem to be satisfied, although we most certainly do not preclude a trial court, on an appropriate factual record, from concluding otherwise.*[155]

The court remanded to the trial court because it "[did] not decide whether City has a meritorious condemnation claim in this case. City's ability to prove a valid public use for its proposed action remains untested."[156] The court added that Oakland should have the opportunity to prove its case according to the "established legal principles" and the trial court could render a different conclusion on an adequate record.[157] Interestingly, Chief Justice Byrd concurred in the conclusion but strongly dissented:

The power of eminent domain claimed by the City in this case is not only novel but virtually without limit. This is troubling because the potential for abuse of such a great power is boundless. Although I am forced by the current state of the law to agree with the result reached by the majority, *I have not signed their opinion because it endorses this unprecedented application of eminent domain law without even pausing to consider the ultimate consequences of their expansive decision. It should be noted that research both by the parties and by this court has failed to disclose a single case in which the legal propositions relied on here have been combined to reach a result such as that adopted by the majority.*[158]

Chief Justice Byrd had serious concerns about the majority's declaration that "established legal principles" actually were to be applied without precedent for the condemnation of a going concern. Eventually, an appellate court reversed the trial court when it held that Section 1240.050 did not apply to intangible property (as the California Supreme Court had stated) and that the Raiders had not rebutted Oakland's prima facie showing that the partnership interest was located in Oakland.[159] This

154. *Oakland Raiders I*, 32 Cal. 3d at 74 (previously published at 31 Cal. 3d at 682).

155. *Oakland Raiders I*, 32 Cal. 3d at 74–75 (emphasis added).

156. *Id.* at 76. The Court reversed the trial court's order that had granted the Raiders' motion for summary judgment.

157. *Id.* at 75, 76.

158. *Id.* at 76–77 (Byrd. C.J., concurring-in-part and dissenting-in-part) (emphasis added).

159. Oakland v. Superior Court, 197 Cal. Rptr. 729, 732 (Cal. Ct. App. 1983).

appellate court's holding was consistent with but did not elaborate on the California Supreme Court's discussion of the factors regarding the location of the partnership interest. The scant facts about the partnership location suggest that both the California Supreme Court and the court in *City of Oakland* concentrated on whether the partnership interest was geographically fixed in Oakland city limits, which takes on a minimum contacts form of analysis.[160] Ultimately, the City of Oakland was not able to condemn the partnership interest because it violated the federal Commerce Clause.[161]

Notably, neither the California Supreme Court in *Oakland Raiders I* nor the *City of Oakland* appellate court explained why Section 1240.050 did not apply to intangible property, though the California Supreme Court did state that intangible property does not have a "permanent situs."[162] Curiously, this suggests that any provision within California's eminent domain law that does not specifically refer to "personal property," "intangible property," or "any property" could not provide authority for a local municipality's condemnation of any species of intangible property. For example, in California Code of Civil Procedure Section 1230.030,[163] the discretion to condemn "property" that is granted would be limited only to real property. To add to the confusion created by the interpretation of Section 1240.050, the California Supreme Court in *Oakland Raiders I* cited Section 1235.170, which provides the definition of property: "'Property' includes real and personal property and any interest therein."[164] Personal property is commonly understood to include intangible and tangible property. In addition, the California Supreme Court opinion in *Harden*

160. *See supra* note 29 and accompanying text. In *Mayor of Baltimore* v. *Baltimore Football Club, Inc.*, 624 F. Supp. 278, 284–85 (1986), Baltimore argued that the Colts football team had "sufficient contacts with the state of Maryland" and that since the "Court [could] assert jurisdiction over the team, the City therefore has power to condemn the club." The Baltimore Colts court rejected the City's argument, and turned to the factors that guided the California Supreme Court in the *Oakland Raiders I* case. The Baltimore Colts court noted that the City of Oakland had started its eminent domain action before the Raiders left for Los Angeles, and found that the Colts had abandoned Maryland, had removed its personal property from Maryland, and had informed the NFL of a possible move of its home games which went without response by the NFL.

161. Oakland v. Oakland Raiders, 220 Cal. Rptr. 153, 158 (Cal. Ct. App. 1985) ("*Oakland Raiders II*").

162. *Oakland Raiders I*, 32 Cal. 3d at 74.

163. CAL. CIV. PROC. CODE § 1230.030 (West 2015) ("Nothing in this title requires that the power of eminent domain be exercised to acquire property necessary for public use. Whether property necessary for public use is to be acquired by purchase or other means or by eminent domain is a decision left to the discretion of the person authorized to acquire the property."). *See supra* note 113 and accompanying text.

164. *Oakland Raiders I*, 32 Cal. 3d at 65.

calls for strict construction of provisions in the state's eminent domain law.[165] Under a *Harden* strict construction, the term "property" found in Section 1240.050 ought to include intangible personal property. The muddle created by the Supreme Court in *Oakland Raiders I* contrasts greatly with the methodical and consistent approach taken by the appellate court in *Mebane*.[166] Moreover, the *Oakland Raiders I* case may have involved intangible personal property in the form of a partnership ownership in a NFL franchise, but the lack of clarity on the definition of property and the decision not to apply Section 1240.050 in *Oakland Raiders I* makes the analysis of the *Mebane* opinion the appropriate analytical framework for the extra-territorial location of targeted property issue raised by the City of Richmond's decision to condemn mortgage loans.

The *Oakland Raiders I* and *II* cases present a problem for the City. The secondary mortgage market is an interstate industry, touching investors from all over the country. The secondary mortgage market, particularly the buying and selling of mortgage-backed securities, is subject to federal securities and tax law. The Richmond condemnation plan is thus vulnerable to a challenge based on the Commerce Clause of the U.S. Constitution.

A second problem for the City of Richmond is raised by the *Oakland Raiders I* case because the factors to determine the location of targeted intangible property do not seem applicable to residential mortgage loans. The factors of principal place of business, "home games," and the situs of tangible personal property indicate the necessity of sufficient contacts within the condemnor's territorial boundaries. By way of analogy to the so-called totality-of-the-circumstances analysis, the City and MRP recast the court's factors into six,[167] five of which primarily focus on residential lenders' remedies for defaults of residential mortgage loans in actions that are tied to the collateral real properties in Richmond. This appears to have

165. Harden v. Superior Court, 284 P.2d 9, 17 (Cal. 1955); *see supra* notes 116 and 120 and accompanying text.

166. Kenneth Mebane Ranches v. Superior Court, 12 Cal.Rptr. 2d 562 (Cal. Ct. App. 1992); *see supra* notes 128 *et seq.*, and accompanying text.

167. Def.'s Opp'n to Pl.'s Mot. for Prelim. Inj., *supra* note 34, at 18–19 (The City and MRP took the factors from the California Supreme Court's opinion in *Oakland Raiders I*, 32 Cal.3d at 74-75 (1982), and recast the factors as follows: "In particular: (1) the debtor is domiciled in the same location as the security (i.e. the home); (2) the loans are secured by real property with a physical location, and the security interest would be condemned with the loan; (3) the security interests are recorded where the property is located; (4) the creditor's remedies are based on the location of the real property; (5) the basis for the public purpose for which the loans would be condemned is assisting residents in the condemnor's jurisdiction; and (6) the information necessary to value the loans concerns the debtor and the security property, not the creditor").

been done in order to obviate the territorial limitation problem. The connection between remedies and land in Richmond is distinguishable from the California Supreme Court's factors that directly relate to essential characteristics of ownership in a partnership entity with direct, physical contacts in the City of Oakland. The place of business, the place of performing the entertainment, and the place of tangible property were all in Oakland. As a matter of critical distinction, the key attributes of the mortgage loan debts are the promissory notes possessed outside of Richmond, the legal and beneficial ownership of said debts that are outside of Richmond, and the borrowers' place of performance, i.e., the place of payment to the lender (or loan servicer or the trustees) at a location most likely outside of Richmond. The security lien on the land follows the debt, which is located at the domicile of the creditor, according to authority cited by the trustees.[168]

Though it is not surprising that the City seeks to pin the factors to land inside its boundaries, it ignores the fact that loan agreements are more than remedies. Remedies are but one set of choices made available to lenders in a much broader set of terms in private contracts in which the parties accept a division of rights and duties. Loans give lenders substantive contractual rights, including the right to sue a borrower personally for the intentional waste of collateral property though he is located elsewhere, or to designate the borrower's place of performance (i.e., the place of payment), which could very well be outside of California.[169] Even if these latter types of lawsuits are few, the City's particular emphasis on remedies actually forces a restricted view of the loan agreement and thus should not be dispositive in the determination of the location of the loans.

A sixth factor that the City considers relevant in determining the location of the loans is the public purpose of helping persons within the condemnor's territorial jurisdiction. This adds nothing new to the analysis since the federal and state constitutions require a public use, and state

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168. Pls' Motion for Prelim. Inj., *supra* note 38, at 6–7; *see* CAL. CIV. CODE § 2936 (West 2015). In their opposition, Richmond and MRP partly rely on cases that involved the forfeiture of assets under federal law during the extreme circumstances of war, including a federal law that called for the forfeiture of assets, including credit, held by Confederate enemies during the Civil War. Def.'s Opp'n to Pl.'s Mot. for Prelim. Inj., *supra* note 34, at 19. Forfeiture of enemy assets during times of war is too extraordinary to be an appropriate precedent for the well-established interstate secondary mortgage market during a time of peace.

169. For instance, a lender may decide to sue a borrower who has moved outside of Richmond on the promissory note or for intentional waste of the real property, both of which in certain circumstances can be exceptions to the anti-deficiency protection that borrowers have under California law. For the intentional waste exception, *see generally* Cornelison v. Kornbluth, 542 P.2d 981, 990–93 (Cal. 1975); Nippon Credit Bank v. 1333 North Cal. Blvd., 103 Cal. Rptr. 2d 421 (Cal. Ct. App, 2001).

statutes require a taking to be tied to the public entity's purposes. Every public entity will make statements that its project and related condemnation of property outside its district will be for the purpose of assisting citizens who reside within the district; this is the constant refrain of public officials. A great risk exists that these types of self-serving statements will be readily accepted as proof that the extra-territorial taking satisfies the public purpose no matter how tenuous the linkage between the property and the circumstances that create the necessity for the property to be taken to achieve the purpose. As it is now, it is very tenuous whether the circumstances in Richmond create the need to condemn 624 residential mortgage loans, even if located inside Richmond, in order to accomplish a public use. If self-serving statements are accepted as a criterion and taken at face value, then the requirements for the resolution of necessity are made superfluous.[170] Therefore, such self-serving statements should not be a factor in the determination of the location of the targeted property.

Meanwhile, the more persuasive parallel is that of the government's tax claims against creditors with assets such as loans because only government is given the authority to assert the taxing power, and only under limited circumstances.[171] Because the power of eminent domain is uniquely given to government, the power to condemn is more akin to the power to tax than it is to the attributes of remedies available to private residential mortgage lenders.[172]

Therefore, California courts ought to consider the location of residential mortgage loans to be the domicile of the lenders, which would require the local municipality to meet the higher standard of showing that there is a legal necessity for its extra-territorial taking, as well as satisfy all other

170. CAL. CIV. PROC. CODE §§ 1245.220, 1240.040 (West 2015) ("A public entity may not commence an eminent domain proceeding until its governing body has adopted a resolution of necessity that meets the requirements of this article."). For the requisite information of a resolution of necessity, *see* CAL. CIV. PROC. CODE § 1240.030 (West 2015). *See supra* note 137 and accompanying text. For the type of presumption created by a resolution of necessity, *see* CAL. CIV. PROC. CODE §§ 1245.250 (a), (c) (West 2015). *See infra* notes 174, *et seq.* and accompanying text.

171. One commentator argues that the appropriate rule for the location of mortgage loans that are targeted for condemnation is based on government's authority to tax. *See* Moskowitz, *supra* note 24, at 655–56, 665.

172. In an early California Supreme Court case the distinctions between the powers of taxation and eminent domain were discussed in a dispute where, under the taxing power, assessments were upheld when imposed on street frontage property owners for street improvements. The Court stated: "Indeed, taxation itself, in its ordinary sense, is, perhaps, not the exercise of a distinct, independent sovereign power, but only one form of exercising the right of eminent domain. Yet the terms, the right of taxation, and the right of eminent domain are ordinarily used to express different specific ideas, although both are, doubtless, grounded in the same ultimate sovereign power." Emery v. S.F. Gas Co., 28 Cal. 345, 360 (1865).

requirements imposed on governments that wish to take property from persons to whom they are not accountable.

(i) Resolution of Necessity and Presumptions

It is through the resolution of necessity that local legislatures declare the facts that exist in their jurisdiction that they consider to make it legally necessary to exercise the power of eminent domain against extra-territorial property. If the legislature is unable, the owner of the property may challenge the taking, and may be granted a writ of prohibition to stop a trial court from its attempt to exercise jurisdiction over the proceeding.[173] It is thus appropriate to review the *Mebane* opinion regarding the resolution of necessity.

When there is an attempt to condemn extra-territorial property, the local municipality loses the conclusive presumption it is afforded by the enactment of a resolution of necessity.[174] California Code of Civil Procedure Section 1245.250(a) establishes that the factual circumstances stated in the resolution of necessity are conclusively presumed true when the targeted property is within the locality's territorial limits. On the other hand, if the property is outside city limits the locality's resolution of necessity "merely creates a presumption" under Section 1245.250 (c) that the facts stated therein are true.[175] This change in presumption was another reason, according to the court in *Mebane*, to require the flood district to meet the higher standard of legal necessity when it sought to condemn the targeted extra-territorial property.[176] The *Mebane* court adopted prior case law when it concluded:

Accordingly, we hold that the determination of whether a local public agency's power of extraterritorial condemnation is "necessarily implied as an incident of one of its other enumerated powers" involves a determination of "legal necessity," which has been defined by the courts as a matter of "urgency of extreme expediency or necessity," or "manifestly desirable" or "essential to the declared objects" of the entity [citations omitted], or otherwise indicated by "clear implication" [citation omitted].[177]

The stringent legal necessity standard and the elimination of the conclusive presumption are appropriate, for they serve as a check against excessive local government power.

173. Harden v. Superior Court, 284 P.2d 9, 17 (Cal. 1955).

174. Kenneth Mebane Ranches v. Superior Court., 12 Cal.Rptr. 2d 562, 568–69 (Cal Ct. App. 1992).

175. *Id.*

176. *Id.*

177. *Id.* at 570.

(ii) Necessity and Considerations of Economy

Matters of economic efficiency can bear on whether a condemning agency is able to establish the legal necessity to condemn extra-territorial property. A condemning agency may take into account considerations of economy as it evaluates its project and the need to condemn property.[178] In *Sacramento Municipal Utilities Distribution v. Pacific G&E Co.*, the court acknowledged with approval a public utility's consideration of economy for a project where it sought the condemnation of property outside the district's limits in part because it was more efficient to jointly use another entity's utility poles.[179] That court reasoned:

> There is substantial evidence to sustain a determination that retention of the facilities in that area is necessary or convenient for service to the inhabitants of the district. While the making of a financial profit alone may not authorize a taking, as cases cited by appellant indicate, it does not follow that considerations of economy and the prevention of excessive expenditures may not be taken into account in determining necessity or convenience.[180]

In contrast, the flood district in *Mebane* was not concerned with efficiency when it sought to condemn land outside its district for environmental mitigation purposes. Nor has the City of Richmond taken into consideration matters of economic efficiency in its plan to condemn residential mortgage loans. Instead, Richmond is concerned with underwater mortgages that purportedly will lead to an increase in defaults, foreclosures, and blight.[181] Based on the improvement of economic conditions within the City,[182] it appears the City's greater motivation would become profitability if it actually moves forward with its plan. But, profitability alone cannot justify the taking of residential mortgage loans.

(iii) Necessity and Blight

Blight can justify the taking of property, though there does not appear to be a statute or a case in California that authorizes the taking of extra-territorial property for the purpose of eliminating blight. Notwithstanding the apparent lack of legal authority and the awareness that the residential mortgage loans are held by trusts located outside city limits, City of Richmond councilpersons rested the justification of mortgage loan takings on the threat of blight. In Resolution No. 120-13, they stated:

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178. Sacramento Mun. Util. Dist. v. Pac. G. & E. Co., 165 P.2d 741, 750 (Cal. Dist. Ct. App. 1946).

179. *Id.* at 750–751.

180. *Id.* at 750.

181. *See infra* note 183 and accompanying text.

182. *See supra* notes 42, 43, and 44 and accompanying text.

[¶] **WHEREAS,** home values in Richmond plummeted after the crash and still have a long way to go to recover, with large numbers of Richmond homeowners having "underwater loans" or "negative equity"—where the outstanding principal balance on the home loan exceeds the market value of the house—which *increases the likelihood of further foreclosures, inhibits the ability to refinance, and dampens consumer confidence and economic activity*; and

[¶] **WHEREAS,** in recognition of the severity of this crisis the City of Richmond ("Richmond") has already begun working to develop the Richmond CARES (Community Acton to Restore Equity & Stability) program in order to help address this crisis; *Richmond CARES being a program that seeks to reduce foreclosures and blight* by helping more homeowners get into affordable sustainable mortgages; . . . .[183]

As discussed above,[184] the conditions in Richmond are evidently improving and the City is not in a crisis. There is, however, a difference of opinion within the Richmond City Council and the majority that passed the initial resolution may, in fact, proceed with its plan to condemn mortgage loans. In that event, the City Council must comply with California law relevant to the reduction or elimination of blight.

California law typically addresses the elimination of blight through a local municipality's redevelopment plan.[185] Local regulations that seek to remove blight are upheld by California courts,[186] which look for the regulation to include a redevelopment plan that will invalidate the regulation if enacted without sufficient evidence that blight exists in the

183. Res. No. 120-13, Richmond City Council ¶ 3-4 (Cal. 2013), *available at* http://www.alicelaw.org/uploads/asset/asset_file/1955/2013_Richmond_Resolution_120.pdf, (emphasis added).

184. *See supra* notes 42, 43, and 44 and accompanying text.

185. In 2012 California law regarding funding for local municipality's redevelopment agencies changed. In response, the California legislature enacted new legislation, effective January 1, 2014, that empowered local agencies (defined as cities, counties, city and county, and housing authorities) to undertake remediation measures on blighted property (defined as property that is contaminated by the release of hazardous materials) within a blighted area. *Cf.* CAL. HEALTH & SAFETY CODE §§ 25403-25403.8 (West 2014). *See generally* Michael M. Sandez, *Nature Abhors A Vacuum And So Do Local Governments: But Vacant Property Ordinances Go Too Far,* 10 J.L. ECON & POL'Y 345, 365–70, n. 114 (2014) (discussing California legal requirements for the elimination of blight by redevelopment agencies in the context of a local vacant property ordinance that by legislative fiat modified underlying residential mortgage loans secured by real property within the city so that lenders rather than borrowers were obligated to maintain and keep secure homes where lenders had initiated nonjudicial foreclosures because the borrowers had defaulted on their loans and vacated their homes).

186. E. Bay Mun. Util. Dist. v. Richmond Redevelopment Agency, 155 Cal. Rptr. 636, 642–43 (Cal Ct. App. 1979) (holding the City properly exercised its police power in removing urban blight).

area of the proposed project.[187] Such evidence is measured by the statutory definitions of blight. Blight involves physical and economic conditions[188] that are so prevalent and substantial that "a serious physical and economic burden on the community"[189] is created. If the administrative record is deficient with regard to substantial evidence of blight, the regulation will be invalidated.[190] These requirements ensure that the regulation is promulgated pursuant to a municipality's "legitimate governmental function."[191]

The City of Richmond faces a stiff challenge should it choose to move forward with a resolution of necessity. Though it is possible that some of the residential loans the City wants to condemn are within its boundaries, the probability is that they are beyond city limits.[192] As such, the City will not have a conclusive presumption that the statements in its resolution of necessity are true, imposing on it the burden of passing a resolution of necessity with substantial empirical data that indeed confirms that the underwater mortgages, defaults, and foreclosures result in blight, which severely impacts the City's economic standing. Recent statements by Richmond officials say otherwise, however.[193] Given the state of the City, Richmond officials are unlikely to satisfy the urgency that is required by the higher standard of legal necessity or prove that blight exists.

b. Policies Protective of Representative Government

As a second element derived from the *Mebane* case, policy reasons

187. *See, e.g.*, Boelts v. Lake Forest, 25 Cal. Rptr. 3d 164, 178–79 (Cal. Ct. App. 2005) (holding the city's assertions were conclusory and failed to meet the definition of blight; city unsuccessfully argued there was blight because, among other reasons, a shopping center had antiquated design, 23 commercial vacancies, and signs of deterioration and deferred maintenance; the court pointed out that the city failed to show a connection between the project and health and safety problems, structural defects, or depreciation of property values); Friends of Mammoth v. Mammoth Lakes Redevelopment Agency, 98 Cal. Rptr. 2d 334, 359, 365 (Cal. Ct. App. 2000) (insufficient evidence to support the project even though 29% of buildings affected by deterioration and dilapidation); L.A. v. Glendora Redevelopment Project, 111 Cal. Rptr. 3d 104, 116–117 (Cal. Ct. App. 2010) (explaining the criteria that must be found for there to be a finding of blight).

188. CAL. HEALTH & SAFETY CODE § 33030(b)(2), § 33031(a) [physical conditions] and (b) [economic conditions] (West 2011).

189. CAL. HEALTH & SAFETY CODE § 33030 (b)(1) (West 2011).

190. Beach-Courchesne v. Diamond Bar, 155 Cal. Rptr. 2d 265, 268, 274 (Cal. App. Ct. 2000).

191. E. Bay Mun. Util. Dist. v. Richmond Redevelopment Agency, 155 Cal. Rptr. at 642.

192. Moskowitz, *supra* note 24, at 665, nn. 217–218.

193. *See supra*, notes 42, 43, and 44 and accompanying text; Eagle, *supra* note 49, at 833.

further support the "significant limitation [of a mere presumption created by Section 1245.250(c)] on an entity's exercise of extra territorial condemnation."[194] An owner of targeted property that is located outside the local entity's territorial limits is not a citizen who can, through his vote hold officials of the condemnor (or the local legislative body) accountable and is not a local citizen or taxpayer who has the full knowledge to adequately assess the public use project contemplated by the condemning agency.[195] The *Mebane* court put it this way: "But where the property sought to be taken is outside and distant from these territorial limits, neither such knowledge [helpful to the agency officials, citizens, and taxpayers] nor such accountability [of the legislative body and its functionaries] may be present."[196] Though it would be a fair assumption that the owners of the targeted extra-territorial property and their neighbors would prefer environmentally safe land, the court in *Mebane* was correctly concerned with the use of excessive power by local flood district officials who could take advantage of the affected property owners. Where the eminent domain law did not supply express or legally necessary implied authority, the *Mebane* court did not grant it either.

For the City of Richmond, the risk of minimizing or ignoring the policy concern regarding political representation exists. It must be kept in mind that although the trustees in the recent litigation are major banks and probably have branches within Richmond city limits, the banks filed their claims in their capacity as trustees and on behalf of trusts located outside of Richmond. The trusts are made up of investors from all over the country that include "various labor unions, credit unions, retirement pension funds and individuals."[197] To help some people in the City, councilmembers want to ignore the people who invest in it through labor unions, credit unions, and retirement pension funds.

Checks and balances, when used within a properly functioning constitutional republic, are effective antidotes to excessive power. Whether the municipality's concern relates to foreclosures and blight, or to

194. Kenneth Mebane Ranches v. Superior Court, 12 Cal.Rptr. 2d 562, 569 (Cal. Ct. App. 1992).

195. *Id.*

196. *Id.* (citing L.A. v. Keck, 14 Cal.App.3d 920, 925, 926 (1971)) ("But where the property sought to be taken is outside and distant from these territorial limits, neither such knowledge nor such accountability may be present. Thus, the Legislature has specifically provided that the courts shall pass upon such a taking [citation omitted]. [W]e hold that neither the resolution of the board of a public utility district or the ordinance of the legislative body of a city is prima facie evidence of necessity under Code of Civil Procedure section 1241, subdivision 2, where the property is outside the condemning agency's territorial limits." [Section 1241 repealed; subd. 2 replaced by CAL. CIV. PROC. CODE §§ 1240.030, 1240.040, 1245.210 *et seq.*]).

197. *See supra* note 43 and accompanying text.

economic revitalization, the condemnation of extra-territorial property pursuant to an unclear implied power is tantamount to a de facto disenfranchisement of owners of such extra-territorial property. Officials who are wont to exercise power, regardless of whether the law permits it or the data supports it will weaken principles relative to lawful jurisdiction and constitutional representation. Because trust in government is quite low, it is detrimental for local government to reach for property that may be located anywhere in the world[198] and whose owners have no voice, no vote, and no representation.

c. *Extension of Implied Authority to Condemn Extra-Territorial Property that is Incidental to a Statutory Mandate*

The third element requires a showing that a statute that grants a municipality the express power to take property will also enable an implied power to condemn extra-territorial property if the extra-territorial taking is incidental to the statute's mandates. Section 1240.050 provides an alternative source of authority where "[the power is] necessarily implied as an incident of one of its other statutory powers." There are few cases that have held that the implied power to condemn property outside a public agency's boundaries is valid. The *Mebane* court noted a case in which a city that had the express power to construct sewers also had the power to "extend them beyond its boundaries to an outfall as an *implied incident* of its express powers when necessary or manifestly desirable."[199] Also, it noted another case that held that where a city was authorized by statute to condemn water systems inside its boundaries, condemn wells and water on adjacent lands, and provide water services inside and outside its boundaries, the city also had the implied [] power [to take a water system outside its boundaries] as *incidental* to the existence of the powers expressly granted.[200] Land for a sewerage outfall and water systems for the delivery of water services were within the implied authority of condemnation because they were incidental to and accompanied the respective statutory mandates in providing essential infrastructure needs.

In *Mebane*, the issue became whether the mitigation of environmental conditions on extra-territorial land was incidental to the flood district's express regulatory mandate to construct, maintain, or operate all works or improvements inside or outside the district for the purposes of flood control and water conservation. The *Mebane* court was consistent when it

198. Moskowitz, *supra* note 24, at 656.

199. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 562 (citing *Harden*, 44 Cal.2d at 638–39) (emphasis added).

200. *Id.* at 562–63 (citing City of N. Sacramento v. Citizens Utilities Co., 192 Cal.App.2d 482, 485 (1961)) (emphasis added).

followed the analogy of the water system condemnation case (i.e., *City of N. Sacramento v. Citizens Utilities Co.*) to find the flood district's implied power to condemn property outside its district on the ground that it would be incidental to the district's express statutory purposes of flood control and water conservation.[201] The analogic reasoning led to the next question: whether environmental mitigation was "legally necessary" to achieve the flood district's statutory purposes. Because the California statutory environmental scheme only required mitigation when feasible and did not grant additional powers to local agencies, the *Mebane* court held that it could not extend an implied power to condemn the extra-territorial land for mitigation purposes as incident to the flood district's statutory purposes of flood control and water conservation.[202] Consequently, the court issued a writ of prohibition that ordered the trial court to sustain the demurrer with leave to amend.[203]

The City of Richmond has neither an express statutory purpose, nor express constitutional authority, to engage in residential mortgage loan restructuring. As a consequence, it cannot claim that there is an implied power to condemn mortgage loans outside its city limits incidental to some express mandate. Authority to condemn property within its boundaries for the elimination of blight or economic redevelopment may exist, but such authority, to the extent it exists, does not imply the power to condemn intangible property such as mortgage loans outside its city limits.

IV. CHALLENGES FOR THE CITY OF RICHMOND

Notwithstanding the number of favorable articles in support of the plan to condemn residential mortgages, the City has a number of challenges ahead of it if and when it decides to implement the plan. This Article examines the threshold question of the location of the mortgages and the appropriate legal standard for the condemnation of extra-territorial property and the resolution of necessity. The underlying policies that appear to motivate the City are considered as well.

201. *Id.* at 563.

202. *Id.* at 564–65. The California statutory environmental scheme is known as the California Environmental Quality Act, CAL. PUB. RESOURCES CODE, §§ 21000 *et seq* (West 2015).

203. *Kenneth Mebane Ranches*, 12 Cal. Rptr. 2d at 565–66. The Court granted the flood district leave to amend its complaint because the district contended that in an amended complaint it could allege a cause of action for eminent domain because it was required to conduct environmental mitigation as a condition for approval of its project by the relevant public agencies. The *Mebane* Court did not address this flood district's contention or the adequacy of such an allegation in an amended complaint.

A. The Threshold Question

The threshold question involves the determination of the location of the residential mortgage loans. The case law that lays out the more persuasive reasoning is that which bases the location of intangible property on where the governmental entity asserts its taxing power against a creditor's assets, including loans. The domicile of the creditor is the location of the loan. The power of eminent domain, like the taxing power, is immense and is given exclusively to the government (or its various agencies). The implied power to condemn property approximates the enumerated power of the government to tax its citizens. In contrast, the City seeks the application of a set of factors that are not analogous to governmental authority but instead focus on a geographic-centric view of lenders' remedies for defaults of residential mortgages. If a court in a case of first impression rules that residential mortgage loans are located in the domicile of the lenders, then the City must demonstrate that there is a "legal necessity" to condemn extra-territorial mortgage loans.

B. The Standard of Legal Necessity

According to the *Mebane* court, Richmond would be required to meet the higher standard of a "legal necessity" if it pursues its plan since it seeks to take property that is located outside city limits. California law prior to *Mebane* enunciated a variety of formulations that the *Mebane* court described as "legal necessity." A local municipality must show that the extra-territorial taking is an "urgency of extreme expediency or necessity," is "manifestly desirable," is "essential to the declared objects" of the entity, or is "indicated by clear implication." The facts in Richmond might indicate the effects of an economic downturn, but it does not necessarily follow that blight actually exists or that there is a "legal necessity" to take property located outside its boundaries. Due to the lack of express statutory authority to take property outside its limits, the City will not be able to claim that the taking is "indicated by clear implication" let alone an "urgency of extreme expediency or necessity."

C. Resolution of Necessity and Presumptions

The Richmond City Council must enact a resolution of necessity. If in fact a court rules that the mortgage loans are outside of Richmond, the City Council's resolution of necessity will be given a rebuttable presumption that the statements therein are true. However, there are evident signs of economic improvement in Richmond, which undermine its past claim that there is a serious threat of defaults, foreclosures, and blight. The trustees of the mortgage-backed securitized trusts would likely be in a position to rebut the statements in the City's resolution of necessity because the underlying circumstances in Richmond do not create a legal necessity.

D. Policy

The California legislature has an implicit, if not an explicit, concern for owners of property that are located outside the territorial jurisdiction of the condemning agency. This is indicated by the distinction in Section 1240.050 between property inside and outside an agency's boundaries. Also, the legislature created a difference between conclusive and rebuttable presumptions given to a resolution of necessity, depending on the location of the property. The concern rightly focuses on the property owner as a citizen and taxpayer, and appropriately places limits on the power to condemn property beyond territorial limits. The policy to protect representative government requires the condemnor to act only pursuant to express statutory mandates and to make a greater showing of need before it can take property from those without a vote or representation. The City must recognize that its paternalistic desire to provide assistance to those within its city limits will adversely affect those people who invest in trusts located outside of its city limits.

There are broader policy implications at work. The U.S. Supreme Court has spoken of government's longstanding function of *promoting* economic development.[204] But promoting economic development should not mean participating in it. Government repeatedly has proven itself to be grossly inefficient, unsurprisingly incompetent in all but a few tasks such as law enforcement and military (which themselves are incompetent at times), and unjustly prone to cronyism. A significant majority of elected, appointed, and bureaucratic officials take every opportunity to create a bigger, more paternalistic government, regardless of the cost and debt accumulation. It is often said by such officials that for those who have much, much is required,[205] as justification to take money and property from those who have it in order to redistribute to those who do not have it.[206] Politicians and others who use this biblical reference completely ignore the biblical admonitions regarding stewardship,[207] prudence,[208] and diligence.[209] Those

204. *See supra* note 14 and accompanying reference to Berman v. Parker, 348 U.S. 26 (1954).

205. *Luke* 12:48 ("Everyone to whom much was given, of him much will be required, and from him to whom they entrusted much, they will demand the more.").

206. "Man can live and satisfy his wants only by ceaseless labor; by the ceaseless application of his faculties to natural resources. This process is the origin of property. But it is also true that a man may live and satisfy his wants by seizing and consuming the products of the labor of others. *This process is the origin of plunder.*" *See* FREDERIC BASTIAT, THE LAW, 10 (Dean Russell, trans., The Found. for Econ. Educ., Inc. 1993) (1850)) (emphasis added).

207. *Proverbs* 27:23-27.

officials who press for greater government expansion and more redistribution have yet to understand that reliance on the civil magistrate for one's sustenance is not a biblical model,[210] but instead is a paternalism that is a form of idolatry.[211] They also strive to grow government through economic means that are contrary to the biblical principle that the debtor is the servant of the lender.[212] Printing money by fiat will not solve the debt problem; nor will it win the war on poverty, as the past fifty years has proven. It is no secret that federal, state, and local governments are overwhelmed by their debt service, which, in turn, imposes greater and greater burdens on taxpayers. To take a phrase used in another context, government's promotion of economic development is not an economic suicide pact, yet that is the road on which we have been put by officials who make short-sighted decisions based on their job retention or a belief that governmental paternalism serves the public good. An overwhelming amount of economic evidence demonstrates that the many forms of wealth redistribution and subsidy programs concocted by the government are ruining the country's economic health.

The financial crisis of 2008 had far-reaching effects, and governments—federal, state, and local—have sought to provide remedies through the promulgation of more regulation and bureaucracy. What government has not done is eliminate the governmental policies and programs that helped create the crisis in the first place.[213]

E. Implied Power Incidental to Statutory Purpose

According to the analysis by the court in *Mebane*, the City of Richmond

208. *Proverbs* 22:3 ("The prudent sees danger and hides himself, but the simple go on and suffer for it."); *Proverbs* 10:5 ("He who gathers in summer is a prudent son, but he who sleeps in harvest is a son who brings shame.").

209. *Proverbs* 21:5 ("The plans of the diligent lead surely to abundance, but everyone who is hasty comes only to poverty."); *Proverbs* 10:4 ("A slack hand causes poverty, but the hand of the diligent makes rich.").

210. *Proverbs* 27:23-24 ("Be sure you know the condition of your flocks, give careful attention to your herds; for riches do not endure forever, and *a crown is not secure for all generations*.") (italics added); *Psalms* 118:9 ("It is better to take refuge in the LORD than to trust in man. It is better to take refuge in the LORD than to trust in princes."); *Psalms* 146:3-4 ("Put not your trust in princes, in a son of man, in whom there is no salvation. When his breath departs, he returns to the earth; on that very day his plans perish.").

211. HERBERT SCHLOSSBERG, IDOLS FOR DESTRUCTION 177–231 (Crossway Books 1993).

212. *Proverbs* 22:7b ("[T]he borrower is the slave of the lender.").

213. *See* GRETCHEN MORGENSON & JOSHUA ROSNER, RECKLESS ENDANGERMENT: HOW OUTSIZED AMBITION, GREEN, AND CORRUPTION LED TO ECONOMIC ARMAGEDDON (Times Books, Henry Holt and Company, LLC, 2011); THOMAS SOWELL, THE HOUSING BOOM AND BUST (Basic Books rev. ed. 2010).

will need to first show that it has express authority to condemn intangible property outside its jurisdiction, and if it can do that, it must then show that it has an implied power to condemn mortgage loans as incidental to the cited statutory purpose. As of this writing, there does not appear to be any authority, constitutional or statutory, that enables a local municipality to condemn intangible property, like residential mortgage loans, for the sake of the elimination of blight or economic revitalization. Without express authority, it will not have an implied power to condemn such property. Thus, the City cannot claim that its plan to condemn residential mortgage loans is incidental to a statutory mandate.

CONCLUSION

The open legal question as to whether local government can force itself into the secondary mortgage market through the exercise of its eminent domain powers to condemn residential mortgage loans must be answered in the negative. California courts must prohibit local public entities from the exercise of eminent domain power in this way. Local government does not have the expertise or the resources to engage in such activity. Reliance on third parties for the expertise and capital to pay just compensation for the loans only confirms that the local municipality is beyond its function and purpose. Moreover, participation in the secondary mortgage market takes local government away from the core purposes of protecting life and property.[214]

An exercise of eminent domain powers to condemn residential mortgage loans attempts to fix the consequences of a financial problem that was, to a great extent, created by the government. Assertion of government power in this fashion when market forces already are at work would be a colossal error. Condemnation of residential mortgage loans is unprecedented; it ignores the limits imposed on local municipalities by the constitution, statutes, and case law; it injects an incompetent actor into the secondary mortgage market; and it attempts a fix when there is an insufficient need in the locale. The City of Richmond ought to cease and desist.

214. The argument in favor of the mortgage loan condemnation plan is ironic in that it basically seeks to take property from some so that *others* may keep their property. That those from whom property is taken might be able to afford or recover from the losses that would occur under the plan does not lessen the reality that property has been taken from lender A to give (sell) to lender B.

* * *

COMMENTS

A TALE OF TWO CITIES: THE REGULATORY BATTLE TO INCORPORATE SHORT-TERM RESIDENTIAL RENTALS INTO MODERN LAW

DANA PALOMBO*

This Comment examines the home-sharing company, Airbnb, and the issues surrounding its legality. The online platform connects hosts willing to rent out their residences on a short-term basis to paying guests. Airbnb's operations raise legal and regulatory questions in terms of liability, taxes, and zoning, in addition to the issue of its encroachment on the hotel industry. However, Airbnb has contributed to city economies by offering to pay hotel taxes and by launching the Shared City initiative to give back to local communities. This Comment focuses on New York City ("NYC") and San Francisco's treatment of short-term residential rentals. NYC's conservative position is that Airbnb is detrimental to the city and to its hospitality and tourism industries. It contends short-term rentals violate New York state's Multiple Dwelling Act ("MDA") and seeks to rid NYC of them altogether. On the other hand, San Francisco, the birthplace of Airbnb, respects the objectives of the company and seeks to regulate its operations by

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incorporating short-term rentals into San Francisco's Administrative Code, as demonstrated by its recent passage of the short-term rental legislation. Ultimately, San Francisco's liberal approach to regulating short-term rentals, in combination with Airbnb's Shared City initiative, is the ideal catalyst for the future of home-sharing in cities across the United States.

INTRODUCTION

The home-sharing company, Airbnb, is rapidly expanding its empire to cities across the globe.[1] Since its start in 2007, Airbnb has had more than eleven million guests stay at hosts' residences,[2] and is worth about ten billion dollars.[3] Innovative companies like Airbnb are developing the sharing economy by infiltrating the traditional economy.[4] The sharing economy is defined as Internet-based sharing through websites or smartphone applications ("apps").[5] The sharing economy raises legal questions and regulatory issues, and must be navigated delicately so that the public welfare and potential for otherwise unattainable economic success and development is not quashed.[6] The sharing economy has opened many doors, especially for those struggling in this difficult economy, and despite its public approval, it often receives condemnation from state legislators.[7] Many people who are suffering because of the economic downturn are turning to sharing platforms to keep their homes,

1. *See* Ryan Lawler, *Amidst Reports of New Funding, Airbnb Growth Accelerates in Europe*, TECHCRUNCH.COM (Mar. 20, 2014), http://techcrunch.com/2014/03/20/airbnb-big-in-europe/ (reporting Airbnb's increasing popularity, notably in Europe, where over 80% of travelers use Airbnb).

2. *Id.*

3. *See, e.g.*, Alex Konrad & Ryan Mac, *Airbnb Cofounders To Become First Sharing Economy Billionaires As Company Nears $10 Billion Valuation*, FORBES (Mar. 20, 2014 6:39 PM), http://www.forbes.com/sites/alexkonrad/2014/03/20/airbnb-cofounders-are-billionaires/ (noting Airbnb's founders become young billionaires).

4. *See* Molly Cohen & Corey Zehngebot, *Heads Up: What's Old Becomes New: Regulating The Sharing Economy*, 58 BOS. BAR J. 6, 6 (2014) (recognizing that sharing companies encourage efficient operation using non-product assets with conventional products).

5. *See id.* (explaining platforms share, "underutilized space, skills, and stuff for monetary and non-monetary benefits").

6. *See id.* (concluding there are environmental, social, and economic benefits to the sharing economy).

7. *See* Elizabeth A. Harris, *The Airbnb Economy in New York: Lucrative but Often Illegal*, N.Y. TIMES, Nov. 4, 2013, http://www.nytimes.com/2013/11/05/nyregion/the-airbnb-economy-in-new-york-lucrative-but-often-unlawful.html?_r=0 (citing a case where illness and job loss led a host to rely on Airbnb in the difficult economy); *see also* Tomio Geron, *Airbnb and The Unstoppable Rise Of The Share Economy*, FORBES (Jan. 23, 2013 7:00 AM), http://www.forbes.com/sites/tomiogeron/2013/01/23/airbnb-and-the-unstoppable-rise-of-the-share-economy/ (quoting a partner at Google saying, "[t]he sharing economy is a real trend. I don't think this is some small blip").

pay rent, or maintain their livelihood.[8]

Sharing platforms are not limited to the same services as Airbnb. Companies like Uber, Sidecar, and Lyft have profited by revolutionizing transportation.[9] Just like the hotel industry suffers from short-term residential rentals, the taxi industry suffers from the use of personal cars as cabs.[10] Sharing economy pioneers meet legal complications and pushback from traditional industries as their technology and business models evolve.[11]

Apprehensions about accepting the sharing economy are valid since many of these sharing companies fly under the legal and regulatory radar.[12] Airbnb has created regulatory concerns that have sparked legal changes worldwide, but it raises the most pressing legal issues in two prominent American cities: NYC and San Francisco.[13] Airbnb found a backdoor into the hotel industry and crafted regulatory hacks that caused unexpected competition and infuriation among traditional businesses that demanded sharing companies follow customary rules.[14] NYC is threatened by Airbnb and has more stringently enforced the New York State "Illegal Hotel Law," formally known as the MDA.[15] NYC seeks to prevent short-term rentals of residences because these rentals may not only break state laws, but may also violate lease agreements.[16]

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8. *See generally* Harris, *supra* note 7 (noting many New Yorkers use Airbnb for extra income through short-term renting).

9. *See* John G. Browning, *Emerging Technology and Its Impact on Automotive Litigation*, 81 DEF. COUNS. J. 83, 84 (2014) (naming these companies as pioneers of alternative transportation services).

10. *See id.* (stating these companies do not consider themselves transportation carriers).

11. *See id.* (noting the pushback by taxi unions and issues with the speed of technological innovation).

12. *See* Geron, *supra* note 7 (noting Airbnb's continued operation despite its illegality).

13. *See id.* (stating there are regulatory issues of short-term rentals in New York and San Francisco).

14. *See* Brad Tuttle, *Sharing is Hard: Legal Trouble for Airbnb, RelayRides, FlightCar*, TIME (June 6, 2013), http://business.time.com/2013/06/06/sharing-is-hard-legal-trouble-for-airbnb-relayrides-flightcar/ (emphasizing that traditional industries need for these new platforms to abide by customary rules).

15. *See* Andrea Peterson, *Airbnb is Facing Off Against New York's Attorney General. Here's Why*, WASH. POST, Apr. 22, 2014, http://www.washingtonpost.com/blogs/the-switch/wp/2014/04/22/airbnb-is-facing-off-against-new-yorks-attorney-general-heres-why/ (explaining Airbnb disrupts local laws, dodges taxes, and perpetuates illegal hotels).

16. *See, e.g.*, Kathy Steinmetz, *Major Reservations: Why Cities Are Worried About Airbnb*, TIME (Apr. 16, 2014), http://time.com/64323/airbnb-san-francisco-new-york/ (taking issue with lease violations and evictions for short-term renting); *see also* Harris, *supra* note 7 (asserting the legality of short-

San Francisco has taken a more liberal approach by passing legislation to incorporate short-term rentals into existing regulations.[17] This legislation requires Airbnb hosts to follow guidelines so that the city can regulate short-term rentals and minimize their potentially detrimental effects on the hotel industry.[18] The legislation amends San Francisco's Administrative Code, but requires key changes in Airbnb's current operations.[19] The pitfalls of the sharing economy include issues surrounding the legal implications of zoning, taxation, insurance, liability, and industry intrusion.[20] Airbnb established the Shared City initiative, which partners Airbnb with cities to return revenue to cities in order to alleviate these drawbacks.[21]

This Comment argues that the regulatory and legal issues surrounding short-term rentals via Airbnb should be evaluated, organized, and incorporated into modern regulation. It compares NYC's conservative perspective and San Francisco's liberal perspective on the concepts surrounding short-term rentals and home-sharing. It assesses zoning, taxation, insurance, and liability issues, and examines current and proposed legislation regarding short-term rentals. Airbnb's legality is considered from a regulatory standpoint, in that the strictly regulated hotel industry is compared against the lenient standards Airbnb follows. This Comment suggests that San Francisco's legislation is a step in the right direction in terms of fusing the sharing economy with current law. Further, it recommends that San Francisco's liberal perspective, in combination with Airbnb's Shared City initiative, should serve as a catalyst for future legislation in American cities.

I. INFILTRATION OF THE SHARING ECONOMY

Sharing companies have become more common, which is attributable to

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term rentals if the permanent resident is present).

17. *See* Steinmetz, *supra* note 16 (declaring the legislation would legalize short-term rentals in a regulated way).

18. *See id.* (stating hosts need rentals approved).

19. *See generally* Steven T. Jones, *Chiu Introduces Legislation To Regulate Airbnb And Short-Term Housing Rentals*, S.F. BAY GUARDIAN (Apr. 15, 2014 4:22 PM), http://www.sfbg.com/politics/2014/04/15/chiu-introduces-legislation-airbnb-and-short-term-housing-rentals (expanding on the legislation's stricter regulations of length and frequency of short-term rentals).

20. *See* Cohen & Zehngebot, *supra* note 4, at 7 (elaborating on each to prove the legal implications sharing companies face).

21. Brian Chesky, *Shared City*, MEDIUM (Mar. 26, 2014), https://medium.com/@bchesky/shared-city-db9746750a3a (describing the Shared City initiative and the beneficial relationships Airbnb can have with cities in which it operates).

the transformation of technology and the desire for the otherwise unobtainable.[22] Technology provides reduced transaction expenditures allowing for low overhead costs.[23] These innovative companies provide a glimpse into the future and leave their users yearning for the cheap convenience the sharing economy offers.[24]

A. Evolution of the Sharing Economy and Companies that Dominate It

The sharing economy is defined as "a system that uses technology to link supply and demand in previously impossible ways."[25] It affords consumers the luxury of convenience while getting the most for their money.[26] It is easier than ever for a consumer to have access to short-term rentals, private drivers, and virtual department stores without having to go anywhere.[27] One click of a button can provide consumers with rock-bottom prices that traditional businesses cannot compete with.[28] However, many view the sharing economy as the enemy, instead of accepting it as the way of the future.[29]

Sharing companies have expanded on traditional industries. Yet there are still more advances to be made within the sharing economy.[30]

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22. *See* Jenny Kassan & Janelle Orsi, *The Legal Landscape of the Sharing Economy*, 27 J. ENVTL. L. & LITIG. 1, 4 (2012) (observing that partaking in excessive consumption is ridiculous, so sharing is the way of the future for things we need or want).

23. *See* Malcolm Seymour, *Litigation May Not Be the Best Way to Fight Airbnb*, LAW360 (Jan. 8, 2014, 2:04 PM), http:/7law360.com/articles /499403/litigation-may-not-be-the-best-way-to-fight-airbnb (expressing Airbnb is underpriced compared to traditional businesses in the same field).

24. *See* Cohen & Zehngebot, *supra* note 4, at 6 (noting the sharing economy's stability and potential for economic growth).

25. Rob Walker, *Why Is the 'Sharing Economy' Starting So Many Arguments?*, YAHOO! (June 25, 2014), https://www.yahoo.com/tech/
why-is-the-sharing-economy-starting-so-many-89792610714.html.

26. *See* Geron, *supra* note 7 (asserting that access can be as convenient as ownership).

27. *See The Rise of the Sharing Economy*, THE ECONOMIST (Mar. 9, 2013), http://www.economist.com/news/leaders/
21573104-internet-everything-hire-rise-sharing-economy (explaining how the sharing economy helps consumers).

28. *See* Seymour, *supra* note 23 (noting Airbnb maintains its user base by having lower prices than conventional hotels).

29. *See The Rise of the Sharing Economy*, *supra* note 27 (noting the growth of the sharing economy and its worth of twenty-six billion dollars).

30. *See* Derek Thompson, *Airbnb CEO Brian Chesky on Building a Company and Starting a 'Sharing' Revolution*, THE ATLANTIC (Aug. 13, 2013, 2:07 PM), http://www.theatlantic.com/business/archive/2013/08/airbnb-ceo-brian-chesky-on-building-a-company-and-starting-a-sharing-revolution/278635/ (indicating Airbnb founders think more innovative businesses will join the sharing economy).

Although ride-sharing and home-sharing companies have established themselves within the taxi and hotel industries respectively, other industries remain untapped.[31] Representative David Schweikert believes that "we are entering the age of the hyper-efficient economy," citing companies like Airbnb among those that are revolutionizing the economy.[32]

Consumers find comfort in using established and familiar entities, and since the sharing economy is still a developing and unfamiliar medium, some users are skeptical of its increasing popularity.[33] While consumer confidence may not be unequivocal, the sharing economy offers society an enhanced social and technological future.[34] For example, sharing companies have contributed to societal organizations during disasters.[35] One such example is Airbnb working with NYC during Hurricane Sandy to connect people who needed shelter to Airbnb hosts who could take in refugees.[36]

Surprisingly, Airbnb appeals more to people over fifty-five, rather than the expected eighteen to twenty-five-year-old demographic.[37] The appeal stems from the efficiency of the sharing economy, "collaborative consumption,"[38] which allows people to capitalize on what they already have access to, and its simplicity of use.[39] Opponents of the sharing

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31. *See id.* (stating an Airbnb founder's ideas on ways to capitalize on untapped areas of sharing from parking to cooking); *see also* Liz Gannes, *Sourcing Petsitters with DogVacay: 500,000 Sleepovers and Counting*, RECODE (June 20, 2014, 10:00 AM), http://recode.net/2014/06/20/dogvacay-half-a-million-nights-later/ (describing DogVacay as "Airbnb for dogs").

32. 160 CONG. REC. H. 5764 (daily ed. June 25, 2014) (statement of Rep. Schweikert) (aiming to tell constituents about the sharing economy's efficiency and how it is a rapidly emerging phenomenon, exemplifying its growth by naming sharing companies, but questions if those companies threaten traditional business).

33. *See* Thompson, *supra* note 30 (quoting an Airbnb co-founder that some may not like untraditional experiences while traveling).

34. *See* Kassan & Orsi, *supra* note 22, at 5 (expressing the most marketable benefits of the sharing economy).

35. *See Emergency Mgmt 2.0: How #Socialmedia & New Tech Are Transforming Preparedness, Response, & Recovery #Disasters: Hearing Before the S. Comm. on Emergency Preparedness, Response, and Commc'ns, Comm. on Homeland Sec.*, 113th Cong. 21 (2013) (statement of Michael Beckerman, President and CEO of the Internet Ass'n) (noting how social media and sharing companies help during disasters in ways traditional businesses cannot).

36. *See id.* (explaining the difference Airbnb could have made if it existed during Hurricane Katrina).

37. *See* Jessica Salter, *Airbnb: The Story Behind the $1.3bn Room-Letting Website*, THE TELEGRAPH (Sept. 7, 2012 7:00 AM), http://www.telegraph.co.uk/technology/news/9525267/Airbnb-The-story-behind-the-1.3bn-room-letting-website.html (explaining how Airbnb anticipates evolving and appealing to a range of users).

38. Walker, *supra* note 25.

39. *See* Salter, *supra* note 37 (expressing Airbnb's co-founders' desire to capitalize

economy claim that sharing suffocates innovation, but supporters counter that traditionalists are simply threatened by what is rapidly becoming the new norm.[40]

Uber, a ride-sharing company that matches drivers with passengers, is in the sharing economy spotlight with Airbnb.[41] Ride-sharing, like home-sharing, has caused controversy and faced legal complications.[42] Like Airbnb's alleged encroachment on the hotel industry, Uber, and companies like it, spark competition within the traditional cab industry.[43] However, many people believe that sharing companies seek to stimulate change and improvements for consumers, rather than destroy existing industries.[44]

B. What is Airbnb? The Brief Six-Year History of the Home-Sharing Company

Airbnb is considered the Uber of residential rentals or the "e-Bay for space."[45] It is the matchmaker between travelers and hosts, seeking to promote the sharing economy and encourage aspiring entrepreneurs.[46] The sharing economy allows anyone to be an entrepreneur by fostering collaboration in a pre-established framework.[47] Peer-sharing does not require individuals to be innovative or to have strong drive and passion to

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on renting things that already exist).

40. *See* Tuttle, *supra* note 14 (discussing that peer sharing companies fail to comply with regulations that traditional companies are required to follow).

41. *See* Stephanie Francis Ward, *'App' Me A Ride: Internet Car Companies Offer Convenience, but Lawyers See Caution Signs*, 100 A.B.A. J. 13, 14 (Jan. 2014), *available at* http://www.abajournal.com/magazine/article/internet_car_companies_offer_convenience_but_lawyers_see_caution_signs (discussing Uber's legal complications because of the taxi associations' complaints that Uber is an "unauthorized service provider" and should not operate without a cab license).

42. *See, e.g.*, Browning, *supra* note 9, at 84 (discussing issues that new technology poses using ride-sharing as a controversial example).

43. *See* Ward, *supra* note 4141, at 14 (contending taxi associations will fight until ride-sharers follow the same rules cabs do).

44. *See* Thompson, *supra* note 3030 (suggesting that other industries need not suffer unless they refuse to change).

45. *See id.* (attributing Airbnb as a prototype for the sharing economy by citing imitation business models).

46. *See* Miguel Helft, *Growing Quietly in Airbnb's Shadow*, FORTUNE (Mar. 12, 2014, 1:08 PM), http://fortune.com/2014/03/12/growing-quietly-in-airbnbs-shadow/ (elaborating on the competitors in the home-sharing economy including HomeAway and Vacation Rentals By Owner (VRBO), and the ways they compete with Airbnb's success).

47. *See* Kassan & Orsi, *supra* note 22, at 7 (clarifying that the sharing economy allows people to succeed by building relationships with others rather than competing with them).

compete in the marketplace.[48]

Airbnb was established in San Francisco by two friends, Joe Gebbia and Brian Chesky, who were struggling to pay rent.[49] Due to a conference in San Francisco, hotels lacked vacancies, so the pair decided to rent out airbeds in their apartment and serve breakfast to guests.[50] Based on this idea, they created airbedandbreakfast.com.[51] They quickly realized that their idea could work on a larger scale if they capitalized on their strengths and expertise by taking advantage of space that already existed and only required a few modifications.[52] The third founder, Nathan Blecharczyk, maintained Airbnb's online presence and put together its first online platform just two weeks before the conference that put Airbnb on the map.[53]

The founders launched Airbnb just before the Democratic National Convention where President Barack Obama was due to speak, and they booked almost 1,000 rentals.[54] Despite its success, Airbnb did not generate profits until it gained investors and began charging a booking fee catapulting Airbnb from a small start-up into a budding company.[55] As Airbnb received more funding and investments, it rocketed to the ten billion dollar company it is today.[56] The founders adjusted their approach,

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48. *See id.* (explaining anyone can be an entrepreneur despite lacking competitive drive).

49. *See* Salter, *supra* note 37 (noting the co-founders stumbled upon the idea for Airbnb while pursuing other careers).

50. *See, e.g.*, Christine Lagorio-Chafkin, Brian Chesky, Joe Gebbia, & Nathan Blecharczyk, *Founders of Airbnb*, INC.COM (July 19, 2010), http://www.inc.com/30under30/2010/profile-brian-chesky-joe-gebbia-nathan-blecharczyk-airbnb.html (stating attendees of the conference were buzzing about the new way to stay); *see also* Salter, *supra* note 37 (describing the first three guests who were charged just eighty dollars per night).

51. Salter, *supra* note 37.

52. *See id.* (explaining the co-founders wanted to take advantage of the eco-friendly idea).

53. *See* Lagorio-Chafkin, *supra* note 50 (noting Blecharczyk was recruited because of expertise in computer science programming).

54. *See id.* (stating 80,000 people were expected to attend the conference, allowing Airbnb to succeed because there was a shortage of hotel rooms in the area and noting the shortening of airbedandbreakfast.com to Airbnb.com); *see also* Salter, *supra* note 37 (noting Airbnb targeted festivals and conventions where cities struggled to accommodate an influx of people).

55. *See* Thompson, *supra* note 30 (elaborating on the founders' cereal fundraiser, which sold boxes of 'Obama O's' and 'Cap'n McCains' for forty dollars each profiting over $30,000).

56. *See generally* Anna Vital, *How Airbnb Started*, FUNDERSANDFOUNDERS.COM (Apr. 10, 2014), http://notes.fundersandfounders.com/post/82297315548/how-airbnb-started (depicting the timeline of Airbnb's developments).

which led to an increase in rentals and celebrity investments in Airbnb.[57] As it expanded, Airbnb offered more luxurious options ranging from rentals in Paris with views of the Eiffel Tower to castles in England.[58] Airbnb was established as a cheap alternative to a hotel, so the founders were surprised when users started to prefer homes to hotel rooms.[59]

Airbnb currently operates in 190 countries and over 34,000 cities; it has hosted over fifteen million guests since its founding, and boasts more than 800,000 listings worldwide.[60] The story behind these impressive numbers reveals that Airbnb must work hand-in-hand with each of these 34,000 cities because each city imposes strikingly different short-term rental regulations..[61] Despite the legal woes Airbnb has faced in terms of taxes, liability, zoning, safety, and many other regulatory issues, it has managed to escalate itself to success and raise over one hundred million dollars through investments.[62]

C. Airbnb's Shared City Initiative

Airbnb launched Shared City, an initiative that attempts to bring cities back to the concept of sharing spaces and operating with greater efficiency.[63] Cities are the original sharing platforms, and Airbnb believes that returning to community-sharing will strengthen cities socially, economically, and environmentally.[64] Shared City is the "initiative to help civic leaders and [communities] create more sharable, more livable cities through relevant, concrete actions and partnerships."[65] The first city to partner with Airbnb was Portland, Oregon.[66] Shared City encourages hosts to donate money from renting properties in order to to support local

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57. *See id.* (citing that singer Barry Manilow rented a house through Airbnb and actor Ashton Kutcher invested in the company and sits on the board as an advisor).

58. *See About Us*, https://www.airbnb.com/about/about-us (last visited Mar. 2, 2015) (noting Airbnb's listings of over 600 castles for rent).

59. *See* Thompson, *supra* note 30 (explaining that many guests contend that hotels can feel cold and impersonal).

60. *See About Us*, *supra* note 58 (showing Airbnb's success across the globe in terms of total statistics since its founding).

61. *See* Thompson, *supra* note 30 (commenting on the legal issues Airbnb faces at the neighborhood level and noting a New York judge recently ruling against an Airbnb host).

62. *See* Vital, *supra* note 56 (describing Airbnb's increased success between 2010 and 2014).

63. *See* Chesky, *supra* note 21 (indicating that Airbnb hosts benefit by acting entrepreneurial).

64. *See id.* (expressing Airbnb's commitment to support local businesses and celebrate cultural heritages).

65. *Id.*

66. *See id.* (noting Airbnb wants many partners for Shared City).

businesses and causes.[67]

Airbnb also seeks to launch its Home Safety initiative in more American cities to educate and encourage host responsibility and the adoption of effective safety practices.[68] Airbnb wants to prevent hosts from abusing the platform by skirting laws and regulations.[69]

Shared City encourages mom-and-pop shops to become staples in communities once again.[70] Shared City aims to offer significant community benefits, and even vows to "collect and remit taxes" on behalf of Airbnb hosts.[71] Airbnb believes hosts should pay taxes and abide by the same regulations under which established businesses operate.[72] This initiative seeks to bond communities through charity, safety, and support for local businesses, while addressing Airbnb's legal issues.[73] Airbnb is proactive in reaching out to cities to lessen the strain on short-term rentals.[74] If Shared City successfully creates more close-knit, stable communities in its initial cities, Airbnb intends to launch it in other cities across America.[75]

II. CONSERVATIVE VS. LIBERAL: THE DISPARITY BETWEEN NEW YORK CITY AND SAN FRANCISCO'S PERSPECTIVES ON HOME-SHARING THROUGH AIRBNB

NYC and San Francisco express opposing views on the benefits that

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67. *See id.* (explaining Airbnb would match donations as a percentage of its fees).

68. *See id.* (expressing Airbnb's goal of placing smoke and carbon monoxide detectors in rental residences).

69. *See* Leigh Gallagher, *Airbnb Cozies Up To Cities*, FORTUNE (Mar. 26, 2014 5:01 PM), http://fortune.com/2014/03/26/airbnb-cozies-up-to-cities/ (contending Airbnb seeks to enrich cities where it operates while making rentals safer and collecting taxes).

70. *See id.* (noting that supporting small business would perpetuate sharing communities and reduce waste).

71. *See id.* (stating Airbnb vows to maintain tax payments throughout experimentation with Shared City); *see also* Chesky, *supra* note 21.

72. *See* Malia Spencer, *Airbnb Launches Shared City Initiative in Portland*, PORTLAND BUS. J. (Mar. 26, 2014, 5:39 PM), http://www.bizjournals.com/portland/blog/2014/03/airbnb-launches-shared-city-initiative-in-portland.html (indicating Airbnb's willingness to collect taxes and then pass proceeds on to the city and offer disaster relief training to hosts).

73. *See* Chesky, *supra* note 21 (explaining Airbnb's efforts to better connect and work with the community).

74. *See* Gallagher, *supra* note 69 (highlighting Airbnb's Shared City initiative as a proactive approach that works with local governments by undertaking the creative leg work to alleviate the burden placed on cities because of short-term rentals).

75. *See* James Brasuell, *Airbnb's 'Shared City' Program Will Collect, Remit Taxes*, PLANETIZEN (Mar. 30, 2014, 11:00 AM), http://www.planetizen.com/node/68090 (noting Airbnb wants to work with governments through Shared City to help with its legal issues).

Airbnb can have on their communities. NYC leans in a conservative direction, seeking to expel short-term rentals because of their potential to infringe on the current economic stability of the city. San Francisco is more liberal in its acceptance of the changes that Airbnb offers and the benefits that can arise from accepting short-term rentals in a restricted way.

A. New York's Conservative View of Short-Term Rentals

NYC contends that short-tem rentals pose too many issues with regard to various aspects of the community and economy. The city is much less willing to consider regulating short-term rentals as San Francisco has chosen to do.

1. Does Airbnb Have Any Liability if Its Hosts Encounter Legal Issues?

Like many legal disclaimers, Airbnb renounces liability if a legal issue arises.[76] Airbnb's website articulates hosts' responsibilities to obey local laws by stating, "[b]y accepting our Terms of Service and activating a listing, you certify that you will follow your local laws and regulations."[77] From a business perspective, it makes sense for companies to protect themselves from liability.[78] Unexpected accidents can occur when guests stay in unfamiliar places. On one occasion, a hot water heater could have led to severe injuries had a guest bumped into it.[79]

The sharing economy, and home-sharing specifically, has encountered liability issues.[80] Ride-sharing companies' encroachment of the taxi industry is comparable to Airbnb's encroachment on the hotel industry.[81]

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76. *See Airbnb Responsible Hosting*, https://www.airbnb.com/help/responsible-hosting (last visited Mar. 2, 2015) (listing host responsibilities and stating a liability disclaimer); *see also Airbnb's $1,000,000 Host Guarantee*, https://www.airbnb.com/guarantee (last visited Apr. 13, 2015).

77. What Legal and Regulatory Issues Should I Consider Before Hosting on Airbnb? https://www.airbnb.com/support/article/376 (last visited Apr. 13, 2015).

78. *See generally* Ron Lieber, *Home-Sharing? Don't Ignore Liability*, N.Y. TIMES, Apr. 20, 2012, *available at* http://www.nytimes.com/2012/04/21/your-money/home-insurance/home-sharing-dont-overlook-your-liability-your-money.html?pagewanted=all (explaining any amount of guests staying increases liability concerns).

79. *See id.* (noting if a "naked toddler" leaned against the hot water heater it could have been a tragedy).

80. *See id.* (considering potential conflicts with insurance when using a residence for a commercial use).

81. *See* Nicole Gelinas, *The City That Never Shares? Airbnb, Uber & NYC*, N.Y. POST (June 22, 2014, 10:11 PM), http://nypost.com/2014/06/22/the-city-that-never-shares-airbnb-uber-nyc/ (expressing that New York City real-estate has high value,

Uber and Lyft are currently facing legal challenges regarding their refusal to acknowledge that their drivers are employees and continue to insist that they are independent contractors.[82] Airbnb chose to renounce liability, claiming that its users are not employees, and that it only provides a platform to connect parties.[83] This rejection of liability should not mean Airbnb is exempt from responsibility if hosts act illegally or if something goes wrong during a guest's stay.[84] However, Airbnb contends that it is just a matchmaker, similar to an online dating platform.[85] A dating site connects two parties using the site as a starting point, but what happens from there is not the dating site's responsibility.[86]

Airbnb appears to set its users up to break the law.[87] Its terms and conditions state, "Airbnb is not responsible for and disclaims any and all liability related to any and all listings and accommodations."[88] Airbnb encourages users to familiarize themselves with local laws to ensure their compliance, but this is ironic since most laws prohibit short-term residential rentals.[89]

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which is why sharing for profit is controversial).

82. *See* Allison Griswold, *Are Uber Drivers Employees? The Trial That Could Devastate the "Sharing Economy."*, SLATE (Mar. 12, 2015, 12:54 PM), http://www.slate.com/blogs/moneybox/2015/03/12/uber_lyft_employment_cases_juries_could_decide_the_legal_fate_of_the_sharing.html (indicating that the legal controversy that ride-sharing companies are facing in California because they categorize their drivers as independent contractors, deprive drivers of benefits and require them to pay for "on-the-job costs like gas and vehicle maintenance out of their own pockets," will now have to be resolved by a jury).

83. *See generally* Ward, *supra* note 41, at 14 (describing sharing platforms as intermediaries, similar to e-Bay or Match.com).

84. *See generally* Lieber, *supra* note 78 (contrasting the potential for liability claims by citing Airbnb's statement that it has not heard of a liability claim or judgment over $10,000).

85. *See generally* Marc Champion, *London Must Choose Uber Or Nostalgia*, BLOOMBERG VIEW (June 11, 2014, 1:15 PM), http://www.bloombergview.com/articles/2014-06-11/london-must-choose-uber-or-nostalgia (expressing Uber's claim that is not physically attached to the car, it is simply the intermediary).

86. *See generally id.* (citing Uber claiming it is not a taxi company but rather a "kind of dating site that matches passengers to drivers and handles the money.").

87. *See* Gelinas, *supra* note 81 (stating "Airbnb 'works' because it is what it pretends not to be: an illegal-sublet service.").

88. *Terms of Service*, https://www.airbnb.com/terms (last updated June 30, 2014).

89. *See generally Responsible Hosting*, https://www.airbnb.com/help/responsible-hosting (indicating Airbnb's policies place most of the responsibility on the host); *see also* Harris, *supra* note 7 (discussing the severity of consequences from short-term renting illegally in New York City, but also the difficulty of enforcing those laws).

i. Airbnb Requires Hosts to Provide Insurance

After the initial excitement over the opportunity to profit from short-term renting, hosts began asking questions about insurance coverage.[90] Airbnb shields itself from liability in this regard by explicitly stating that it:

> recommends that hosts obtain appropriate insurance for their accommodations. Please review any insurance policy that you may have for your accommodation carefully, and in particular please make sure that you are familiar with and understand any exclusions to, and any deductibles that may apply for, such insurance policy, including, but not limited to, whether or not your insurance policy will cover the actions or inactions of guests (and the individuals the guest invites to the accommodation, if applicable) while at your accommodation.[91]

Airbnb suggests that hosts have homeowners or rental insurance; however, if an insurance company refuses to provide coverage, a host should bring the complaint to Airbnb because it may motivate Airbnb to create a better insurance policy.[92] Airbnb publicizes its host-friendly guarantee, which claims to provide a one million dollar insurance policy for hosts.[93] This policy seems admirable, but the small print reveals that the one million dollar guarantee only applies after a host's personal insurance is exhausted.[94] Airbnb may suffer if hosts decide that renting through Airbnb is not worth the insurance risk.[95]

ii. Blindly Signing Your Life Away

Airbnb, like most electronic companies, lists its terms and conditions in a

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90. *See generally* Leiber, *supra* note 78 (noting that most insurance companies say they can deny a claim if it is related to commercial activity under residential coverage).

91. *See id.* (expressing disdain for the refusal to take legal responsibility and stating, "If someone gets hurt, don't go crying to Airbnb."); *see also Responsible Hosting*, https://www.airbnb.com/help/responsible-hosting.

92. *See generally* Leiber, *supra* note 78 (noting some insurance companies will provide policies for renters, but that the insurance issue could be the downfall of Airbnb).

93. *See* Andrew Couts, *Terms & Conditions: Airbnb Makes Everything Your Problem*, DIGITAL TRENDS (Nov. 4, 2013), http://www.digitaltrends.com/web/terms-conditions-airbnb/#!bil0QG (disclosing how Airbnb puts responsibility on hosts about illegal subletting consequences, personal insurance policies, minimal reimbursement for loss from damage, and the responsibility to pay taxes on rentals); *see also Airbnb's $1,000,000 Host Guarantee*, https://www.airbnb.com/guarantee (last visited Apr. 13, 2015).

94. *See* Couts, *supra* note 93 (insinuating that Airbnb makes most of the legal problems the hosts' problem to deal with).

95. *See generally* Leiber, *supra* note 78 (noting not having insurance while breaking rental laws is a dangerous mixture).

difficult format to read, making it likely that they are not read at all.[96] Terms and conditions, while often written in small print in an arbitrary location, or not listed at all, may still be legally binding.[97] Users often click "I agree" to accept terms and conditions that may bind them to contractual terms they never read.[98] Courts have accepted these clickwrap contracts as valid following the decision in *ProCD, Inc. v. Zeidenberg*. In that case, the United States Court of Appeals for the Seventh Circuit held that Zeidenberg was bound to the terms he agreed to when he loaded ProCD's software onto his computer.[99] Zeidenberg chose to ignore the terms and conditions and clicked "I agree" despite being unaware of the what he was agreeing to.[100]

Therefore, users who blindly accept Airbnb's terms and conditions would likely be held to their agreements.[101] Users are prompted to enter personal information, and in small print at the bottom of the sign-up window, a message states, "[b]y signing up, I agree to Airbnb's Terms of Service, Privacy Policy, Guest Refund Policy, and Host Guarantee Terms."[102] Each policy explanation is extensive in length and written using complicated legalese.[103]

The conditions in Airbnb's "Terms of Service" state, in all caps:

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96. *See generally* Rachel S. Conklin, Note, *Be Careful What You Click For: An Analysis of Online Contracting*, 20 LOY. CONSUMER L. REV. 325, 326 (2008) (expressing concern about unassuming people accepting contractual agreements unknowingly).

97. *See id.* (noting that during browsing sessions a user may agree to terms by visiting a site).

98. *See* Mark A. Lemley, *Terms of Use*, 91 MINN. L. REV. 459, 466 (2006) (elaborating that every court that examined the issue has held clickwrap acceptances as enforceable contracts).

99. *See* ProCD v. Zeidenberg, 86 F.3d 1447, 1450 (7th Cir. 1996) (indicating that Zeidenberg "decided to ignore the license").

100. *See id.* at 1449, 1452 (explaining that clicking the "I accept" button constitutes acceptance, binding Zeidenberg to the contract); *see also* Lemley, *supra* note 98, at 468–69 (explaining that before the *ProCD* case, clickwrap licenses were not always upheld, but following the decision, courts now uphold clickwrap agreements).

101. *See generally* Lemley, *supra* note 98, at 468–69 (noting that courts' holdings now find clickwrap acceptances as binding).

102. *Sign Up*, https://www.airbnb.com/signup_login?redirect_params[action]=show&redirect_params [controller]=homepages (last visited Apr. 13, 2015).

103. *See Terms of Service*, www.airbnb.com/terms; *see also Privacy Policy*, www.airbnb.com/terms/privacy_policy (last visited Apr. 13, 2015); *see also Host Guarantee Terms and Conditions*, www.airbnb.com/terms/host_guarantee (last visited Apr. 13, 2015); *Guest Refund Policy Terms*, www.airbnb.com/terms/guest_refund_policy (last visited Apr. 13, 2015).

> [y]ou understand and agree that Airbnb is not a party to any agreements entered into between hosts and guests, nor is Airbnb a real estate broker, agent or insurer. Airbnb has no control over the conduct of hosts, guests and other users of the site, application and services or any accommodations, and disclaims all liability in this regard to the maximum extent permitted by law.[104]

If users were aware that Airbnb renounced insurance liability, they would be more likely to question and contest this practice, which could compel Airbnb to take on more responsibility for issues that arise as a result of its operations.[105]

2. Airbnb Is Asking New York State to Tax It Like a Hotel

Airbnb has not been paying taxes like legally operating hotels are required to do, but the company is determined to pay the hotel tax in order to be considered legitimate and operate without concern.[106] In the case of *Airbnb, Inc. v. Schneiderman*,[107] New York State's Attorney General Eric Schneiderman subpoenaed Airbnb's NYC user records in a campaign to enforce the MDA, which prohibits "illegal hotels."[108] The Attorney General sought to determine how many Airbnb users were avoiding occupancy taxes, due to hotel industry complaints that this lack of payment hurts hotels.[109] Airbnb argued that collecting information on 15,000 of its hosts was unreasonable and a "fishing expedition," and it challenged the

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104. *Terms of Service*, www.airbnb.com/terms (last visited Apr. 13, 2015).

105. *See generally* Lieber, *supra* note 78 (suggesting Airbnb should create more stable liability and insurance policies).

106. *See* Kaja Whitehouse, *Airbnb Aims to Start Taxing Renters by July 1*, N.Y. POST (Apr. 14, 2014, 5:46 AM), http://nypost.com/2014/04/14/airbnb-aims-to-start-taxing-renters-by-july-1/ (stating the New York Hotel Association's opposition to Airbnb paying taxes since that would legitimize Airbnb).

107. 989 N.Y.S.2d 786, 788–89 (Sup. Ct. 2014).

108. *See id.* (stating the Attorney General requested a list of Airbnb's users in an attempt to gain more control of short-term rentals in New York City); *see also* Seymour, *supra* note 23 (navigating Airbnb's complications because of the MDA, which prohibits rentals except for "permanent resident purposes").

109. *See* Kevin Roose, *Will Airbnb's $21 Million Olive Branch Get It Legalized in New York?*, N.Y. MAG. (Apr. 18, 2014, 8:00 AM), http://nymag.com/daily/intelligencer/2014/04/will-airbnbs-21-million-get-it-legalized.html (citing a hotel representative claiming Airbnb impinges on housing stock, loses revenue for New York City, and increases job loss in the hotel industry); *see also* Joe Coscarelli, *NYC Sues First of Many Illegal Airbnb-ers*, N.Y. MAG (Oct. 17, 2014, 2:15 PM), http://nymag.com/daily/intelligencer/2014/10/nyc-sues-first-of-many-illegal-airbnb-ers.html (specifying that seventy-two percent of New York City Airbnb apartment listings are illegal, but the first targets of lawsuits are brothers Hamid and Adbolmajid Kermanshah who are using Airbnb to become "mini hospitality moguls" by using two large residential buildings as hotels in midtown Manhattan).

Attorney General's request.[110] The judge agreed that the subpoena was overly broad, and gave the Attorney General's office a year to review the Airbnb host data of only 124 hosts, which was made anonymous for privacy reasons.[111] The New York State government's concern is that Airbnb gives users the ability to abuse the platform by operating residentially-zoned buildings as illegal hotels.[112] New Yorkers purchase shares of a cooperative or condominium to live in residential buildings; however, permanent residents may experience strangers coming and going because neighbors use these residences as illegal hotels.[113]

David Hartman, head of Airbnb's Public Policy Department, reports that eighty-seven percent of hosts rent the property where they permanently reside and are not transforming residential buildings into illegal hotels.[114] Airbnb contends that most of its hosts do not abuse the platform and announced that it removed about 2,000 listings that made NYC "worse, not better."[115]

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110. *See* Andrea Peterson, *Airbnb is Facing Off Against New York's Attorney General. Here's Why.*, WASH. POST, Apr. 22, 2014, http://www.washingtonpost.com/blogs/the-switch/wp/2014/04/22/ airbnb-is-facing-off-against-new-yorks-attorney-general-heres-why/ (delving into the dispute between New York's Attorney General and Airbnb over Airbnb's concerns about releasing user information and the local tax dilemma).

111. *See* David Hantman, *Our Community in New York*, AIRBNB PUB. POL'Y (June 12, 2014), http://publicpolicy.airbnb.com/author/ david-hantman/ (contending the Attorney General was after a few bad actors, but demanded information on thousands of New York Airbnb users); *see also* Joel Stashenko, *AG to Learn Names of 124 Airbnb Hosts*, N.Y. L.J. (Aug. 27, 2014), http://www.newyorklawjournal.com/this-weeks-news/id=1202668144807/AG-to-Learn-Names-of-124-Airbnb-Hosts?mcode=1202615038803&curindex=5&slreturn=20140729135958 (stating the "vast majority" of the 124 disclosed hosts have stopped using Airbnb).

112. *See* Peterson, *supra* note 110 (adding Schneiderman's finding that 12% of hosts are responsible for about one third of New York listings, implying those are illegal hotel operations); *see also* David Streitfeld, *Airbnb Listings Mostly Illegal, New York State Contends*, N.Y. TIMES, Oct. 15, 2014, http://www.nytimes.com/2014/10/16/business/airbnb-listings-mostly-illegal-state-contends.html (reinforcing that most Airbnb rentals are illegal because they violate zoning and other property laws, and while New York is not looking to target small-time Airbnb hosts, it wants to shut down the illegal hotels to protect the real estate market).

113. *See generally* Peterson, *supra* note 110. (noting the Attorney General's office thinks Airbnb listings raise housing costs).

114. *See* David Hantman, *New York and the Airbnb Community*, AIRBNB PUB. POL'Y (Apr. 21, 2014), http://publicpolicy.airbnb.com/author/david-hantman/page/2/ (clarifying Airbnb's motivations by explaining that it helps more than it hurts by creating jobs and helping 62% of hosts to keep their homes).

115. *See* Peterson, *supra* note 110 (suggesting, however, that 2,000 listings does not indicate just a few isolated cases); *see also* Coscarelli, *supra* note 108 (explaining that attorney general Eric Schneiderman found that "six percent of Airbnb hosts in the city are making thirty-seven percent of the revenue").

Airbnb continues to request that NYC alter its laws to allow Airbnb to collect taxes on rentals.[116] Airbnb claims it could bring in sixty-five million dollars in hotel occupancy tax revenue[117] for NYC and it reached out to Mayor Bill de Blasio for his endorsement.[118] Critics argue that Airbnb hurts the hotel industry's success by encroaching on its tourist base.[119] The hotel industry argues that Airbnb is an "illegitimate enterprise,"[120] and it initially demanded that Airbnb pay hotel taxes.[121] Hotels want a level playing field, arguing that Airbnb should have to comply with hotel regulations, or that they should be able to take advantage of Airbnb's more lenient standards.[122] Therefore, it was surprising when Airbnb's attempt to pay taxes was met with opposition by the hotel industry, which claimed that if Airbnb pays taxes it would fall "under the umbrella of legality."[123] Airbnb's path to operational legality through the tax vein has not been overwhelmingly embraced, but it is necessary for fair competition. That being said, it requires compromise by lawmakers and the hotel industry.[124]

Airbnb adopted a goodwill angle to win over NYC and convince lawmakers to consider its tax proposal.[125] Airbnb has pulled on NYC's heartstrings by emphasizing that the tax would provide the city with

116. *See* Craig Karmin, *Airbnb to New York's Mayor: Tax Our Hosts, Fund Pet Programs*, WALL ST. J. (Mar. 27, 2014, 10:31 PM), http://online.wsj.com/news/articles/SB10001424052702303779504579465532885246114 (explaining that Airbnb wants New York's Mayor to help reform laws so Airbnb can pay taxes).

117. *See* Ryan Lawler, *As It Seeks New Regulations in NY, Airbnb Estimates It Would Collect $65 Million in Taxes There*, TECH CRUNCH (Jan. 16, 2015), http://techcrunch.com/2015/01/16/airbnb-65-million-in-ny/ (contending that the amount of tax revenue will only continue to increase over time).

118. *See* Karmin, *supra* note 116 (citing Airbnb's attempt at legitimacy by gaining mayoral support of Airbnb tax payments).

119. *See generally id.* (suggesting the hotel industry calls Airbnb illegitimate to protect itself from Airbnb's operations).

120. Whitehouse, *supra* note 106.

121. *See generally* Seymour, *supra* note 23 (insinuating hotels want Airbnb to abide by the same regulations hotels do).

122. *See id.* (noting hotels want fair competition not a "race to the bottom").

123. Roose, *supra* note 109; *see also* David Hantman, *New York Hotel Lobbyists Flip-Flop On Taxes*, AIRBNB PUB. POL'Y BLOG (Apr. 17, 2014), http://publicpolicy.airbnb.com/new-york-hotel-lobbyists-flip-flop/ (explaining hotels' changed stance and quoting a Hotel Association representative stating hotels would "oppose it, certainly," in reference to Airbnb paying taxes).

124. *See* Roose, *supra* note 109 (insinuating the hotel industry's argument that Airbnb should not pay taxes is circular: "Airbnb shouldn't be legalized because it is illegal.").

125. *See* Whitehouse, *supra* note 106 (noting Airbnb says it wants to do the work for the lawmakers by initiating tax collection).

millions of dollars, which could go toward programs to help residents.[126] For example, the taxes could provide 420,000 textbooks to public schools and nearly three million meals to the elderly.[127] Airbnb also tackles its issue from an emotional angle by describing how it enhances the lives of New Yorkers in helping citizens keep their homes during a difficult economy.[128] For instance, one New York woman who rented out a bedroom through Airbnb would not have been able to pay her rent and medical bills without the extra income she received.[129] Taxing Airbnb would remedy concerns about Airbnb's unfair competition in the hotel industry, and would allow some hosts to retain their residences, which would benefit the city overall.[130]

3. Zoning Issues Surrounding Short-Term Rentals and New York State's MDA

The MDA is unique to New York State because not all states have comparable multiple dwelling laws.[131] However, most states do regulate residential areas, landlords, and hotels, usually reserving the right to rent rooms to the hotel industry.[132] The MDA was amended in 2010 to eliminate interpretations that would allow illegal hotels.[133] This affected Airbnb and its hosts who operate their businesses out of residential dwellings.[134]

Under the MDA, Class A dwellings are for permanent resident purposes only.[135] "Permanent resident" means that the same person or family inhabits the dwelling for thirty or more consecutive days.[136] The

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126. *See id.* (adding Airbnb has deferred directly to New Yorkers to pay taxes to show its dedication).

127. *Id.*

128. *See* David Hantman, *Our Community in New York*, AIRBNB PUB. POL'Y (June 12, 2014), http://publicpolicy.airbnb.com/community-new-york/. (expressing hosts' need for Airbnb to afford homes in a difficult economy).

129. *See* Harris, *supra* note 7 (noting that being present while guests stay is often a legal way to short-term rent).

130. *See id.* (suggesting that allowing short-term rentals and taxing hosts would be a win for the City and for its residents).

131. *See* Seymour, *supra* note 23 (explaining the MDA has been on New York's books for decades to protect the City's real estate).

132. *See id.* (adding those who rent are usually categorized as a hotel or landlord, but Airbnb hosts fall into neither category).

133. *See id.* (noting the amendment to the MDA closed loopholes that used to technically allow illegal hotels and rentals).

134. *See id.* (elaborating that Schneiderman seeks to enforce the MDA since most Airbnb hosts violate it).

135. N.Y. MULT. DWELL. LAW § 4 (McKinney 2011).

136. *Id.*

occupancy of a Class A dwelling can only be modified if guests staying for under thirty days reside in the dwelling while the permanent resident is present.[137] If the permanent resident is not present and guests stay in the house for under thirty days, the permanent resident cannot receive payment from the guests for their occupancy.[138] Unless the location is zoned as a hotel or hostel, any rental under thirty days — where the permanent resident is not present — is illegal and violates New York State zoning laws.[139] However, the MDA is hard to enforce because violators fly under-the-radar, as landlords and neighbors may not notice transient guests, especially if no one monitors who frequents the building.[140]

Additionally, hotels must follow various safety provisions that Airbnb user bypass.[141] The MDA requires fire sprinklers and alarms in multiple dwellings, provisions that Airbnb hosts may not have since private residences are not required to follow such strict safety standards.[142] Airbnb hosts currently have no legal obligation to make potential dangers apparent to guests.[143]

Zoning laws are hard to modify and can lead to complications or community disruptions.[144] While Airbnb offers tourists a unique experience and allows hosts to make extra income, zoning may not be the best solution to its legal issues.[145] This is because if a residential neighborhood's zoning changes to commercial for short-term renting, nothing prevents a person from opening up other short-term commercial operations in those areas as well.[146]

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137. *Id.*

138. *Id.*

139. *See id.* (creating a loophole by broadly defining family).

140. *See generally* Jessica Dailey, *An Introduction to New York's Short Term Rental Laws*, CURBED (Mar. 25, 2013), http://ny.curbed.com/archives/2013/03/25/an_introduction_to_new_yorks_short_term_rental_laws.php (insisting amending the MDA is necessary to better regulate short-term rentals).

141. *See* Jay Karen, *The Rise of Airbnb.com and the Illegal, Short-Term Rental*, INNKEEPING BLOG (Aug. 3, 2013), http://www.innkeepingblog.com/2011/08/the-rise-of-airbnb-com-and-the-illegal-short-term-rental/ (questioning Airbnb's legality and its steps to create safety provisions).

142. N.Y. MULT. DWELL. LAW § 29-02-09 (McKinney 2011).

143. *See* Leiber, *supra* note 78 (noting hosts do not have the safety regulations hotels do, which could lead to injuries).

144. *See* Ngai Pindell, *Home Sweet Home? The Efficacy of Rental Restrictions To Promote Neighborhood Stability*, 29 ST. LOUIS U. PUB. L. REV. 42, 46–47 (2009) (noting that it is arguable that without zoning regulations there are negative effects like more traffic and lower property care).

145. *See generally id.* at 47 (implying that tampering with zoning may create additional issues).

146. *See generally id.* at 54 (noting rental restrictions protect the aesthetic

i. Policy Issues Resulting from Commercial Use in Areas Zoned for Residential Use

Short-term renting raises questions about the effects it has on the stability of a community.[147] From a policy perspective, economic and resident stability is at stake.[148] In *Ewing v. City of Carmel-by-the-Sea*, the California Court of Appeals emphasized the importance of resident stability and the compromising effect short-term rentals have on the character of a community.[149] The city council contended that the zoning was meant to create an area "for permanent single-family residential uses and structures and to enhance and maintain the residential character of the City."[150] The commercial use of residential areas leads to more traffic, demand for parking, light and noise issues, and a need for public services to accommodate the influx of people.[151] Transient residents do not have a stake in the community and do not join community activities.[152] The *Ewing* court cites *Miller v. Board of Public Works* and *Euclid v. Ambler Realty Co.* to emphasize that zoning is essential to maintaining community character.[153] Separating commercial and residential areas serves a purpose for the welfare of residents and "promote[s] and perpetuate[s] the American home."[154]

In *United Property Owners Ass'n. v. Borough of Belmar*, owners challenged zoning provisions affecting their residences.[155] The owners took issue with "undesirable conduct" by transients and wanted to purge

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tranquility and quality of a community).

147. *See generally* Charles Gottlieb, *Residential Short-Term Rentals: Should Local Governments Regulate The "Industry"?*, 65 PLAN. & ENVTL. LAW 4, 4 (2013) (implying that there are consequences that come along with unstable renting).

148. *See id.* at 4 (noting that transients lack commitment, which creates unstable communities).

149. *See* Ewing v. City of Carmel-By-The-Sea, 286 Cal. Rptr. 382, 387 (Ct. App. 1991) (upholding a ban on short-term rentals to keep the community's character and limit negative impacts).

150. *Id.*

151. *See id.* at 387 (noting short-term rentals harm communities).

152. *See id.* (listing community features that suffer because of transients, such as local government or little league).

153. *See id.* (citing Miller v. Bd. of Pub. Works, 234 P. 381, 493 (Cal. 1925) (noting the court observed that with homeownership comes stability, which is untrue of short-term rentals); Euclid v. Ambler Realty Co., 272 U.S. 365, 395 (1926) (elaborating that zoning does not constitute a taking because the purpose of zoning is to "limit the property owner's rights to make profitable of some segments of his property")).

154. *Ewing*, 286 Cal. Rptr. at 388.

155. *See* United Prop. Owners Ass'n of Belmar v. Borough of Belmar, 447 A.2d 933, 934 (N.J. 1982) (stating the purpose of zoning was to confine short-term rentals to hotels and boarding houses along the beach, but it slowly encroached on residential areas).

such people in order "to restore peace and quiet and other characteristics of neighborhoods where people . . . live in relative permanency."[156] The court explained that "[z]oning laws are designed to control types of uses in particular zones,"[157] but that ultimately in a vacation area, banning or strictly regulating rentals is an "arbitrary . . . restraint on use of private property."[158] Bans on short-term rentals have typically been enforced to control stability and restrict owners from using residences for unauthorized purposes.[159] Traditionally, problems arose because of seasonal rentals, but because of Airbnb, short-term rentals have become commonplace.[160]

ii. Violations of the Multiple Dwelling Act Set Precedents

Short-term rentals not only face resistance from neighbors and the community, but also from landlords who will evict tenants to maintain control of their properties.[161] In a recent New York housing court case, *Gold Street Properties v. Freeman*, an Airbnb host violated her lease and the MDA by renting her apartment short-term.[162] The court allowed the host to stay in her apartment, as long as she removed her listing from Airbnb and cancelled future guest reservations.[163] This case sets a precedent that may result in difficulties for landlords who want to evict tenants for breaching their leases by renting short-term.[164] The holding in that case is not a slam-dunk for Airbnb, but it provides hosts with greater protection against immediate eviction for short-term renting.[165]

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156. *Id.*

157. *Id.* at 937.

158. *Id.*

159. *See* Pindell, *supra* note 144, at 54 (explaining that the law tries to restrict illegal property use by narrowly defining family and by increasing enforcement of nuisance codes).

160. *See generally id.* (discussing issues arising because of seasonal vacation rentals).

161. *See generally* Natalie Rodriguez, *NYC Housing Court Ties Landlords' Hands In Airbnb Fight*, LAW360 (June 18, 2014, 8:30 PM), http://www.law360.com/articles/549322/nyc-housing-court-ties-landlords-hands-in-airbnb-fight (citing a recent decision that makes it harder for landlords to evict because of zoning).

162. *See* Gold Street Properties v. Freeman, N.Y. L.J., July 2, 2014, at 1 (N.Y. Civ. Ct. June 16, 2014) (holding the short-term renting was illegal, but set a one strike before eviction precedent).

163. *See* Rodriguez, *supra* note 161 (clarifying the court allowed the tenant to maintain her residence in *Gold Street* because she cured her breach by removing her listing, although the landlord argued that the tenant did not cure the issue fast enough).

164. *See id.* (quoting a tenant's rights litigator stating this case is not "a victory for Airbnb. The judge still found what the tenant did was illegal.").

165. *See id.* (indicating that tenants may be punished less impulsively, are not gaining more rights, and if the landlord requests no short-term renting, the tenant must

In a case brought before New York's Environmental Control Board, an Airbnb host rented out his apartment,[166] and was served with Notices of Violation for violating the MDA.[167] However, the fines were dismissed on a technicality that allows short-term stays if the resident is present, and in this case, a roommate was there while guests were present.[168]

B. San Francisco's Liberal View on Short-Term Rentals

San Francisco has chosen to adopt a decidedly liberal perspective on the operations of Airbnb than NYC, possibly because San Francisco calls itself the home of the company.. Although San Francisco is more open to home-sharing than NYC, it does intend to impose some limitations on the growing industry.

1. San Francisco's Landlord-Tenant Liability and Landlord Abuse of Airbnb

Until recently, short-term rentals were illegal in San Francisco, like most areas of the country, because short-term rentals not only violated the San Francisco Administrative Code ("SFAC"), but they also usually violated lease agreements as well.[169] For instance, one San Francisco resident needed extra income, so he rented his apartment through Airbnb.[170] His landlord found out and notified him that he breached his lease and could be

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comply).

166. *See* Ron Lieber, *A $2,400 Fine For An Airbnb Host*, N.Y. TIMES, May 21, 2013, http://money.cnn.com/2013/05/21/technology/innovation/airbnb-illegal-new-york/ (stating a New York City Environmental Board ruled renting via Airbnb violates the MDA).

167. *See id.* (noting the law is not concerned with smaller scale tenant rentals, but primarily seeks to stop landlords who use residential buildings to run illegal hotels in violation of New York's "illegal hotel" law, also known as the MDA).

168. *See* Tomio Geron, *Airbnb Wins New York City Appeal On Short-Term Rentals*, FORBES (Sept. 27, 2013, 6:26 PM), http://www.forbes.com/ sites/tomiogeron/2013/09/27/airbnb-wins-new-york-city-appeal-on-short-term-rentals/ (explaining it is unclear how Airbnb is affected when the resident does not stay with the guest).

169. *See* Carolyn Said, *Airbnb Sublets in S.F. Land Some Renters in the Doghouse*, S.F. GATE (Mar. 18, 2014, 9:38 PM), http://www.sfgate.com/ realestate/article/Airbnb-sublets-in-S-F-land-some-renters-in-the-5326019.php#page-1 (describing the frustration landlords feel when tenants profit from the landlord's property); *see also* Dara Kerr, *San Francisco Mayor Signs Landmark Law Making Airbnb Legal*, CNET.COM (Oct. 28, 2014, 1:25 PM), http://www.cnet.com/news/san-francisco-mayor-makes-airbnb-law-official/ (announcing that San Francisco's Mayor Ed Lee approved a bill that amended local zoning laws, legalizing short-term rentals that company like Airbnb make possible).

170. See Said, *supra* note 169 (adding the Airbnb host stayed elsewhere so the Airbnb guest could have the whole apartment).

evicted.[171]

Generally, if the tenant ceases operations through Airbnb, evictions are remedied under a "cure or quit" notice.[172] Many landlords dislike when tenants profit off of their property, and demand strict enforcement of the "no-rentals-under-thirty-days" law.[173] However, because of "cure or quit" notices, many tenants can remove their Airbnb listings and avoid eviction.[174] Some lease agreements prohibit subleasing, which includes short-term renting to transient guests.[175] Therefore, when landlords are made aware that their properties are being rented through Airbnb, they commence eviction proceedings.[176] Now that the proposed bill that sought to legalize short-term rentals has been passed, landlords will continue to face this issue and others like it.[177]

Landlords are not always the victims of short-term renting.[178] Sometimes landlords abuse Airbnb for their own benefit, and to the detriment of their city.[179] These landlords may pay tenants in breach of their lease agreements to move out and then utilize those spaces for short-term rentals.[180] In 2014, City Attorney David Herrera filed two lawsuits against landlords in San Francisco because they each used residential properties as illegal hotels, making those spaces unavailable to permanent

171. *See id.* (stating the host had "three days to vacate the apartment or face an eviction lawsuit").

172. *See* Barbara McDowell, *Developments in Landlord-Tenant Law: 2005-2006*, 10 UDC/DCSL L. REV. 249, 252 (2007) (defining a cure or quit notice as the "time within which tenants ordinarily must take corrective action in order to avoid eviction").

173. S.F., CAL., ADMIN. CODE § 41A-5 (2013) (codifying that permanent residences cannot be rented for under thirty days).

174. *See* Said, *supra* note 169 (noting that taking down Airbnb listings can resolve landlord issues, but if hosts are unable to meet the quit deadlines, landlords may proceed with eviction).

175. *See id.* (quoting San Francisco lawyer Dave Wasserman, "[w]hen tenants do Airbnb and [law enforcement] catch[es] them, [law enforcement] serve them with eviction notices for violating their lease agreements").

176. *See id.* (explaining hosts use Airbnb for a profitable boost, but are cheating landlords out of money).

177. *See* Kerr, *supra* note 169 (indicating that although San Francisco became one of the first cities in the world to legalize short-term rentals, not everyone is happy about it).

178. *See generally* Gerry Shih, *San Francisco Sues Landlords Who Evicted Tenants for Airbnb*, REUTERS (Apr. 23, 2014, 4:42 PM), http://www.reuters.com/article/2014/04/23/us-airbnb-lawsuit-idUSBREA3M1YS20140423 (elaborating on San Francisco suing landlords who were running illegal hotels through Airbnb).

179. *Id.*

180. *See* Said, *supra* note 169. (explaining that landlords will pay rent-controlled tenants to leave to avoid losing in a jury trial and to prevent tenants from profiting by short-term renting).

renters while San Francisco was in a housing shortage.[181]

Removing residential rental units from the market has been termed "hotelization," which is what San Francisco's legislation on short-term rentals intends to prevent.[182] The Ellis Act allows landlords to take properties off the market, but not without restrictions.[183] The two lawsuits filed by the city were against landlords who converted residential units into illegal hotels, and charged rent well above what the Ellis Act permits[184] *San Francisco v. Lee* concerned a landlord who took the property he owned off the market in 2006, with an Ellis Act rental cap of $1,087 per month.[185] The landlord used the property as an illegal hotel before returning to long-term renting, with an extreme rental increase to a range of $4,200 and $7,038 per month.[186]

In the second lawsuit, *San Francisco v. Yurovsky*, the landlords took their three residential units off of the long-term rental market.[187] In 2006, the landlords were served with Notices of Termination of Tenancy pursuant to the Ellis Act, San Francisco's Rent Stabilization Ordinance, and SFAC Section 37.9.[188] Unless the landlords intended to "go out of the rental

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181. *See* Bob Egelko, *S.F. Attorney Sues 2 Landlords Over Short-Term Rentals*, SF GATE (Apr. 24, 2014, 6:52 AM), http://www.sfgate.com/ bayarea/article/S-F-city-attorney-sues-2-landlords-over-5425826.php (expressing concern for the "dwindling housing supply" and landlord use of residences as illegal hotels).

182. *See* Lydia O'Connor, *Airbnb Faces Near-Ban In San Francisco*, HUFFINGTON POST (Apr. 29, 2014, 11:59 PM), http://www.huffingtonpost.com/ 2014/04/29/airbnb-laws-san-francisco_n_5235820.html (defining "hotelization" as short-term rentals, which proposed legislation seeks to regulate).

183. *See* Andrew McIntyre, *SF Sues 2 Landlords for Tourism Hotel Conversion*, LAW360 (Apr. 24, 2014), http://www.law360.com/articles/531352/sf-sues-2-landlords-for-tourism-hotel-conversion (noting that Ellis Act restrictions for violating a rental cap could last between five to ten years).

184. *See id.* (stating the landlords rented buildings illegally, violated, and exceeded Ellis Act rent caps).

185. *See* Compl. for Injunctive or Other Relief at ¶ 12, San Francisco v. Lee, No. 14-538857 (Sup. Ct. Cal. Apr. 23, 2014) (specifying that there can be incremental increases of the Ellis Act cap if it is approved); *see also* McIntyre, *supra* note 183 (explaining that the $1,087 rental rate was to be maintained for subsequent long-term renters).

186. *See* Complaint for Injunctive or Other Relief at ¶¶ 7, 9, San Francisco v. Lee, No. 14-538857 (Sup. Ct. Cal. Apr. 23, 2014) (indicating that the landlord stopped short-term renting the residential space around 2009 and then re-rented for a monthly rate well above the requisite Ellis Act rate).

187. *See* Complaint for Injunctive or Other Relief at ¶¶ 7, 9, California v. Yurovsky, No. 14-538857, 2014 WL 1623802 (Sup. Ct. Cal. Apr. 23, 2014)
(describing the residential property as a building with three residential units and one commercial unit).

188. *But see id.* (conceding that landlords are not required to offer residential rentals in their properties).

business" altogether, evicting tenants for the purpose of short-term renting is arguably illegal.[189] These cases are pending in San Francisco, but the city's end goal is to obtain injunctions and monetary compensation for each day the violations occurred.[190]

Although San Francisco has had landlord-tenant issues, the city's Mayor, Ed Lee, supports Airbnb.[191] Since Airbnb's start in 2008, the San Francisco Tenants Union has remained unwavering in its stance against the company, stating that it has "begun a process with city regulators to sue seven other landlords on similar charges."[192] The lawsuits against the two San Francisco landlords send a strong message to Airbnb and its users that laws will be enforced until legal change is implemented.[193]

2. Airbnb Mimics Hotel Industry Tax Standards

Although Airbnb's home city is in San Francisco, it has sustained regulatory issues there prior to the passage of legislation pertaining to its regulation.[194] Despite the conflict over Airbnb's legality and San Francisco's laws and regulations, Airbnb is determined to maintain a relationship with the city.[195] Airbnb asserts its intention to collect and pay taxes on its operations in San Francisco under the new short-term rental regulations.[196] The taxes amount to fourteen percent of hosts' profits.[197] Taxing hosts may be a setback for the Airbnb-host relationship, but it is a step in the right direction because allows the company to maintain relations

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189. *Id.*

190. *See* McIntyre, *supra* note 183 (elaborating the defendants should pay penalties and cease unlawful behavior).

191. *See* Shih, *supra* note 178 (explaining that San Francisco's Mayor supports Airbnb's cause and its technological advances).

192. *Id.*

193. *See id.* (noting the determination to limit illegal rentals).

194. *See* O'Connor, *supra* note 182 (recognizing the controversy around Airbnb when citizens protested Airbnb's elimination).

195. *See* Kim-Mai Cutler, *Airbnb Says It Will Start Collecting Hotel Taxes In San Francisco*, TECH CRUNCH (Mar. 31, 2014), http://techcrunch.com/2014/03/31/airbnb-sf-hotel-tax/ (quoting Airbnb's Head of Global Public Policy, "[w]e have repeatedly said that we believe our community in San Francisco should pay its fair share of taxes").

196. Dara Kerr, *Airbnb Begins Collecting 14% Hotel Tax in San Francisco*, CNET.COM (Sept. 17, 2014, 12:23 PM), http://www.cnet.com/news/ airbnb-begins-collecting-14-hotel-tax-in-san-francisco/; *see also* Kerr, *supra* note 168 (explaining that the new legalization push limits short-term renters and requires Airbnb hosts to "sign up in a city registry, collect transient occupancy taxes and carry liability insurance").

197. *See* Cutler, *supra* note 195 (illuminating Airbnb's attempt to prove it has not been avoiding its tax responsibilities).

with the city as Airbnb explores its newfound legitimacy.[198] San Francisco could generate about $274 million by requiring Airbnb to pay hotel taxes on short-term rentals.[199]

Airbnb's payment of hotel taxes mimics the requirements of the hotel industry.[200] Airbnb has put a lot of effort into trying to follow the law, but San Francisco's "arcane" and "difficult" tax laws make it so difficult that some Airbnb hosts claimed to have been denied the ability to pay taxes.[201] Allowing Airbnb hosts to pay taxes under the new legislation gives Airbnb legitimacy by placing it within the realm of the hospitality industry, thus refuting claims that Airbnb's operations are comparable to other illegal operations petitioning to pay taxes in exchange for validity.[202] Now that Airbnb will pay hotel taxes, it will no longer severely compromise the prosperity of the hotel industry and those who rely on it for jobs, or add to the housing crisis. Instead, it can continue to help San Francisco residents, but in a legal manner.[203]

3. San Francisco's Past Housing Laws and the Proposed Legislation for Short-Term Rentals that Made the Jump to Legalization

San Francisco has chosen to embrace the changes that short-term rental platforms offer its community. The city is accepting home-sharing, but on its own terms through restricting regulations.

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198. *See generally* Andrew Szeto, *Activists Hold Competing Rallies On Short-Term Rental Restrictions*, BEYOND CHRON (Apr. 30, 2014), http://beyondchron.org/activists-hold-competing-rallies-on-short-term-rental-restrictions/ (describing rallies for and against legalizing short-term rentals indicates that taxing hosts may only be a temporary compromise); *see also* Samantha Shankman, *Airbnb to Begin Collecting Taxes in Four New Cities*, SKIFT (Jan. 30, 2015, 12:00 PM), http://skift.com/2015/01/30/airbnb-to-begin-collecting-taxes-in-four-new-cities/ (contending that hosts may be upset that they now have to pay taxes on their rentals).

199. *See* Cutler, *supra* note 195 (explaining 14% occupancy tax would be added to the guest's bill as an additional charge).

200. *See id.* (indicating that the 14% tax would be in addition to the tax hosts already pay on income they make from Airbnb).

201. David Hantman, *San Francisco, Taxes and the Airbnb Community*, AIRBNB PUB. POL'Y BLOG (Mar. 31, 2014), http://publicpolicy.airbnb.com/san-francisco-taxes-airbnb-community/.

202. *See generally*, Alan Farnham, *Airbnb: Towns Crack Down on Homeowners Who Take Guests*, ABC NEWS (Sept. 9, 2013), http://abcnews.go.com/Business/users-airbnb-breaking-law-critics-claim/story?id=20148183 (referring to concerns about where the law-breaking ends if short-term rentals are not restricted and comparing Airbnb to running a residential escort service).

203. *See generally* Szeto, *supra* note 198 (emphasizing how Airbnb's existence takes away jobs from the hotel industry); *see also* Kerr, *supra* note 168 (quoting San Francisco Mayor Ed Lee, "Now, San Franciscans who just want to share their home with occasional visitors will have a clear set of rules and restrictions to earn extra money to make ends meet").

i. San Francisco's Administrative Code

Airbnb's zoning issues are not limited to New York City. Airbnb has also encountered zoning concerns in San Francisco, in addition to tax and liability issues.[204] San Francisco's legislation on short-term rentals is codified in the SFAC.[205] Chapter 41A of the SFAC states that a permanent resident cannot rent out his residential unit for less than thirty days at a time.[206] A similar version of this SFAC rule appears under San Francisco's Planning Code ("Planning Code"),[207] which regulates business owners from converting residential units for commercial or transient purposes.[208] The Planning Code states that a residential unit rented short-term alters the categorization of the unit from residential to commercial, which is why many opponents are demanding stricter reform of the short-term rental laws.[209] Additionally, under Chapter 37.9 of the SFAC, a landlord can evict a tenant if a residential unit is rented in a way that violates the law.[210] The Department of Building Inspection ("DBI") enforces these provisions, but often does not take action unless neighbors or landlords complain.[211]

ii. San Francisco's Proposed Legislation Made Into Law

San Francisco is a pioneer in proposing to incorporate short-term rentals into local laws and regulations.[212] David Chiu, President of the Board of

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204. *See generally* Farnham, *supra* note 202 (noting short-term rentals often "violate local zoning laws, which prohibit rentals shorter than thirty days, except for hotels and licensed bed-and-breakfasts").

205. S.F., CAL., ADMIN. CODE § 41A.4(c) (2013); *see also San Francisco, CA: Airbnb Help Center*, https://www.airbnb.com/help/article/871 (noting that the new legislation is not effective until February 1, 2015, and the SFAC codes remain the same and are still in effect).

206. S.F., CAL., ADMIN CODE § 41A-5 (2013).

207. S.F., CAL., PLANNING CODE § 101.1.

208. *See generally* O'Connor, *supra* note 182 ("The short-term rental market is exploding and cries out for some sort of regulation . . . People are stunned to find out that a house on their block is now a hotel.").

209. *See generally* Carolyn Said, *S.F. Ballot Would Severely Limit Short-Term Rentals*, SF GATE (Apr. 29, 2014, 7:40 AM), http://www.sfgate.com/news/article/S-F-ballot-measure-would-severely-limit-5436664.php (indicating if an area wants to host transients then it should request a zone change to legitimize its actions); S.F., CAL., PLANNING CODE § 101.1 (2013).

210. S.F., CAL., ADMIN. CODE § 37.9 (2013).

211. *See* Randy Shaw, *Will SF Finally Stop Illegal Tourist Rentals?*, BEYOND CHRON (Apr. 21, 2014), http://beyondchron.org/will-sf-finally-stop-illegal-tourist-rentals/ (indicating the DBI is an enforcement agency, but its lack of funding limits its prevention of short-term rentals).

212. *See generally* Steven T. Jones, *Chiu Introduces Legislation To Regulate Airbnb And Short-Term Housing Rentals*, S.F. BAY GUARDIAN (Apr. 15, 2014, 10:49 AM), http://www.sfbg.com/politics/

Supervisors in San Francisco, created the legislation that sought to do this.[213] The current SFAC Section 41A prohibits renting residential units, and prevents multiple dwellings from being used as illegal hotels.[214]

Legislation was passed in October that legalizes short-term rentals in a highly regulated manner, by limiting the rentals to ninety nights per year, and requiring permanent residents to occupy their homes for at least 275 days per year (sixty of which must be consecutive).[215] The ninety-night limit could prevent San Francisco residents from getting displaced by Airbnb rentals.[216] However, this legislation will not excuse tenants from violating their lease agreements with landlords.[217] Hosts will be held to a higher standard, requiring them to maintain liability insurance and register their residences with the city.[218] A registry of hosts will redact names, but will list addresses for landlords for eviction and lease enforcement purposes.[219] This registry will incentivize hosts to maintain compliance with short-term rental laws in order to avoid sanctions or eviction.[220] Fortunately for hosts, this legislation has a one-strike rule preventing landlords from evicting tenants on their first offense, but it does increase fee penalties for repeat offenders.[221] Proponents of the legislation argue

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2014/04/15/chiu-introduces-legislation-airbnb-and-short-term-housing-rentals (discussing the proposed legislation seeks to legalize, but regulate short-term rentals).

213. *See id.* (noting it took two years to finish the legislation).

214. *See id.* (explaining regulations are meant to stop conversions of rental units solely for transient use).

215. *See id.* (noting the legislation requires the resident to physically occupy the home for 275 days a year); *see also* Kate Rogers, *San Francisco Moves Closer to Legalizing Airbnb*, CNBC (Oct. 22, 2014, 9:40 AM), http://www.cnbc.com/id/102102286 (enumerating the new legislations restrictions and discussing "Airbnb law" that brings the company further into legitimacy).

216. *See* Stephen T. Jones, *SF Supervisors Vote to Legalize and Regulate Airbnb's Short-Term Rentals*, S.F. BAY GUARDIAN (Oct. 7, 2014, 6:31 PM), http://www.sfbg.com/politics/2014/10/07/sf-supervisors-vote-legalize-and-regulate-airbnbs-short-term-rentals (indicating that while San Franciscans rely on Airbnb for rent, it is also important to retain a ninety-night limit to prevent the displacement of the city's residents).

217. *See* Cutler, *supra* note 195 (describing that the legislation does not override lease agreements).

218. *See* Jones, *supra* note 212 (showing the legislation allows landlords to identify and evict tenants violating their leases).

219. *See id.* (noting opponents claim the registry violates privacy, but agree it helps to achieve the legislation's goal).

220. *See id.* (providing that the legislation regulates rental costs and prevents the abuse of sharing platforms thereby incentivizing host compliance).

221. *See id.* (adding Airbnb is held to a higher standard to inform hosts about local laws); *see also* Carolyn Said, *Chiu Toughens Proposed SF Airbnb Legislation*, S.F. GATE (Sept. 2, 2014, 5:53 PM), http://blog.sfgate.com/techchron/2014/09/02/chiu-toughens-proposed-sf-airbnb-legislation/ (noting the legislation requires city approval

these changes are necessary to protect San Francisco's residents and the hotel industry so as to not worsen the housing crisis.[222]

iii. Opposition to the Legislation

Since short-term rentals have established a niche in San Francisco despite their illegality, this new legislation is necessary to regulate their permissibility.[223] However, opponents assert that the legislation does not regulate short-term rentals strictly enough.[224] Because of this skepticism, opponents and housing advocates have established a ballot initiative that rivals the legislation as a much more conservative counterpart.[225] This initiative seeks to hinder Airbnb's ability to grow in San Francisco and would harshly regulate short-term rentals.[226]

Controversially, this initiative would reward witnesses who report hosts who rent their residences short-term.[227] The initiative goes further by proposing that short-term rentals should only be allowed in commercially zoned areas, which would devastate Airbnb hosts in residential zones.[228] Further, the ballot initiative agrees that there should be a registry, but the initiative seeks to increase visibility to the public.[229] This initiative would also require hosts to get rentals approved by their landlords or homeowners associations, require Airbnb to confirm the host is registered, and make the host demonstrate proof of personal rental or homeowners insurance.[230] The initiative threatens to damage Airbnb's operations and the company strongly opposes it; instead, Airbnb supports the new legislation as the best way to begin the legalization process for Airbnb's operations in San Francisco, despite the restrictions the new legislation imposes.[231] If this

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for rentals as well as protection of affordable housing and ensuring building and fire safety compliance).

222. *See* O'Connor, *supra* note 182 (noting Airbnb's efforts to help regulate short-term rentals and improve the economy).

223. *See generally* Jones, *supra* note 212 (implying without regulating the rentals, they will continue to create problems).

224. *See generally* Said, *supra* note 209 (pointing out that housing advocates have prepared a ballot initiative that would more strictly regulate short-term rentals).

225. *See id.* (noting the ballot initiative is tougher than Chiu's proposed legislation).

226. *See id.* (citing the ballot initiative would only allow short-term rentals in commercially zoned areas).

227. *See* Jones, *supra* note 212 (expressing Airbnb's disdain for this initiative because it would severely hurt its operations).

228. *Id.*

229. *See id.* (noting the proposed legislation would only make names on the registry known through sunshine law requests).

230. *See id.* (suggesting that making hosts jump through hoops will discourage people from short-term renting).

ballot initiative went on to trump the passed legislation, reversing the harm it would do to the legality of short-term rentals would be nearly impossible.[232]

4. Shared City

Airbnb has made efforts to gain acceptance within the communities where the majority of its hosts operate. Most notably, Airbnb has partnered with Portland, Oregon to work with the community while allowing residents to utilize Airbnb's services.[233] In doing this, Airbnb has portrayed itself as a company that gives back, offering cities services and funding that other companies do not.[234] Airbnb ties itself to communities through Shared City, creating a connection that bonds cities with the company before creating a formal legal relationship. This non-legal relationship provides cities with large sums of tax revenue to put toward projects cities ideally seek to implement, but otherwise do not have the funds for.[235] To win over the community, Airbnb has created an initiative that provides safer spaces, a boosted economy, and a way to benefit residents by supporting local businesses, encouraging entrepreneurs to pursue business ventures, and creating opportunities to make extra income to sustain a budget.[236]

Recently, Portland became the first city in the United States to narrowly legalize short-term rentals.[237] Portland appreciated the sharing economy bringing people to Portland, but strictly regulates short-term rentals by only allowing one or two bedrooms to be rented at a time, requiring hosts to purchase a permit from the city, and requiring hosts to pass safety inspections.[238] Portland vows to use some of the proceeds for affordable

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231. *See id.* (stating the legislation and the ballot initiative agree that hosts should pay hotel taxes).

232. *See id.* (expressing Airbnb's desire to work with San Francisco to prevent infringement on the hotel industry).

233. *See generally* Chesky, *supra* note 21 (noting that Airbnb is making progress with Shared City in Portland).

234. *See id.* (explaining Portland hosts can donate money earned from hosting to local causes and Airbnb will match donations).

235. *See* Cutler, *supra* note 195 (elaborating that $274 million in tax revenue could be used to benefit locals).

236. *See* Chesky, *supra* note 21 (intending to work with communities to highlight unique characteristics and diverse neighborhoods by promoting small businesses to guests).

237. *See* Steve Law, *City Legalizes Airbnb, Other Short-Term Home Rental Services*, PORTLAND TRIBUNE (July 30, 2014, 12:12 PM), http://portlandtribune.com/pt/9-news/228670-92077-city-legalizes-airbnb-other-short-term-home-rental-services- (detailing the unanimous vote by Portland city commissioners to legalize, but strictly regulate, short-term rentals).

238. *See id.* (adding whole-house rentals, apartments and condos cannot partake in

housing and to use Airbnb for lodging during emergencies.[239]

III. A LIBERAL APPROACH AS THE CATALYST GOING FORWARD

Although NYC has valid reasons for rejecting short-term rentals, San Francisco's decision to embrace the change on its own terms is ultimately the best approach. As technology advances and people become more comfortable with the sharing economy as whole, it would behoove the nation to embrace, but regulate, the sharing economy while it is in its infancy.

A. The Sharing Economy is Here to Stay

Although the sharing economy has created copious amounts of legal issues within cities, it has also created a new norm. The simplicity of using the Internet to access almost anything has become the standard way to do everything from calling a personal driver to renting out homes for short-term stays.[240] Banning these online platform-based companies is not the way to remedy the legal and regulatory issues. NYC's conservative attempt to prohibit Airbnb altogether is unrealistic because hosts will continue to break the law. The most practical option is to model future laws on the regulations set out in San Francisco's new legislation as a launching point. Regulating companies with business models like Airbnb's from the outset is the best strategy, since its users have already proven they will use these services whether they are legal or not. Unfortunately, regulating these types of innovative companies is notoriously difficult, but societally beneficial in the long run. By regulating these companies, users have the opportunity to comply with the law, whereas if these services are available but illegal, users are pigeonholed into breaking the law.

Sharing platforms allow for a cheaper and more convenient experience, and in this era of technology, users will be unwilling to revert to an inconvenient or more expensive alternative. If these services are regulated and legalized, a more level playing field can be established between Airbnb and the hotel industry. Fair competition is an important part of business and sharing companies should not be exempt from competing.

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short-term rentals).

239. *See id.* (conceding officials expect illegal short-term rentals, but think the benefits outweigh the harm).

240. *See* Tuttle, *supra* note 14 ("The sharing economy is here to stay, and so are we.").

B. Airbnb Should Be Treated Like Hotels

Although Airbnb does not seek to encroach on the hotel industry, it has caused some problems in that regard.[241] The company competes directly against hotels and should not be immune to the fourteen percent tax requirement, zoning regulations, and liabilities that hotels must comply with.[242] As Airbnb's Shared City initiative suggests, the company should be required to sustain some of the same safety precautions as hotels.[243] Additionally, Airbnb should focus on the legality of its operations in larger cities where its influence is most heavily concentrated, like NYC or San Francisco, and where short-term rentals are more likely to be abused. Establishing overarching regulations to standardize home-sharing would create fair competition and continuity throughout this up-and-coming industry.

Creating an equal playing field between competitors within the same industry is crucial for Airbnb to be successful in American communities. [244] Airbnb and other hosting platforms are not following the law and they cause disturbances within traditional industries that abide by regulations. Further, Airbnb should take more responsibility in educating its users on the local laws of places where Airbnb is prominent as well as provide clarity about necessary insurance coverage and the potential for legal complications.[245] Regulating Airbnb would not only legalize its operations, but also create a safety net for users should they encounter legal issues in cities where it is still illegal.[246] To further ensure the security of its users, Airbnb should take more responsibility rather than renouncing liability by claiming to simply be an online medium that exists to link hosts and guests to one another. It does not make sense for Airbnb to renounce liability when the operations it emboldens are the reason legal issues exist in the first place.

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241. *See* Szeto, *supra* note 198 (arguing that Airbnb takes away hotel jobs and people lose wages and benefits).

242. *See id.* (noting reform is months away).

243. *See* Chesky, *supra* note 233 (indicating hosts will be educated in safety, install smoke and carbon monoxide detectors, have first aid kits, and fire safety or escape route information).

244. *See* Patrick Mayock, *Airbnb/Hotel Playing Field Beginning to Level*, HOTEL NEWS NOW (Sept. 26, 2014), http://www.hotelnewsnow.com/Article/14493/Airbnb-hotel-playing-field-beginning-to-level (expressing the importance of Airbnb agreeing to play by the same rules as the hospitality industry).

245. *See generally* Julie Bort, *Airbnb Host Can't Get Squatter To Leave*, BUS. INSIDER (July 21, 2014, 1:48 PM), http://www.businessinsider.com/airbnb-host-cant-get-squatter-to-leave-2014-7 (explaining an Airbnb rental gone wrong because a guest refused to leave and now must be evicted).

246. *See* Jones, *supra* note 212 (implying a safety net exists if hosts have a law to follow, plus the delayed eviction benefit).

C. San Francisco's New Legislation in Combination with Shared City

Airbnb welcomes regulations in the cities where it primarily operates. It is better for lawmakers to regulate a new industry in its infancy, in order to gain control early and to mitigate the risk of harm to consumers, operators, and surrounding industries. Hosting platforms like Airbnb are rapidly gaining popularity and are calling for the law to catch up with technology, so as to not irreversibly damage existing businesses and industries.

Airbnb has agreed to make it clear to hosts when they may be breaking the law by posting information on its website; however, the information currently available is vague and suggests that hosts should still familiarize themselves with local laws.[247] The legal information on Airbnb's website needs to be more comprehensive for users because hosts are still responsible for Airbnb-related infractions.[248] Ultimately, Airbnb and short-term rentals are illegal in most places, so hosts who take a chance using Airbnb will run the risk of legal complications until legislation is amended.[249]

Now that San Francisco's proposed legislation has been passed, it should be implemented in tandem with the incorporation of Airbnb's Shared City initiative. The new legislation should also include requirements for safety regulations. Shared City should work in conjunction with cities' regulations to offer benefits to the community as a whole, not just to those who have chosen to host for extra income. NYC's treatment should not be further pursued because it just incentivizes people to find more creative ways to skirt the law. A preferable solution would be for Airbnb's operations to be incorporated into the laws of cities across the country, thus regulating short-term rentals and creating fair competition with the hotel industry, while simultaneously working with the community to economically benefit its local residents.

CONCLUSION

Airbnb has revolutionized the way people travel, and its innovative technology is here to stay. Despite the legal issues Airbnb has faced in terms of its legal liability, such as failure to pay hotel taxes, and zoning complications, it has produced a service that many hosts and guests are fond of. The legislation in San Francisco incorporating short-term rentals

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247. *See Responsible Hosting*, https://www.airbnb.com/help/responsible-hosting (last visited Apr. 13, 2015) (reiterating hosts should make sure they know their local laws).

248. *Id.*

249. *See* Seymour, *supra* note 23 (stating not all states have laws like the MDA, but most states regulate short-term rentals).

into the city's regulations should act as the catalyst for other cities affected by short-term rentals. Not only should home-sharing be regulated, but it should also work in tandem with Airbnb's Shared City initiative to contribute to local economies and businesses. Additionally, safety provisions should be added to existing regulations to make home-sharing a safer, more enjoyable experience for hosts, guests, and Airbnb. Proactively establishing boundaries and regulations for innovative companies like Airbnb is essential because the sharing economy is not decelerating.

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THE CLEAN POWER PLAN: AN INTRODUCTION TO COOPERATIVE FEDERALISM IN ENERGY REGULATION

TINA CALILUNG*

The regulation of electricity markets in the United States can be viewed as an optimization problem involving several objective functions: balancing electricity supply and demand; minimizing consumer prices; and minimizing environmental costs. The ideal regulatory scheme would produce the perfect mix of generation resources, to provide reliable capacity that meets consumer demand at the lowest price with the least environmental impact. Federalism, however, requires the separation of regulatory authority over electricity production between federal and state bodies. Moreover, in restructured energy markets, deregulation further distributes decision-making authority to market actors who, through their collective actions, determine market prices and supply. Such fragmented jurisdictional authority can lead regulatory bodies, acting in furtherance of their individual objectives, to work towards conflicting goals. In some instances, federal preemption requires legitimate state goals to yield to federal objectives. The Clean Power Plan ("CPP"), the U.S. Environmental Protection Agency's ("EPA") proposed regulation of carbon emissions released by existing coal-fired power plants, establishes a framework of cooperative federalism that grants states vast flexibility for achieving federally-mandated emissions reduction goals. The tools available to states for designing implementation plans can also advance state energy goals, like promoting fuel diversity and enhancing system reliability, which may otherwise be preempted by federal law.

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INTRODUCTION

Electricity is the indispensable form of energy that enables technological innovation and productivity growth in the modern world.[1] The unique characteristics of electricity, however, create challenges for the regulation of electricity generation and transmission.[2] Electricity cannot be efficiently stored in bulk and as a result, the supply and demand for electricity must be instantaneously and continuously balanced over the interconnected transmission grid.[3] Interconnected grids ensure that any electricity that enters the system moves in interstate commerce.[4] As such, the Commerce

1. *See generally* Stephanie Karekezi et al., *Energy, Poverty and Development*, *in* GLOBAL ENERGY ASSESSMENT: TOWARD A SUSTAINABLE FUTURE, 151, 157 (2012), *available at* http://www.iiasa.ac.at/web/home/research/Flagship-Projects/Global-Energy-Assessment/Global_Energy_Assessment_FullReport.pdf (explaining that access to electricity supply is a prerequisite to reducing poverty).

2. Steven Ferrey, *Alternative Energy in a Spaghetti Western: Clint Eastwood Confronts State Renewable Energy Policy*, 32 UTAH ENVTL. L. REV. 279, 279 (2012) (asserting that the characteristics of electric energy have legal facets that states have not always fully appreciated).

3. *Id.* (explaining that generator imbalance can cause disruptions to the national electricity system, including shut downs and equipment damage).

4. N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 81 (3d Cir. 2014); *see also* FERC v. Mississippi, 456 U.S. 756, 757 (1982) ("[I]t is difficult to conceive of a more basic element of interstate commerce than electric energy . . . No [s]tate relies on its

Clause necessitates separate federal and state regulation of electricity sales.[5] However, the site selection and construction of new power plants, excluding nuclear and hydropower plants, is deemed a local concern subject to state regulation.[6] The Nuclear Regulatory Commission ("NRC") licenses and regulates commercial nuclear power plants, and the Federal Energy Regulatory Commission ("FERC") provides similar oversight for hydropower facilities.[7]

Electric power generation is also a source of significant environmental costs. Fossil fuel generation provided 67% of global electricity-generating capacity in 2008.[8] It also accounted for most local conventional pollution, including sulfur oxides, nitrous oxides, particulate matter, and global carbon dioxide pollution.[9] To this end, the EPA regulates conventional fuel power plant operations, including pollution control, the handling of coal combustion byproducts, and cooling water intake structures.[10]

Fragmented authority over electricity generation and sales can lead regulators to work at cross-purposes.[11] To the extent that regulatory

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own resources in this respect").

5. *See* Pub. Utils. Comm'n of R.I. v. Attleboro Steam & Elec. Co., 273 U.S. 83, 89–90 (1927) (holding that the interstate sale of electricity is not subject to regulation by either of the two states for the protection of their local interests); *see also* 16 U.S.C. § 824(a) (2012) (establishing exclusive federal regulation of transmission and wholesale electricity sales); 16 U.S.C. § 824(b) (2012) (reserving for the states the authority to regulate retail electricity sales).

6. 16 U.S.C. § 824(b) (2012) (reserving for the states the authority to regulate "facilities used for the generation of electric energy").

7. *See* James W. Moeller, *State Regulation of Nuclear Power and National Energy Policy*, 12 J. ENERGY NAT. RESOURCES & ENVTL. L. 1, 4–5 (1992) (explaining that the Atomic Energy Act establishes a "virtually unique" comprehensive scheme for the regulation of commercial nuclear power plants by the NRC); *see also* Peter Huber, *Electricity and the Environment: In Search of Regulatory Authority*, 100 HARV. L. REV. 1002, 1011 (1987) (referring to *First Iowa Hydro-Elec. Coop. v. FPC*, which upheld the authority of the federal agency to preempt state regulation of the licensing of new hydroelectric development).

8. Eric D. Larson et al., *Fossil Energy*, *in* GLOBAL ENERGY ASSESSMENT: TOWARD A SUSTAINABLE FUTURE, 901, 910 (2012), *available at* http://www.iiasa.ac.at/web/home/research/Flagship-Projects/Global-Energy-Assessment/Global_Energy_Assessment_FullReport.pdf.

9. *See id.* at 910–911 (observing that reduction of conventional pollution is more urgent in developing countries due to the immediate damage to public health and the environment).

10. *See* Michael Gergen et al., *Walking the Line Between the Clean Air Act and the Federal Power Act: Balancing Emission Reductions and Bulk Power Reliability*, 35 ELECTRICITY J. Jan.–Feb. 2012, at 16, 18. (explaining that EPA regulations are promulgated under Clean Air Act, Clean Water Act, and Resource Recovery and Conservation Act).

11. *Cf.* Huber, *supra* note 7 at, 1044, 1054 (arguing that the irretrievably fragmented regulation of the safety and environmental impacts of electric power plants

decision-making is disjointed and dispersed among numerous entities with competing goals, one regulatory objective, whether it is market competition, system reliability, or environmental stewardship, may have to yield to another.

This Comment argues that the EPA's cooperative federalism approach to the regulation of greenhouse gas emissions by coal-fired power plants may afford states with deregulated electricity markets the opportunity to achieve objectives for the provision of electricity supply that would otherwise be barred by federal preemption of state laws. Part II provides an overview of the regulation of wholesale electricity sales and the development of deregulated electricity markets. Part III examines a series of cases involving the PJM electricity market to illustrate how the FERC's wholesale ratemaking authority preempts the authority of states participating in deregulated electricity markets to subsidize the construction of new power plants in order to resolve reliability concerns. Finally, Part IV suggests that states participating in deregulated electricity markets can use the regulatory framework of the CPP to mandate the construction of new power plants, despite the preemption findings in the PJM cases.

This Comment assumes the validity of the CPP. The proposed regulation, however, is the subject of legal challenges that pertain to issues that lie outside the purview of this Comment.[12] Notwithstanding current and prospective legal challenges, the CPP's design may afford deregulated states the ability to direct some of their generation resource planning, which would otherwise be determined solely by market mechanisms.

I. ENERGY REGULATION IN THE UNITED STATES: FROM THE NEW DEAL TO DEREGULATION

Regulation of the production and sale of electricity is an expansive task that has resulted in a system of rules as complex and multi-faceted as the energy commodity itself.[13] At the turn of the twentieth century, electric utility companies were largely organized as vertically integrated monopolies that owned and operated electric power plants, transmitted electricity to captive local service areas, and distributed electricity to retail

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leads to environmentally regressive technological choices).

12. *See, e.g.*, Neela Banjaree, *12 States Sue Over the EPA Proposed Power Plant Regulations*, L.A. TIMES, Aug. 4, 2014, http://www.latimes.com/business/la-fi-epa-lawsuit-20140805-story.html (reporting that plaintiffs allege that the EPA regulation is illegal because power plant emissions are regulated under a different part of the Clean Air Act).

13. *See generally* Jim Rossi & Thomas Hutton, *Federal Preemption and Clean Energy Floors*, 91 N.C.L. REV. 1283, 1316 (2013) (observing that the regulation of electricity addresses multiple services consisting of the wholesale supply of electricity, transmission, and retail distribution to end-use customers).

customers.[14] Because each utility supplied its own capacity resources,[15] electricity sales consisted entirely of retail sales, which were subject to state and local regulation.[16] The lack of interconnection meant that there was little competition among utilities.[17] However, as the development of high-voltage transmission lines capable of carrying electricity over long distances enabled interstate wholesale electricity sales, a federal regulatory framework emerged.[18] This framework would adapt over time to address multiple policy objectives, namely the provision of least-cost electricity through competition, the promotion of system reliability, and the minimization of adverse environmental impacts.[19]

A. The Rise of Federal Electricity Regulation

Growing interstate competition among electric utilities in the early twentieth century necessitated federal oversight of wholesale electricity sales.[20] The ability of electric utilities to generate power in one state and transmit it to another state for distribution raises Commerce Clause issues and effectively elevates the regulation of electricity sales from a state concern to a national interest.[21] In the seminal case, *Public Utilities Commission of Rhode Island v. Attleboro Steam & Electric Co.*, a Rhode Island electric utility agreed to supply Attleboro Steam & Electric Company, a Massachusetts utility, all of the electricity required to serve Attleboro's retail electricity load.[22] When the Public Utilities Commission of Rhode Island unilaterally increased the wholesale electricity price,

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14. PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372, 383 (D.N.J. 2013).

15. *Id.* at 381 (defining capacity as the ability to produce sufficient energy to meet demand).

16. *Id.* at 383 (explaining that each utility was granted an exclusive service territory by the state).

17. New York v. FERC, 535 U.S. 1, 5 (2002) (stating that although there were some interconnections between utilities, most operated as separate individual monopolies).

18. *Hanna*, 977 F. Supp. 2d at 383–84 (explaining that utilities no longer had to maintain capacity to meet peak demand because they could contract bilaterally in wholesale markets to supply peak demand).

19. *See New York v. FERC*, 535 U.S. at 7–10 (explaining that improved efficiency in power generation and the development of interconnected transmission grids leads to Congressional action to promote the development of new generation facilities, the conservation of fossil fuels, and the development of competitive bulk power markets).

20. *See* 16 U.S.C. § 824(a) (2012) (illustrating the Attleboro gap, which was ultimately filled by the Federal Power Act).

21. Pub. Utils. Comm'n of R.I. v. Attleboro Steam & Elec. Co., 273 U.S. 83, 89–90 (1927) (holding that the transmission of electricity between two states is interstate commerce, and as such the rates charged for wholesale electricity is not subject to regulation by either state).

22. *Id.* at 85–86 (specifying a basic rate for electricity sold).

Attleboro objected on the ground that the Commission's regulation placed a direct burden on interstate commerce.[23]

The Supreme Court held that the price of electricity sold by the Rhode Island company to the Massachusetts company was not subject to regulation by either state "in the guise of the protection of their local interests."[24] Instead, the regulation of wholesale electricity sales could be achieved only "by the exercise of the power vested in Congress."[25] Congress enacted Part II of the Federal Power Act ("FPA") in 1935 to fill the regulatory gap identified in *Attleboro*.[26]

B. The FPA and Public Utilities Regulatory Policy Act ("PURPA"): Zeitgeists of the New Deal and the Arab Oil Embargo

Part II of the FPA is broadly viewed as a New Deal consumer protection measure that curbs monopoly abuses by utility companies and promotes the provision of electricity at the lowest possible rates.[27] The statute bifurcates the regulation of electricity sales between the federal government and the states.[28] Section 201 of the FPA established exclusive federal jurisdiction, exercised by the FERC, over the transmission and sale of electric energy in interstate commerce.[29] Section 205 requires the FERC to ensure just and reasonable rates for the transmission or sale of wholesale electricity, and, at the same time, prohibits undue discrimination and preferential treatment.[30] States, on the other hand, retain their traditional authority over retail

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23. *Id.* at 86 (finding that the rate was unreasonably low and could threaten the general public welfare if it prevented the Rhode Island utility from fully serving its other customers).

24. *Id.* at 90 (creating the "Attleboro gap").

25. *Id.* (noting the national interest encompassed within interstate electricity sales).

26. New York v. FERC, 535 U.S. 1, 6 (2002) (noting that the FPA went beyond the Attleboro gap and extended federal control to some areas that had previously been governed by the states).

27. *See* Pub. Sys. v. FERC, 606 F.2d 973, 979 n.27 (D.C. Cir. 1979) (observing that the just and reasonable standard of the FPA aims to protect consumers from exorbitant prices and unfair business practices); *Contra* Rossi & Hutton, *supra* note 13, at 1320 (arguing that Congress' original design in the FPA was not limited to preserving low electricity rates, but also "established a framework for articulation of national energy goals and their implementation by the states").

28. *See* Rossi & Hutton, *supra* note 13, at 1343 (noting that the FPA provided a structure designed to disable states from the extremes of protectionist wholesale price regulation that imposed costs on other states, without displacing the ability of states to pursue their own retail pricing policies).

29. 16 U.S.C. § 824(a) (2012) (expressly limiting federal regulation only to those matters which are not subject to regulation by the states).

30. 16 U.S.C. § 824d(a)-(b) (2012) (clarifying that FERC jurisdiction does not extend to local distribution and transmission of electricity in intrastate commerce).

electricity rates and power generation facilities.[31]

While the FPA may have been founded on the principle of consumer price protection, evolving market conditions have forced Congress to explicitly incorporate other goals into the national electricity regulatory policy.[32] For example, in the 1970s, approximately one-third of the nation's electricity was generated using oil and gas.[33] When the 1973 Arab Oil Embargo almost quadrupled oil prices within a six-month period,[34] the rapid increase in the price of fuel inputs resulted in higher power plant operating costs, decreased efficiency of the generating units, and ultimately higher consumer electricity prices.[35] Congress passed PURPA in 1978 to combat the impacts of the energy crisis on the electricity sector through conservation and energy efficiency.[36]

PURPA explicitly embraced multiple policy goals, namely, (1) conservation of energy supplied by electric utilities; (2) optimization of the efficiency of facilities and resources by electric utilities; and (3) provision of equitable rates to electricity consumers.[37] The development of renewable energy resources, such as solar, wind, biomass, and geothermal energy, was an attendant PURPA goal, as non-traditional energy sources signified safe, environmentally attractive substitutes for scarce fossil fuels.[38] Accordingly, Section 210 of PURPA required electric utilities to purchase wholesale electricity from qualifying cogeneration[39] and small

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31. PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372, 383–84 (D.N.J. 2013) (observing that from 1920 to the late 1980s, utilities operated under the concurrent supervision of federal and state regulators).

32. *E.g.*, FERC v. Mississippi, 456 U.S. 742, 743 (1982) (enumerating the three regulatory goals of PURPA).

33. *Id.* at 745 (noting that electricity generation was one of the fastest growing sectors of the nation's economy).

34. Michael L. Ross, *How the 1973 Oil Embargo Saved the Planet*, FOREIGN AFF. (Oct. 15, 2013), *available at* http://www.foreignaffairs.com/articles/140173/michael-l-ross/how-the-1973-oil-embargo-saved-the-planet.

35. *FERC v. Mississippi*, 456 U.S. at 745–46 (determining that Congress was concerned with conserving oil and natural gas).

36. *See* Richard D. Cudahy, *PURPA: The Intersection of Competition and Regulatory Policy*, 16 ENERGY L.J. 419, 421 (1995) (explaining that PURPA was Part V of the National Energy Act, which was intended to further the United States' energy self-sufficiency).

37. 16 U.S.C. § 2611 (2012) (achieving these goals entailed adopting and implementing specific rate designs).

38. Cudahy, *supra* note 36, at 421 (explaining that non-traditional resources were non-depletable and environmentally benign).

39. *See generally* W.M. WARWICK, U.S. DEP'T OF ENERGY FEDERAL ENERGY MANAGEMENT PROGRAM, A PRIMER ON ELECTRIC UTILITIES, DEREGULATION, AND RESTRUCTURING U.S. ELECTRICITY MARKETS, A.5 (2002), *available at* http://eere.pnnl.gov/femp/publications/Primer-ElectricUtilitiesDeregulationRestructuring.pdf (defining a cogenerator as an efficient,

power production facilities at full-avoided cost.[40] As the energy crisis subsided, however, competition and energy market liberalization overtook conservation and fuel diversity as prime regulatory goals.

C. The Rising Tide of Deregulation and Market-Based Reforms

Academic criticism of regulatory capture is considered the fountainhead of the deregulation movement.[41] The notion that regulatory agencies tend to be captured by the industries that they are tasked to regulate cast doubt on the need for direct regulation, and has galvanized industry-wide restructuring of telecommunications, railroads, airlines, and natural gas.[42]

In 1992, the FERC issued Order No. 636, which increased competition in the natural gas market by requiring gas pipeline companies to unbundle their supply and transportation services, and to provide "open access transportation that is equal in quality for all gas supplies, regardless of whether the gas is supplied by the pipeline company or not."[43] This non-discriminatory access to pipeline transportation services revolutionized the natural gas industry by spurring unprecedented exploration and pipeline construction, which increased natural gas supply, reduced prices, and effectively erased memories of the fuel shortages of the 1970s.[44] These market forces had a profound impact on the electricity industry, as cheap natural gas became the preferred fossil fuel for electricity generation.[45] Moreover, the deregulation of the natural gas market became the model for restructuring the electricity market.[46]

Rising electricity costs, despite little to no growth in electricity usage, had led to the general sense that electricity prices could only be reduced

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environmentally preferable facility that produces electricity and another useful form of thermal energy).

40. Cudahy, *supra* note 36, at 422 (explaining that electric utilities were reluctant to purchase power from competing independent power producers).

41. Richard D. Cudahy, *Whither Deregulation: A Look at the Portents*, 58 N.Y.U. ANN. SURV. AM. L. 155, 161 (2001) (citing works by Coase, Demsetz, and Stigler & Friedland).

42. *Id.* at 161–69 (citing the Interstate Commerce Commission as a bellwether of declining independent regulatory agencies).

43. Re Pipeline Serv. Obligations, 59 FERC ¶ 61,030, 1992 WL 510723, at *4 (Apr. 8, 1992) (allowing gas pipeline customers to select gas supply and transportation services).

44. Warick, *supra* note 39, at 6.3 (noting that as gas prices fell, profits increased from increased sales).

45. Cudahy, *supra* note 36, at 424 (explaining that natural gas is utilized by combustion turbine plants, which can be constructed quickly and with less capital).

46. Warick, *supra* note 39, at 6.4; *accord* Cudahy, *supra* note 41, at 169 ("In a number of respects, natural gas was to be the model for electricity deregulation, but in practice electricity has proven more challenging.").

through competition.[47] In response, Congress and the FERC followed the natural gas deregulation model and undertook a series of market-based reforms to promote competition in the wholesale electricity market.[48] First, the Energy Policy Act of 1992 authorized the FERC to order individual utilities to provide transmission services to unaffiliated wholesale power generators on a case-by-case basis.[49] In 1995, the FERC issued a Notice of Proposed Rulemaking that outlined a rule requiring public utilities that own transmission facilities to provide non-discriminatory open-access transmission services, essentially making transmission companies common carriers of electricity.[50] The Notice of Proposed Rulemaking ultimately resulted in FERC Order No. 888, which ordered the "functional unbundling" of wholesale generation and transmission services.[51] To promote the efficiency of electricity transmission systems, the FERC encouraged market participants to organize into Regional Transmission Organizations ("RTOs"), which exercise consolidated control of all transmission services and provide a platform for wholesale power markets.[52]

The market-based transformation of wholesale electricity markets also aligned with PURPA reform, as reformers decried the law's mandatory purchase obligation as outdated and anticompetitive.[53] The Energy Policy

47. *See* Cudahy, *supra* note 41, at 171 (explaining that cost overruns in the construction of nuclear power plants implied that economies of scale could not be realized to reduce electricity prices).

48. *See generally id.* at 159 (clarifying that electricity transmission and distribution remain regulated functions as they constitute natural monopolies). *See also id.* at 170 (noting that large industrial users seeking to shop for cheaper power pushed for retail competition).

49. Energy Policy Act of 1992, § 721, 16 U.S.C. § 824(j) (2012).

50. Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities, 60 Fed. Reg. 17,662, 17,663–64 (Mar. 28, 1995) (codified at 40 C.F.R. pt. 86) ("To achieve the benefits of robust, competitive bulk power markets, all wholesale buyers and sellers must have equal access to the transmission grid.").

51. New York v. FERC, 535 U.S. 1, 11 (2002) (explaining that functional unbundling requires "each utility to state separate rates for wholesale generation, transmission, and ancillary services, and to take transmission of its own wholesale sales and purchases under a single general tariff").

52. PPL EnergyPlus, LLC v. Nazarian, 974 F. Supp. 2d 790, 799–800 (D. Md., 2013) (explaining that vertically integrated utilities denying transmission access to alternative producers inhibited the development of wholesale electricity markets).

53. Michael D. Hornstein & J.S. Gebhart Stroemer, *The Energy Policy Act of 2005: PURPA Reform, the Amendments and Their Implications*, 27 ENERGY L.J. 25, 31 (2006) (proffering other critiques such as unnecessary costs and insufficient encouragement of renewable resource development). *Contra* Cudahy, *supra* note 36, at 425 (arguing that PURPA introduced competition into the electric marketplace through regulatory intervention).

Act of 2005 provided for the termination of an electric utility's obligation to purchase wholesale power from qualifying facilities if the FERC finds that cogeneration and small power production facilities have nondiscriminatory access to sell energy and capacity in wholesale electricity markets.[54] Critics of PURPA reform, however, were concerned that a competition regime would result in market mechanisms that would converge on a "cheapest power approach," which recognizes only internalized costs and ignores intangible societal values such as fuel diversity, reliability, and environmental costs.[55] Electriccity market restructuring at both the wholesale and retail levels unearthed tensions between consumer populism, which entails providing electricity at the lowest possible cost, and advancement of other societal and regulatory values.[56]

By way of example, deregulation of retail electricity markets enjoyed wide support in states with high retail electricity rates, which stymied economic growth as businesses chose to expand in low-cost states.[57] Proponents of deregulation promised lower retail rates through both consumer choice and competition in electricity supply.[58] , California's deregulation measures required investor-owned utilities to divest their electricity-generating assets.[59] The deregulated power supply would be bid to the California Independent System Operator on a daily basis, and load-serving utilities would purchase their supply requirements in a competitive wholesale market.[60] Utilities were prohibited by law from purchasing

54. 16 U.S.C. § 824a-3(m).

55. *See* Cudahy, *supra* note 36, at 421 (commenting that the FERC, in disapproving a PURPA order as unnecessary and expensive, "does not seem to permit assessing the probabilities of even an impending or foreseeable conversion of social costs to pecuniary costs").

56. *See id.* at 436 (predicting that the FERC's PURPA enforcement could lead to an approach wherein internalized costs are dispositive and work to the exclusion of other regulatory values, including environment, diversity of generation, energy self-sufficiency).

57. Warwick, *supra* note 39, at 6.1.2 (explaining that state integrated resource planning maintained low rates, but the process was adversarial, time-consuming, and expensive).

58. *See* Cudahy, *supra* note 41, at 170 (explaining that large industrial retail customers promoted retail deregulation as means of securing cheaper power).

59. Steven Ferrey, *The Eagles of Deregulation: The Role of the Courts in a Restructured Environment*, 32 ENVTL. L. 297, 299 (2002) (clarifying that as retail price caps discouraged retail customers from switching electricity suppliers, utilities still had to supply over 90 percent of the power being sold in the state despite having divested their generation assets).

60. *Id.* (explaining that after deregulation the California Energy Commission no longer assessed the State's generation needs).

power through long-term contracts.[61] On the demand side, consumers were free to shop among retail service providers; however, retail prices were initially reduced by ten percent and subsequently frozen at that level.[62]

The California plan famously imploded in 2000 when the market failed to produce sufficient electricity supply to meet consumer needs.[63] A combination of factors, including increased demand due to a growing economy and unusually hot summer temperatures, as well as a lack of supply due to reduced output from hydropower facilities, a failure to add new generating capacity in the past, and manipulation of the spot market, resulted in soaring wholesale electricity rates and rolling blackouts.[64] Utility companies faced bankruptcy as the retail rate freeze prevented them from recovering their purchased power costs.[65]

The market failure in California challenges the notion that the least-cost mix of generation produced by a competitive market, also provides the most reliable sources of electricity.[66] Some observers questioned whether market price signals alone are enough to ensure the level of system reliability demanded by the public.[67] The tension between competitive electricity markets and reliability concerns arose once again in recent litigation over state-subsidized power projects.

D. The PJM Cases

In a series of cases involving the PJM Interconnection, LLC ("PJM") market, (hereinafter collectively referred to as the PJM cases) t federal courts were called upon to adjudicate the boundary between the FERC's authority to set wholesale electricity rates and a state's authority to incentivize the construction of generating facilities in deregulated

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61. Cudahy, *supra* note 41, at 174 (explaining that utilities could not hedge their forward electricity supply, leaving them exposed to wholesale price increases).

62. *Id.* at 175 (describing the retail price freeze as a concession to residential customers to garner political support for deregulation).

63. *See id.* at 177 (recounting that when wholesale electricity prices increased dramatically, electric utilities implemented rolling black-outs as a means of rationing the available wholesale electricity, which was in shortage).

64. *Id.* at 174 (noting also that the Department of Energy under the Clinton Administration issued orders for wholesale generators to continue serving the California market; the Bush Administration discontinued the order in Jan. 2001).

65. Ferrey, *supra* note 59, at 309 (describing PG&E's Chapter 11 bankruptcy filing in April 2001).

66. See Cudahy, *supra* note 36, at 438 (observing that market proponents espoused an "expansive faith in competition and toward the rejection of policy judgments articulated independently of market forces").

67. Cudahy, *supra* note 41, at 186 ("It may be that the price signals are not quick enough or sure enough means of controlling the electricity delivery system to satisfy the public demand for reliability and price stability.").

electricity markets.[68]

PJM operates the country's largest competitive wholesale electricity market, in a region spanning from North Carolina to Chicago.[69] As the system operator, PJM must secure a sufficient amount of electric capacity within its footprint to provide reliable service during periods of peak demand.[70] To this end, PJM holds competitive capacity auctions wherein generators bid to supply capacity three years in advance; the auction clears at the price where the offered supply equals the forecasted demand.[71] PJM's FERC-approved market design, known as the Reliability Pricing Model ("RPM"), is meant to provide long-term forward price signals to indicate scarcity and the need for new capacity.[72] Electricity-generating companies will decide whether to expand operations or construct new power plants based on these market signals.[73]

While the FERC was satisfied that the RPM had succeeded in securing sufficient capacity for the PJM region as whole, some state and local authorities, including those in Maryland and New Jersey, argued that the RPM failed to inspire new development necessary to meet reliability needs in their local areas.[74] In response to the perceived localized market failures, Maryland and New Jersey individually offered out-of-market subsidies to select project developers for the construction of new natural gas-fired power plants in certain capacity-deficient areas.[75] The FERC

68. N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74 (3d Cir. 2014); .PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372 (D.N.J. 2013), *aff'd by* PPL EnergyPlus, LLC v. Solomon, 766 F.3d 241 (3d Cir. 2014), *petition for cert. filed,* 83 U.S.L.W. 3564 (Dec. 10, 2014) (No. 14–694); ; PPL EnergyPlus, LLC v. Nazarian, 974 F. Supp. 2d 790 (D. Md. 2013), *aff'd* 753 F.3d 467 (4th Cir. 2014), *petition for cert. filed,* 83 U.S.L.W. 3450 (Nov. 25, 2014) (No. 14–614).

69. PJM Interconnection, LLC, 117 FERC ¶ 61,331 (2006) (explaining that the PJM market covers 14 states from the Eastern Seaboard, including North Carolina, to Chicago).

70. *N.J. Bd. of Pub. Utils.*, 744 F.3d at 82 (explaining that PJM requires member utilities that sell electricity to end-use customers to secure their proportionate shares of the expected peak load three years in advance).

71. *Hanna*, 977 F. Supp. 2d at 388.

72. *Id.* at 387–88; *see also PJM Interconnection, LLC*, 117 FERC at ¶ 62,652–56 (approving the RPM to replace existing market rules, which the FERC found to be unjust and unreasonable because the old rules created significant price volatility and failed to set prices at levels necessary to ensure sufficient investment to meet the anticipated growth in electricity demand).

73. *Hanna*, 977 F. Supp. 2d at 387–88 (clarifying that forward price signals do not signify long-term revenue assurances for generators and developers).

74. PJM Interconnection, LLC, 137 FERC ¶ 61,145, 2011 WL 5893596 at *1–2 (Nov. 17, 2011) (recounting the states' argument that the Minimum Offer Price Rule (MOPR) impedes state and local efforts to ensure reliability by mitigating or automatically raising the offer price of certain new projects).

75. *See* PPL EnergyPlus, LLC v. Nazarian, 974. F. Supp. 2d 790, 821 (D. Md.

countermanded these state initiatives by changing the PJM tariff to eliminate such state-sponsored entries.[76] The FERC argued that subsidized, uneconomic entry into competitive markets can produce unjust wholesale rates by artificially depressing capacity prices.[77] Conversely, Maryland and New Jersey argued that the FERC's action encroached upon the states' exclusive authority over "facilities used for the generation of electric energy" under the FPA.[78]

The courts ultimately resolved the jurisdictional conflict in the FERC's favor based on the field preemption doctrine. In *PPL Energyplus, LLC v. Nazarian* and *PPL Energyplus, LLC v. Hanna*, the federal district courts of Maryland and New Jersey respectively determined that the states impermissibly intruded upon the FERC's exclusive ratemaking authority under Section 205 of the FPA when they mandated subsidized payments to state-approved projects.[79] The United States Court of Appeals for the Third Circuit wrestled with the inverse proposition in *New Jersey Board of Public Utilities v. FERC*, and found that the FERC, in limiting the states' ability to subsidize capacity bids, did not interfere with the states' authority to regulate generating facilities.[80] Thus, the traditional power of the states to direct the construction of electricity generation resources is inherently circumscribed by the constructs of the competitive markets in which they participate.[81] However, the Third Circuit, in *PPL EnergyPlus, LLC v.*

2013) (explaining that the Maryland Public Service Commission ordered electric distribution companies ("EDCs") to enter in contracts for differences, which guarantee project developers fixed revenues); *Hanna*, 977 F. Supp. 2d at 393 (explaining that the N.J. LCAPP statute required EDCs to pay eligible generators the difference between the capacity auction clearing price and their actual development costs).

76. PJM Interconnection, LLC, 135 FERC ¶ 61,022, 61,106, 2011 WL 1383624 at **28–29 (Apr. 12, 2011) (eliminating the state-mandated exemption to the Minimum Offer Price Rule).

77. *Id.* at 61,105–06 (citing the Pennsylvania Commission's argument that one state's subsidized uneconomic entry can depress overall market prices and discourage investment in other states).

78. N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 95 (3d Cir. 2014) (also articulating the states' second argument that the FERC acted arbitrarily and capriciously when it approved the elimination of the state-mandated exemption to the MOPR without sufficiently explaining its reasons for departing from the 2006 Settlement).

79. *Nazarian*, 974 F. Supp. 2d at 825–29; *Hanna*, 977 F. Supp. 2d at 407–09.

80. *N.J. Bd. of Pub. Utils.*, 744 F.3d at 97–98 (citing Conn. Dep't of Util. Control v. FERC, 569 F.3d 477, 18 (D.C. Cir. 2009) (stating that New Jersey and Maryland are free to make their own decisions regarding how to satisfy their capacity needs, but they "will appropriately bear the costs of [those] decisions")'.

81. *See Nazarian*, 974 F. Supp. 2d at 829 ("[A]fter a generator physically comes into existence and operation and participates in the wholesale electric energy market, the prices or rates received by that generator in exchange for wholesale energy and capacity sales are within the sole purview of the federal government.").

Solomon, affirmed the findings of the district court in *Hanna* and clarified that states can use other policy tools that do not affect wholesale rates to achieve their reliability goals.[82] Thus, when states regulate within their authority to select the types of new generation facilities to be built and where to build them, the incidental effects of the new supply on wholesale electricity rates do not trigger federal jurisdiction.[83]

II. BEYOND SUBOPTIMAL: MOVING AWAY FROM DECISION-MAKING IN A SILO

The essential nature of electricity in the modern world demands that regulation of this commodity embrace various societal goals.[84] If regulation is "the art of making unpleasant choices wisely,"[85] then the regulation of electricity is an optimization problem with several simultaneous objective functions. To the extent that electricity is positively correlated with economic wellbeing, regulation must aim to minimize electricity costs in order to protect consumers from the abuses of monopoly power by electric utility companies.[86] Moreover, as reliable electric supply is necessary to support public welfare, regulation must secure sufficient generating and transmission capacity to meet electricity demand.[87] Finally, as the national grid and the myriad power plants that feed it impose significant environmental costs, regulation must both minimize harm to public health and the environment, and secure public consent for

82. PPLEnergyPlus, LLC v. Solomon, 766 F.3d 241, 253 (3d Cir. 2014).

83. *Id.* at 255 ("The states' regulatory choices accumulate in to the supply transacted through the interstate market.").

84. *See* Huber, *supra* note 7, at 1003–04 (arguing that electricity is inseparably married to national welfare through its impact on the national economy and the environment).

85. *Id.* at 1004–05 (internal quotations omitted) (as risk is ubiquitous, "the regulation of health, safety, and the environment presents its own brand of tragic choice").

86. *See id.* at 1003 n.1 (noting that growth in electricity supply has accompanied growth in the national economy for many decades, but causation is unclear); Rossi & Hutton, *supra* note 13, at 1318 (explaining that the conventional account of the FPA's just and reasonable standard as a New Deal deterrent against monopoly abuses is consonant with the progressive era's regulatory focus on keeping rates as low as possible to protect consumers); Rossi & Hutton, *supra* note 13, at 1306 (explaining that the avoided cost requirement under PURPA reflects a consumer protection objective).

87. *See also* Amy L. Stein, *The Tipping Point of Federalism*, 45 CONN. L. REV. 217, 254 (2012) (observing that the growing gap between electricity supply and demand, as evidenced by prior blackouts, raised Congressional concern over national energy security); *Cf.* 16 U.S.C. § 824a(c) (2012) (providing that in times of war or electricity shortage, the FERC has the authority to order the generation, delivery, interchange, or transmission of electric energy that will best meet the emergency or serve the public interest).

development.[88]

Some of the decisions that confront electricity regulators include: how much generating and transmitting capacity should be installed; what type of generating technology should be employed; how much utility companies can charge for wholesale and retail sales; and whether the rates should be determined through regulation or market-based processes.[89] To complicate matters further, constitutional limitations, federalism, and the discrete jurisdictional boundaries of federal agencies demand that the authority to make such decisions be distributed among numerous national and sub-national actors.[90] For example, the Commerce Clause mandates federal regulation of wholesale electricity rates.[91] States, however, retain authority over retail electricity rates and most power plant siting and construction.[92] Nuclear and hydro power plants are federally licensed and regulated by the Nuclear Regulatory Commission ("NRC") and the FERC, respectively.[93] Further, environmental regulation of power plants is split along similar lines between the EPA, the NRC, and the FERC.[94] Finally, where states have chosen to deregulate their electricity generation markets, they implicitly vest the competitive market with the authority to set price and capacity levels.[95]

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88. Huber, *supra* note 7, at 1002–04 (describing the national power system as the "largest, most costly, and environmentally most voracious structure on our landscape").

89. *See* Stein, *supra* note 87, at 219–223 (siting of electricity generation); CLAIRE E. KREYCIK ET AL., NAT'L RENEWABLE ENERGY LAB., PROCUREMENT OPTIONS FOR NEW RENEWABLE ELECTRICITY SUPPLY (2011), *available at* http://www.nrel.gov/docs/fy12osti/52983.pdf (evaluating renewable energy procurement and pricing). *See generally* Huber, *supra* note 7, at 1003–07 (discussing regulatory choices in the environmental regulation of electricity).

90. *See, e.g.*, Steven Ferrey et. al., *Fire and Ice: World Renewable Energy and Carbon Control Mechanisms Confront Constitutional Barriers*, 20 DUKE ENVTL. L. & POL'Y F. 125, 127 (2010) (commenting that in a federalist system, state action to abate global warming and promote renewable energy is limited by the Supremacy Clause of the Constitution, which among other things, acts as a barrier to State implementation of feed-in tariffs).

91. FERC v. Mississippi, 456 U.S. 742, 757 (1982) (declaring that "it is hard to conceive of a more basic element of interstate commerce than electric energy").

92. 16 U.S.C. § 824(b) (reserving for the States the authority to regulate retail electricity sales).

93. 42 U.S.C. § 5842 (2012) (establishing NRC jurisdiction over commercial nuclear power plants); 16 U.S.C. § 797(e) (2012) (establishing FERC jurisdiction over federal hydropower plants).

94. *See* Huber, *supra* note 7, at 1010–12 (discussing the authority of the EPA, NRC and FERC, as the three main environmental and safety agencies in the power industry, to promote and force technologies within their jurisdictions).

95. *See* Ferrey, *supra* note 59, at 299 (explaining that after California deregulated, market participants, not the California Energy Commission, were responsible for securing power supply).

The partition of decision-making functions along jurisdictional bounds, while necessary given our federal system, effectively reduces multi-objective optimization — the procuring right mix of electricity production and technology that minimizes cost, maximizes reliability and minimizes environmental damage — into a series of discrete choices.[96] When multiple regulators each act in isolation to maximize their individual objective functions, they can work at cross-purposes and thereby arrive at suboptimal or even zero-sum outcomes.[97] The federal preemption of states' initiatives to develop renewable energy and new capacity resources are salient examples of how jurisdictional partitions may prioritize one regulatory regime to the detriment of another.[98]

A. The Problem of Preemption: Crowding Out State Authority over Electricity Markets

The Supremacy Clause allows federal law to supersede state law either expressly by an act of Congress, or impliedly through occupation of a field or as a the result of a conflict with state law.[99] Energy law relies on jurisdictional clarity to resolve preemption issues.[100] The settled approach to federal preemption in energy statutes assumes that federal and state governments serve as functional substitutes. Thus, when Congress expands federal authority in a given field, it produces a commensurate contraction in state and local authority through the adoption of preemption "ceilings," which create unitary national standards.[101] When Congress has not clearly

96. *Cf.* Huber, *supra* note 7, at 1003 (illustrating a similar dynamic in the context of environmental regulation wherein multiple federal agencies sharing authority with states over the single market for electric power never squarely confront total electricity supply and its aggregate environmental cost).

97. *See id.* (explaining that as regulatory authority over the electric power industry is dispersed among numerous regulators, final policy choices are often litigated and extreme positions crowd out the broader middle ground).

98. *See* N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74 (3d Cir. 2014); .PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372 (D.N.J. 2013), *aff'd by* PPL EnergyPlus, LLC v. Solomon, 766 F.3d 241 (3d Cir. 2014), *petition for cert. filed,* 83 U.S.L.W. 3564 (Dec. 10, 2014) (No. 14–694); PPL EnergyPlus, LLC v. Nazarian, 974 F. Supp. 2d 790 (D. Md. 2013), *aff'd* 753 F.3d 467 (4th Cir. 2014), *petition for cert. filed,* 83 U.S.L.W. 3450 (Nov. 25, 2014) (No. 14–614).

99. *Compare Hanna*, 977 F. Supp. 2d at 408–11 (finding that the LCAPP statute was preempted under both the field and conflict preemption doctrines) *with Nazarian*, 974 F. Supp. 2d at 841 (leaving open the issue of conflict preemption after finding that the Generation Order was field preempted).

100. Rossi & Hutton, *supra* note 13, at 1286 (observing that while the entire field of electric power regulation of public utilities is within Congress' power to preempt under its Commerce Clause authority, Congress has consistently protected the role of states in controlling certain aspects of public utility operations).

101. *Id.* at 1287 (noting also that state and local authority expands in areas where Congress fails to adopt a clear national policy, such as a comprehensive policy

delineated the limits of federal and state authority, courts define the boundaries.[102]

The unitary preemption approach presumes that the federal statute and the challenged state law address the same regulatory objective.[103] However, where Congress has not articulated a clear regulatory purpose, or where a pervasive federal regime touches upon a state law addressing an unrelated regulatory aim, the unitary preemption standard may prevent states from implementing their desired policies.[104] In the PJM cases, federal courts Circuit applied the unitary field preemption approach to interpret the FERC-approved RPM as a price ceiling that prevents Maryland and New Jersey from guaranteeing above-market prices.[105] However, unlike the preemption of state clean energy regulations, which signify state experimentation in a field unaddressed by Congress, the PJM cases resulted in the preemption of state initiatives intended to resolve reliability needs, a traditional state concern.[106]

B. Expansion of Federal Authority in Deregulated Electricity Markets

At first blush, the finding of federal preemption in the PJM cases may be a surprise given that the Supreme Court has articulated a general presumption that in the case of a conflict with a state law, the "historic police powers of the states shall not be superseded unless it [is] the clear

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addressing climate change).

102. *See id.* (arguing that the interpretive approach adopted by courts with respect to energy statutes should favor floor preemption similar to the approach applied in environmental law).

103. *Id.* at 1287–88 (explaining that traditional federal preemption in energy law assumes that federal and state governments can serve as substitutes for each other).

104. *See id.* (asserting that the unitary preemption approach is likely to be incongruous when applied to clean energy regulation); *cf.* SCOTT HEMPLING ET AL., NAT'L RENEWABLE ENERGY LAB., RENEWABLE ENERGY PRICES IN STATE-LEVEL FEED-IN TARIFFS: FEDERAL LAW CONSTRAINTS AND POSSIBLE SOLUTIONS (2010), *available at* http://www.nrel.gov/docs/fy10osti/47408.pdf (explaining that the FERC's ratemaking authority under the FPA and the avoided cost cap under PURPA may likely preempt states from establishing feed-in tariffs to promote the deployment of renewable energy resources).

105. *See* PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372, 406 (D.N.J. 2013) (holding that the LCAPP standard offer capacity contracts occupy the same field as the RPM Auction); PPL EnergyPlus, LLC v. Nazarian, 974 F. Supp. 2d 790, 833 (D. Md. 2013) (holding that the Generation Order fixes the monetary value of wholesale energy and capacity and is thus preempted by the FERC-approved auction mechanism).

106. Response/Reply Final Brief for Petitione'r/Cross-Respondent't Maryland Public Service Commissio'n at 7, N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74 (3d Cir. 2013) (Nos. 11–4245, et al.), 2013 WL 2474552, at *7 (arguing that the FERC disregarded substantial, undisputed evidence that the Maryland Public Service Commission acted solely to address a legitimate reliability need).

and manifest purpose of Congress."[107] This implies that despite the pervasiveness of the FERC's regulation of wholesale electricity rates, states may still be permitted to operate at the interstices of the regulatory scheme to address their local concerns.[108] However, Congress' promotion of competitive markets over the last twenty years can be construed as evidence of its clear purpose to displace state initiatives that impact wholesale market price mechanisms.[109]

Further, deregulation and competition expand the scope of federal regulation over electricity markets simply by increasing the number of wholesale transactions.[110] Aside from the fact that the RTOs operating competitive markets are subject to FERC jurisdiction,[111] deregulation introduces numerous brokers, aggregators, and intermediaries, thereby increasing the total number of wholesale transactions.[112] Thus, as deregulation confers federal authority over a larger proportion of electricity sales, the prerogative to define the governing principles over such sales shifts from state to federal authority.[113]

Some of the FERC's pricing principles are generally held to pose obstacles to state efforts to deploy renewable energy resources using state-level feed-in tariffs.[114] For example, the FERC has determined that while states are not precluded from implementing feed-in tariffs to support renewable energy projects, the prices that can be offered under such tariffs are capped by PURPA's avoided cost standard with respect to "Qualifying Facilities", and by FPA wholesale rates with respect to all other facilities.[115]

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107. *See* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947) (enumerating several ways in which Congress may manifest its intent to preclude state regulation).

108. *See* Viet D. Dinh, *Reassessing the Law of Preemption*, 88 GEO. L.J. 2085, 2106 (2000) ("[A] presumption against preemption at least would permit the States to regulate interstitially rather than be displaced altogether.").

109. *See Id.* (arguing that as Congress passes more legislation in a given field, the inference that Congress intends to displace state law through field preemption becomes stronger).

110. Steven Ferrey, *Exit Strategy: State Legal Discretion to Environmentally Sculpt the Deregulating Electric Environment*, 26 HARV. ENVTL. L. REV. 109, 172 (2002) (positing that competition creates more wholesale power transactions as generators sell power to aggregators and retail customers for distribution).

111. N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 82 (3d Cir. 2014).

112. Ferrey, *supra* note 110 (explaining that in 1998 wholesale power sales exceeded retail power sales by 500% compared to 1996).

113. *Id.* (predicting that the FERC's pricing principles may dominate state-level regulations through the filed rate doctrine).

114. *See* Jim Rossi, *Clean Energy and the Price Preemption Ceiling*, 3 SAN DIEGO J. CLIMATE & ENERGY L. 243, 250 (2012) (citing two FERC decisions that endorse a strong preemption position regarding prices in feed-in tariffs).

115. Cal. Pub. Utils. Comm'n, 132 FERC ¶ 61,047, 2010 WL 2794334 at **18

Similarly, the FERC's policy of promoting competitive markets has been construed as preempting state pricing initiatives.[116]

The PJM cases expand this trend as the PJM's FERC-approved capacity auction mechanism has been interpreted as a constraint on the ability of states to incentivize the development of new capacity resources, despite the fact that states have historically regulated power plant siting and construction.[117] As a result, the market clearing prices set by the RPM act as a ceiling to prices that electricity generators can receive, which in turn guide where and when new resources will be developed.[118]

The FERC's application of ceiling preemption in setting prices tends to emphasize the singular policy of consumer protection at the expense of other regulatory goals.[119] To allow for some rebalancing in favor of other objectives, Rossi & Hutton have proposed interpreting federalism in energy statutes to permit regulatory floors, similar to those found in environmental statutes, as a means of facilitating clean energy policies and other energy innovation by state and local regulators.[120] Thus, federal law, including the FERC's wholesale pricing standards, would serve as a minimum that precludes more lax state standards.[121] This approach to statutory interpretation is premised on the recognition that federal energy statutes encompass a broader range of values[122] in addition to consumer

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(Oct. 21, 2010) (setting forth the conditions under which California's feed-in tariff will escape preemption by PURPA and the FPA).

116. Rossi, *supra* note 114, at 254–55 (citing Duke Energy Trading & Mktg. v. Davis, 267 F.3d 1042, 1058–59 (9th Cir. 2001)).

117. *See* N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 97–98 (3d. Cir. 2014) (stating that New Jersey and Maryland are free to make their own decisions regarding how best to satisfy their capacity needs, but they will bear the consequences of those decisions, including possibly having to pay twice for capacity).

118. *See* PPL EnergyPlus, LLC v. Nazarian, 974 F. Supp. 2d 790, 813–14 (D. Md., 2013) (explaining that out-of-market subsidies offer effective rates that are greater than the market–clearing prices and citing expert opinion asserting that higher capacity prices in a locational deliverability area encourages projects to be developed in that area because the RPM "reflects the locational impact on need and on cost" of electric energy).

119. Rossi, *supra* note 114, at 265 (arguing that the "New Deal price regulation relic of ceiling preemption in setting prices" has led the FERC and the courts to emphasize consumer protection over other goals embodied in federal energy statutes).

120. Rossi & Hutton, *supra* note 13, at 1287–88 (arguing that absent clear evidence of congressional purpose to adopt unitary standards, an obvious conflict, or an obstacle to a clearly defined regulatory program, courts and agencies should generally favor floor preemption over ceiling preemption in the context of energy statutes).

121. *See id.* at 1336 (arguing that under a floor preemption approach, the FPA accords with feed-in tariffs and other state and local efforts to promote and subsidize renewable energy).

122. *See* Rossi, *supra* note 114, at 255–57 (arguing that PURPA encompasses numerous goals including conservation and fuel diversity, and that the FPA "just and

protection.[123] Indeed, states account for environmental protection, conservation, and efficiency when implementing state regulations, such as integrated resource planning.[124] The floor preemption approach, however, may not be applicable to the PJM cases because the challenged state actions implicate the FERC–approved market design rather than the actual price levels.[125]

The filed-rate doctrine posits that federal wholesale rate determinations may not be "second-guessed or overruled" by state regulatory commissions.[126] The doctrine is not limited to rates, but rather extends to other "non-rate matters" such that states must defer to any valid federal regulation.[127] Thus, given that the FERC-approved market rules — not the actual price levels — presented the constraint on state actions in the PJM cases, Maryland and New Jersey had to yield to FERC regulations that altered the market design.[128] Conversely, interpreting the final product of the market mechanism (the auction clearing prices) as a price floor would likely contravene the intended purpose of competitive markets.[129]

The FERC acknowledged the potential for deficiencies in market design and intimated that the solution is to incorporate features for the provision of for public goods, such as reliability and environmental attributes, into the overall architecture.[130] However, critics of this solution may point out that the PJM market rules approved by the FERC in 2006 did in fact account for

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reasonable mandate has evolved beyond New Deal consumer protection").

123. *See id.* at 257 (claiming that the recognition of diverse statutory values is more consistent with preemption floors rather than ceilings, except where an obstacle exists or Congress expressly intends to preempt state law).

124. *Id.* (noting a shift in "utility consensus," which recognized environmental and conservation goals, notwithstanding the fact that updates in the law may have been lagging).

125. *See* N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 97–98 (3d. Cir. 2014) (recounting the Petitioners' arguments attacking the FERC's elimination of the MOPR exemption for state-mandated resources).

126. Ferrey, *supra* note 110, at 170 (noting in Fed. Power Comm'n v. S. Cal. Edison, 376 U.S. 205, 215–16 (1964), that the Supreme Court determined that Congress intended to vest the federal government with exclusive jurisdiction over wholesale utility rates).

127. *Id.* at 170–71 (including regulation of QFs, independent power producers (IPPs), and public utilities).

128. *See id.* at 171 ("The [FPA] precludes all state regulation of interstate wholesale power transactions.").

129. *See* PJM Interconnection, LLC, 137 FERC ¶ 61,145, 2011 WL 5893596 at *90 (Nov. 17, 2011) (stating that the objective of the RPM is to provide the least-cost, competitively-priced combination of resources necessary to meet the region's reliability objectives on a three-year forward basis).

130. *Id.* (stating that RPM has no feature to explicitly recognize environmental or technological goals, or to contemplate reliability needs beyond a 3-year forecast).

the long-term reliability goals of the states by guaranteeing auction clearance for a state's self-supplied generation.[131] The provision was eliminated and subsequently reinstated in modified form on the ground that guaranteed clearance would suppress market-clearing prices.[132] The mere fact that these issues were resolved through litigation rather than negotiation demonstrates that following the FERC's suggestion and modifying market rules through the stakeholder process alone may be easier said than done. A separate regulatory framework may be required to force the market to internalize the value of public goods, including long-term reliability.

C. The Clean Power Plan

The PJM's capacity auction operates under the paradigm that a single market clearing price, calculated for individual locational delivery areas, promotes economic efficiency by encouraging sellers to minimize their costs and thereby produce the least expensive mix of electricity resources necessary to meet demand.[133]

Under the "law of one price," it does not matter whether the electric energy is produced by an old generator or a new generator; the energy commodity itself, not its resource attributes, carries value in the marketplace.[134] This model provides incumbent generators with a bidding advantage because older facilities, having operated long enough to recover their capital costs, can bid into the market as "price-takers."[135] In comparison, new generators with un-depreciated capital costs are at a competitive disadvantage because their higher, cost-based bid prices may not clear the auction.[136] To the extent that the single market-clearing price reflects only the fixed cost of generation, and does not incorporate the value of the resource attributes of electricity, the least expensive mix of resources will likely be procured from older, more carbon-intensive

131. *See* N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 104 (3d. Cir. 2014) (criticizing the agency for "fundamentally changing the MOPR's treatment of self-supply, but barely acknowledging that it was making any change at all").

132. PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372, 391 (D.N.J. 2013) (describing changes to the MOPR in 2011 and 2013, which were implemented through modifications to the PJM tariff).

133. *Id.* at 387–88 (recounting expert testimony, which hypothesizes that competition among sellers who minimize costs results in low prices).

134. *Id.* at 389 (clarifying that energy prices may vary among PJM regions, known as Locational Delivery Areas, due to transmission constraints).

135. *Id.* at 390 (explaining that when an existing generator bids zero, it accepts the minimum benchmark price).

136. *Id.* at 389 (N.J. Board of Public Utilities rejecting the RPM theory on grounds that it is biased against new generators and volatile short-term capacity prices render long-term financing of new projects highly speculative).

plants.[137]

It therefore follows that if the market-clearing price can account for the value of resource attributes, then the market — acting as the regulator of last resort — can also advance the states' concomitant goals of promoting long-term system reliability, fuel diversity, and clean energy.[138] The EPA's proposed rulemaking for the regulation of carbon pollution by fossil fuel-fired power plants may provide states with a viable platform to incorporate the value of environmental and reliability attributes into the non-discriminatory wholesale electricity prices produced by deregulated markets.[139]

The CPP can be viewed as energy policy animated by environmental regulation.[140] As with other environmental regulations, the proposed rule establishes a cooperative federalism framework for reducing emissions by setting state-specific rate-based emissions goals, and affording states the latitude to develop individual implementation plans, which reflect the Best System of Emissions Reduction ("BSER").[141] In its narrowest context, the BSER is the combination of four building blocks used to determine state emissions targets.[142] However, the specific components of the BSER, which consist of:

137. *See* Respondent/Reply Final Brief for Petitione'r/Cross-Responden't Maryland Public Service Commission, *supra* note 106 (stating that the value of resource attributes, such as enhancing system reliability, reducing emissions, economic development, and competition are disregarded under the capacity market's net cost of new entry analysis); Petitione'r/Cross-Responden'ts' Joint Statement, N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74 (3d Cir. 2013) (Nos. 11–4245, et al.), 2013 WL 2474553, at *12 (citing the N.J. Legislature's findings in the Long-Term Capacity Agreement Pilot Program (LCAPP) statute that as a result of a lack of new electric generation facilities, New Jersey has become more reliant on coal-fired plants, and the state's fleet of generation facilities is aging, with over 50 percent of the plants being more than 30 years old).

138. FERC precedent contemplates the inclusion of environmental costs in wholesale electricity rates. *See* So. Cal. Edison Co., 70 FERC ¶ 61,215, 61,678 (1995) (Massey, concurring) ("The order expressly leaves open the possibility that states may account for the environmental costs of all fuel sources included in an all-source determination.").

139. *See* Carbon Pollution Emissions Guidelines for Existing Stationary Sources: Electricity Utility Generation Units, 79 Fed. Reg. 34,830, 34,832 (proposed on June 18, 2014) (to be codified at 40 C.F.R. pt. 60) [hereinafter *Clean Power Plan*] (proposing to reduce nationwide carbon emissions released by the power plant sector by 30 percent (compared to 2005 levels) by 2030).

140. *See id.* (imposing emissions reductions requirements for regulated electricity generating units pursuant to section 111(d) of the Clean Air Act).

141. *Id.* at 34,833–34 (characterizing the relationship between the EPA and the States under § 111(d) as a partnership wherein the EPA sets the goals and States take the lead in achieving them).

142. *See id.* at 34,855–58 (describing the EPA's analytical approach for determining the components and scope of the BSER).

> (1) reducing the carbon intensity of existing coal plants through technological changes designed to improve heat rates; (2) substituting generation from coal-fired plants through increased utilization of existing less carbon intensive units, including natural gas combined cycle plants; (3) substituting generation from coal-fired plants with generation from nuclear and renewable energy resources; and (4) reducing the total amount of electricity required through demand-side management[,][143]

encompass energy strategies that are already being implemented in some states.[144] As such, the CPP has the potential to federalize state energy policies to the extent that they are incorporated into state implementation plans.[145]

Conceptually, the CPP comports with the theoretical approaches articulated by both Rossi & Hutton and the FERC for facilitating the provision of public goods in deregulated electricity markets.[146]

The CPP accords with cooperative federalism in the energy sector because it sets federally enforceable emissions goals while giving states the ability to achieve their targets in a manner that suits their particular circumstances, such as load growth, existing market structures, and availability of generation resources.[147] Whereas Rossi & Hutton suggest that agencies and courts should interpret preemption floors in federal energy statutes, the CPP delineates the preemption floor for carbon emissions. Further, the CPP expressly grants states the flexibility to utilize different policy tools, such as the deployment of low-carbon energy resources, which can also advance concomitant energy goals, including the enhancement of system reliability.[148] Thus, despite the fact that the CPP relies on an environmental statute, Section 111(d) of the Clean Air Act ("CAA"), it promotes energy federalism in the manner envisaged by Rossi

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143. *Id.* at 34,877 (explaining that the combination of all four building blocks will result in greater emissions reductions at a lower cost than mandated reductions imposed on affected coal-fired plants only).

144. *See id.* at 34,835 (stating that the proposed rule builds on programs, such as renewable portfolio standards and energy efficiency measures, which have been enacted at the state level).

145. *See id.* at 34,844 (stating that once a state plan is approved by the EPA, its provisions become federally enforceable against the entities responsible for noncompliance).

146. *See id.* at 34,903 (interpreting section 111(d) of the CAA in a manner that gives states the flexibility to include other measures that are not performance standards in their implementation plans).

147. *See id.* at 34,853 (declaring that the statewide application of BSER allows states to account for local circumstances and state policy goals when determining how to reduce emissions from affected local sources).

148. *See id.* (allowing states to impose implementation plan obligations on entities other than the affected generating units).

& Hutton.[149]

In the PJM Cases, the FERC suggested that stakeholders can modify market rules to recognize broader objectives in the valuation of capacity resources. To this end, the CPP gives states the authority to establish requirements, such as emissions allowances or mandated control technologies, which can change the relative cost of coal-fired generation vis-à-vis natural gas-fired, renewable, and nuclear energy generation.[150] These requirements, in addition to forcing emissions reductions, can serve the parallel state goal of promoting the construction of new generating facilities to improve reliability.[151] Natural gas plants, which are subject to price mitigation rules in the PJM's capacity auction, may be more competitive if states require incumbent coal-fired generators to bear the cost of environmental compliance under the CPP.[152]

The FERC has indicated that the CPP need not conflict with the regulation of wholesale electricity markets.[153] Indeed, the regulatory adaptation required under the CPP may simply be an acceleration of changes that are gradually occurring as the state of technology moves the power sector from a resource mix dominated by coal to one grounded in natural gas.[154] For states that have been hindered by market constructs in deploying new natural gas generation, the CPP may be a policy tool, as envisioned by *Solomon*, that can be used to resolve local reliability needs without treading on the FERC's exclusive ratemaking authority.[155]

149. *See* Rossi & Hutton, *supra* note 13, at 1304 (asserting that as energy statutes encompass coextensive national, state, and local regulation, preemption should be applied narrowly to prefer floors over unitary standards).

150. *See Clean Power Plan*, *supra* note 139, at 34,882 (suggesting that states could change the relative costs of generation for more carbon-intensive generating units by imposing a cost on carbon emissions).

151. *See* PJM Interconnection, LLC, 137 FERC ¶ 61,145, 2011 WL 5893596, at *24 (Nov. 17, 2011) (asserting that natural gas-fired plants have the shortest development time to respond to reliability needs).

152. *See* PJM Interconnection, LLC, 135 FERC ¶ 61,022, 61,108, 2011 WL 1383624, at *31 (Apr. 12, 2011) (observing that unlike developers of generation technologies that require long lead times, developers of natural gas combustion turbine and combined cycle plants do not need to incur construction costs until after a project clears its first auction).

153. *FERC Perspectives: Questions Concerning EPA's Clean Power Plan and Other Grid Reliability Challenges: Hearing Before the Subcomm. on Energy and Power*, 113th Cong. 45 (2014) [hereinafter *FERC Hearing*] (statement of Cheryl A. Lafleur, Acting Chairman of FERC) (stating that the EPA makes environmental rules which become the baseline in which the [electricity] system is planned).

154. *Id.* at 51 (statement of Phillip D. Moeller, FERC Comm'r) ("[I]t is a gradual transition that is already occurring. We are already not building coal plants because the science is not changing. . . [S]o science is driving this change, not EPA.").

155. *See Clean Power Plan*, *supra* note 139, at 34,901 n.274 (noting that a state-driven portfolio plan is suitable for states that have restructured their electricity sectors

III. USING THE CPP TO ENABLE RESOURCE PLANNING

States like Maryland and New Jersey, which have electricity capacity needs that are not adequately addressed by competitive markets, should design state implementation plans that meet emissions reduction goals by adding new natural gas generation resources.

The CPP authorizes states to submit implementation plans that either place the responsibility for achieving emissions reduction fully and solely on the regulated coal-fired generators, or to adopt a portfolio approach, which places enforceable obligations on entities other than the regulated generators.[156] A portfolio-based implementation plan may, for example, include emissions limits imposed on coal-fired generators, and also a renewable portfolio standard ("RPS")[157] and energy efficiency measures that avoid carbon emissions.[158] The various measures included in a portfolio-based implementation plan would create enforceable performance obligations on a diverse range of affected entities, aside from the regulated power plants.[159]

State plans may include enforceable measures that reduce emissions by the regulated generators.[160] States participating in competitive wholesale electricity markets should amend the capacity market rules to account for the value of these compliance costs. For example, to the extent that emissions reductions are achieved through the utilization of mandated control technology, which results in additional capital investment or operating costs, these costs should be incorporated into the minimum benchmark prices used to assess the competitiveness of an offer in a capacity auction.[161] When the cost of environmental compliance is

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by requiring utilities to divest their generating assets); *FERC Hearing*, *supra* note 153, at 78 (statement of Tony Clark, FERC Comm'r) (observing that there is a potential in some restructured markets to graft a state-led integrated resource plan onto the market construct).

156. *Clean Power Plan*, *supra* note 139 at 34,901 (citing the Regional Greenhouse Gas Initiative as a possible precedent for a portfolio-based plan).

157. *Id.* at 34,849 (defining an RPS as a requirement that retail electricity suppliers supply a minimum percentage or amount of their retail electricity load with electricity generated from eligible sources of renewable energy).

158. *Id.* at 34,901 (noting that RPS and energy efficiency measures constitute existing state programs).

159. *Id.* at 34,909 (raising concerns about practical enforcement against noncompliance under a portfolio plan). *But see Clean Power Plan* at 34,888 (noting comments by some stakeholders that measures affecting entities beyond the regulated generating units, as a legal matter, cannot be part of the BSER).

160. *Id.* at 34,909 (describing the approvability criteria for § 111(d) state plans, which differ from the criteria applicable to § 110 State Implementation Plans).

161. *See* N.J. Bd. of Pub. Utils. v. FERC, 744 F.3d 74, 85 n.8 (3d Cir. 2013) (defining the PJM's net cost of new entry as the cost of constructing a particular type of

reflected in higher benchmark prices, new generators may avoid upward price mitigation of their sell offers, and thereby remain competitive relative to older, fully-depreciated coal-fired plants.[162] Indeed, placing a "fee" on coal-fired generation to make natural gas-fired generation more competitive — regardless of the market context (regulated or restructured) — may be necessary simply to preclude an unprecedented paradigm shift from economic dispatch to environmental dispatch.[163]

If a state adopts a portfolio-based implementation plan, it can mandate the construction of new natural gas-fired combined cycle generators as part of its system of emissions reduction. Building block two contemplates that part of a state's emissions goal can be achieved by substituting low-carbon natural gas-fired generation for carbon-intense coal-fired generation.[164] A state can likewise incorporate the construction of new natural gas-fired combined cycle generators into its implementation plan.[165] The state, having exclusive authority over the siting and construction of power plants, could then strategically build the new units in capacity-deficient regions.[166]

Any obligation to add new natural gas-fired generation under a state implementation plan would be a legally enforceable obligation.[167] Thus, a state may have the authority to require electric utility companies to enter into long-term contracts for the purchase of energy and capacity from such generating units. The PJM cases, however, suggest that if New Jersey or Maryland were to adopt such a measure without modifying the existing RPM, new capacity resources may still be required to clear a competitive

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generation resource, less the estimated revenue that the unit would receive from energy and ancillary sales).

162. *See* PJM Interconnection, LLC, 135 FERC ¶ 61,022, 61,088, 2011 WL 1383624, at *2 (Apr. 12, 2011) (explaining that uncompetitive sell offers, which fall below the minimum offer price based on the net cost of new entry, may be "mitigated" (increased) to a competitive level).

163. *See FERC Hearing*, *supra* note 153, at 40 (statement of Phillip D. Moeller, FERC Comm'r.) (reconciling economic dispatch with increased natural gas utilization may require "fee" on other carbon emitters to make them less competitive than natural gas).

164. *Clean Power Plan*, *supra* note 139, at 34,877 (including the substitution of coal-fired generation with natural gas-fired generation as building block 2 of the BSER).

165. *Id.* at 34,837 (state plans may incorporate strategies that are not explicitly mentioned in the building blocks, including construction of new natural gas plants).

166. *But see FERC Hearing*, *supra* note 153, at 25 (statement of Phillip D. Moeller, FERC Comm'r.) (observing that limits on natural gas pipeline capacity may constrain the contemplated increase in the dispatch of natural gas generation).

167. *See Clean Power Plan*, *supra* note 139, at 34,903 (proposing to interpret section 111(d) of the Clean Air Act to encompass and allow various components of the portfolio approach, which would render the measures federally enforceable once approved into the SIP).

capacity auction in order to count the resource towards the capacity obligations of the state's load serving entities.[168]

If the cost to construct new projects is prohibitively high relative to other resources bidding into forward capacity auctions, the PJM cases imply that a state mandating new construction under its implementation plan may be placed in the untenable position of either paying twice for the new capacity or not achieving its emissions reduction goals.[169] While this outcome is plausible, it is not inevitable because the state actions taken in the PJM cases were grounded in state authority. In contrast, a state's CPP mandate to develop new natural gas-fired generation would be based on its state plan obligations under federal law, Section 111(d) of the CAA. Any conflict arising between the FPA and CAA would be distinguishable from the controversies in the PJM cases, which involved the federal preemption of state actions by the FERC's ratemaking authority. To the extent that a state's participation in a FERC-approved competitive electricity market can be harmonized with its duties under the CPP, states need not be compelled to double pay for capacity in order to fulfill their enforceable obligations under the CAA. For its part, the FERC has indicated that market rules and rates can adapt to the new regulatory environment created by the CPP.[170]

Alternatively, states that operate within regional electricity markets can adopt a multi-state implementation plan and coordinate their emissions reduction efforts through an RTO, including PJM. The CPP affords states this option as a means of reducing implementation costs.[171] Moreover, both the EPA and the FERC suggest that state actions coordinated through RTOs and independent system operators ("ISOs") can help maintain grid stability and reliability.[172]

To this end, states facing long-term reliability violations may benefit from a coordinated multi-state plan. First, as states adopt a common goal,

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168. *See* N.J. Bd. of Pub. Utils., 744 F.3d 74, 97 (3d Cir. 2014) ("The elimination of the state-mandated exemption means only that if the states wish to use a new generation resource to satisfy their capacity obligations required under the [RPM], the resource must clear the Base Residual Auction at or near its net cost of new entry.").

169. *See id.* ("[I]f the states' preferred generation resources fail to clear the auction, the states are free to use them anyway; the only caveat is that the states cannot use the resources to offset their capacity obligation in the RPM.").

170. *FERC Hearing*, *supra* note 153 (statement of Cheryl A. Lafleur, Acting Chairman of FERC) ("As I see it, the EPA makes environmental rules and those become the baseline within the system is planned, and we have to make certain that within those rules the rates are done in a just and reasonable way . . . .").

171. *Clean Power Plan*, *supra* note 139, at 34,898 (describing several types of flexibilities afforded to states in designing state plans).

172. *Id.* at 34,899; *FERC Hearing*, *supra* note 153,(suggesting that to promote efficient compliance with the Clean Power Plan, the EPA should not only allow, but should also encourage regional compliance).

they will also have the flexibility to spread compliance costs among a more diverse range of parties, rather than concentrating the burden solely on an individual state's existing generators. For example, the Regional Greenhouse Gas Initiative, which has nine participating states, operates a carbon emissions trading program.[173] An overall emissions budget is set for the affected power plants in the region, but the carbon dioxide allowances can be traded by both regulated and non-regulated parties.[174] In a similar vein, states that intend to reduce emissions by substituting carbon-intensive coal-fired generation with natural gas-fired or renewable energy generation would have a wider range of resources to deploy if they coordinated their efforts. Renewable energy resources, in particular, are not evenly distributed, so low-resource states could benefit by partnering with high-resource states.[175] Further, the introduction of new intermittent renewable energy resources to the system could require the addition of more quick-start resources for reliability.[176] Such planning could be more effectively done at the regional level.[177]

Coordination will also allow multiple states to plan and implement the transition from a carbon-intensive mix of resources to a lower carbon-emitting generation fleet with the least amount of disruption to grid stability. The foreseeable capacity reduction that New Jersey attempted to resolve in *Hanna* was precipitated by federal and state government environmental regulations that required coal-fired plants to either be retired or renovated.[178] The state actions taken under the CPP may produce similar results or even exacerbate the number of retirements, depending on the design of the state implementation plan. A state like New Jersey, which already projects future capacity deficiencies, may want to participate in a multi-state plan coordinated by an RTO simply to minimize the risk of disruption to electricity deliveries within the state. Where a state intends to

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173. *Clean Power Plan*, *supra* note 139, at 34,848 (noting that California established a multi-sector, economy-wide GHG emissions trading program under the 2006 Global Warming Solutions Act).

174. *Id.* (explaining that carbon emissions markets create price signals, which factor into the economic dispatch of the affected coal-fired units).

175. Ferrey et. al., *supra* note 90, at 134 (noting that renewable energy resources are not as concentrated in the northeast region of the United States compared to other parts of the country).

176. Ferrey, *supra* note 2, at 280–281 (explaining that the addition of intermittent resources such as solar and wind would introduce more volatility to the grid, thereby requiring more quick-start back-up resources).

177. *See FERC* Hearing, *supra* note (reiterating FERC's insistence on coordination through RTOs).

178. PPL EnergyPlus, LLC v. Hanna, 977 F. Supp. 2d 372, 392 (D.N.J., 2013) (stating that federal environmental regulations enacted in 2008 required 7 to 11 percent of all PJM generation resources to be retired or renovated).

reduce carbon emissions by replacing coal-fired plants with new capacity resources, an RTO can coordinate the transition to ensure that the lights stay on.

CONCLUSION

Our system of national electricity regulation has demonstrated a capacity to adapt to changed circumstances by incorporating multiple regulatory values and goals. Whereas federal authority was first invoked to prevent states from regulating in a way that burdened interstate commerce, the current federal regulatory scheme now addresses the need for competition, reliability, and environmental protection. And yet, the jurisdictional authority of national and subnational regulators is so fragmented that some entities' regulatory goals have yielded to others. In the PJM cases, state plans for resolving reliability concerns were subordinated to the federal aim of promoting competitive markets. However, as federal regulation adapts to deal with the threat of climate change, states may find an opportunity to advance their local reliability goals while simultaneously implementing federally-mandated carbon emissions reductions.

The CPP's framework of cooperative federalism affords states the flexibility to adopt measures that serve energy goals and reduce emissions. States may replace carbon-intensive coal-fired generation with natural gas, renewable energy, or nuclear generation as a means of cutting emissions. To the extent that new natural gas power plants can be quickly deployed in capacity-deficient regions, these projects can both enhance system reliability and promote emissions reduction. Thus, states that have ceded the authority to directly control the local electricity supply by deregulating their electricity markets may use the portfolio and regional planning tools available under the CPP to strategically design implementation plans to advance other energy goals, such as system reliability and fuel diversity.

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NOTE

THE SUPREME COURT'S TIGHTENING OF PATENT DEFINITENESS & THE IMPACT OF NAUTILUS V. BIOSIG ON THE SOFTWARE PATENT INDUSTRY

MALIHA KHAN*

Since the early 2000s, the Supreme Court has issued a series of decisions aimed at reining in what it has viewed as patent system excesses, specifically addressing the need for tightening the patent definiteness requirement in claim drafting. In Nautilus v. Biosig, *decided in June 2014, the Supreme Court altered and tightened the Federal Circuit's standard for definiteness. The decision in Nautilus will have wide-ranging impacts on businesses, particularly those that rely on software patents, like the finance and information technology industries. The decision will likely cause a reduction in the volume of patent infringement suits, thereby saving patent owners large sums of money. Furthermore, it will compel patent drafters to write clearer claims in order to avoid rejection at the examination stage or a judgment of indefiniteness at an infringement hearing.*

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INTRODUCTION

Patents, particularly software patents, are typically wide and unclear in scope. Ambiguity in claims makes it difficult to determine when an invention infringes on existing patented technology and creates problems for competitors. Software patents are particularly vulnerable to this problem because of the constantly changing nature of the technology and the inability of the law to keep up with such changes.[1]

Patent claim drafting is a balancing act: claim writers must tread the fine line between giving away too much information and risking an ineffective patent, or giving away too little and obtaining a broad or unclear patent that may lead to future patent disputes.[2] Claim clarity is critical to a properly functioning patent because it notifies the public about the bounds of the patent, the elements on which the patentee has an exclusive right, and what remains open to the public.[3] Therefore, it is important that courts are equipped with a proper standard for determining when patents are ambiguous and invalid.

1. *See In re: Strategies for Improving Claim Clarity: Glossary Use in Defining Claim Terms*, Comments of Google, Inc. Before the United States Patent and Trademark Office at 3-4 (Oct. 23, 2013), http://www.uspto.gov/patents/init_events/swglossary_e_google_2013oct23.pdf.

2. *See generally* Karsten Mfg. Corp. v. Cleveland Golf Co., 242 F.3d 1376, 1384 (Fed. Cir. 2001) ("The jurisprudence of claim construction reflects the difficult balance between a patentee's exhortation that courts should read the claims broadly and unlimited to the specific embodiments shown in the specification, and the rule that claims should be construed sufficiently narrowly to preserve their validity.").

3. *In re: Strategies for Improving Claim Clarity: Glossary Use in Defining Claim Terms*, *supra* note 1 at 3.

One of the factors weighed in determining the validity of a patent is definiteness.[4] Patent definiteness refers to the metes and bounds of a patent and how well they are delineated.[5] The U.S. Supreme Court recently lowered the bar for proving patent indefiniteness. In *Nautilus, Inc. v. Biosig Instruments, Inc.*, the Court vacated a U.S. Court of Appeals for the Federal Circuit ("Federal Circuit") decision which upheld the validity of a patent under the Federal Circuit's standard for definiteness pursuant to 35 U.S.C. § 112.[6] The Federal Circuit's standard held that a patent is valid if the claim is "amenable to construction" and not "insolubly ambiguous."[7]

The ramifications of *Nautilus* will likely have a significant impact on the software patent industry because of the inherent ambiguity in software patents. One of the difficulties faced by software patent developers is that software patents rely on technology that is difficult to explain in claims because of the lack of adequate terminology. Recognizing the seriousness of this problem, the White House launched a glossary pilot project in early 2014 to promote patent clarity.[8] Despite strong arguments in favor of abolishing software patent protection, the Supreme Court's decision in *Nautilus* demonstrates that the Court is looking to improve the software patent system rather than abolish it.

I. DEVELOPMENT OF SOFTWARE PATENT LAW AND THE CURRENT CHALLENGES IN CLAIM DRAFTING

At the beginning of the digital era, the Supreme Court completely denied patent protection to software.[9] However, in the last few decades the Court

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4. *See 2173 - Claims Must Particularly Point Out and Distinctly Claim the Invention*, U.S. Patent and Trademark Office (last visited Mar. 5, 2015), http://www.uspto.gov/web/offices/pac/mpep/s2173.html.

5. *See* 35 U.S.C. § 112(b) (2012); *see also 2173 - Claims Must Particularly Point Out and Distinctly Claim the Invention*, *supra* note 4 ("The primary purpose of this requirement of definiteness of claim language is to ensure that the scope of the claims is clear so the public is informed of the boundaries of what constitutes infringement of the patent. A secondary purpose is to provide a clear measure of what applicants regard as the invention so that it can be determined whether the claimed invention meets all the criteria for patentability . . .").

6. *See generally* Nautilus, Inc. v. Biosig Instruments, Inc., 134 S. Ct. 2120 (2014).

7. *See id.* at 2123 (According to the Supreme Court, the "Federal Circuit's standard, which tolerate[d] some ambiguous claims but not others, [did] not satisfy the statute's definiteness requirement.").

8. *See USPTO Launches New Glossary Pilot Program to Promote Patent Claim Clarity*, USPTO (Mar. 26, 2014), http://www.uspto.gov/news/pr/2014/14-08.jsp.

9. *See* Gottschalk v. Benson, 409 U.S. 63, 72 (1972) (demonstrating one of first cases in which the Supreme Court addressed software patentability by ruling that a process claim directed to a numerical algorithm was not patentable because "the patent would wholly pre-empt the mathematical formula and in practical effect would be a patent on the algorithm itself").

has expanded the scope of patent protection to include software technology. Yet even with this expanded scope, strict guidelines remain to determine which inventions are patentable. For example, patents are not issued for "laws of nature, physical phenomena, and abstract ideas,"[10] or mathematical formulas and algorithms.[11] Despite such guidelines, the Supreme Court has recently found the need to further tighten the scope of software patent protection due to an increasing rate of litigation and an equal increase in costs to patent owners and businesses.

While *Nautilus* was the most recent example of the Supreme Court tightening patent protection, it was not the first. *Nautilus* was preceded by *Alice Corp. Pty. Ltd. v. CLS Bank Internationa'l*, in which the Court increased the threshold for software patent subject matter eligibility.[12] *Alice* involved a patent on an intermediate-settlement system for approving financial transactions.[13] In *Alice*, the dispute was about patentable subject matter and the Supreme Court invalidated the patent. The Court found that the claims were drawn to an abstract idea, and that abstract ideas did not warrant patent protection merely because they were carried out on a computer; they needed to go above and beyond and show some kind of transformation.[14] Immediately following *Alice*, patent holders and practitioners were relieved to find that the Court had not put all abstract concepts at risk, as they had feared. While recognizing the need to protect and promote innovation, the Supreme Court in *Nautilus* expressed the need to rein in software patents due to their excessive ambiguity and the resulting unnecessary litigation.

A. *Patent Definiteness*

Section 112 of Title 35 of the U.S. Code specifies the requirements of a patent claim.[15] Subsections (a) and (b) are most critical when it comes to

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10. Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980).

11. *See* Eloise Gratton, *Should Patent Protection be Considered for Computer Software-Related Innovations?*, 7 COMPUTER L. REV. & TECH J. 223, 227 (2003) (noting that an "idea in an of itself is also not patentable. The implication is that any mathematical procedure is akin or identical to a law of nature, which leaves doubt as to whether any computer-implemented inventions are patentable").

12. *See* Alice Corp. Pty. Ltd. v. CLS Bank Int'l, No. 13-298, slip op. at 1 (U.S. 2014).

13. *Id.*

14. *See id.* at 17.

15. *See* 35 U.S.C. § 112 (2012) (stating that the claim "specification shall contain a written description of the invention, and of the manner and process of making and using it, in such full, clear, concise, and exact terms as to enable any person skilled in the art to which it pertains, or with which it is most nearly connected, to make and use the same, and shall set forth the best mode contemplated by the inventor or joint inventor of carrying out the invention.").

claim drafting because they lay out the rules that a patent drafter must follow in order to draft a valid claim. Subsection (a) describes the written requirement for a patent claim and subsection.[16] Subsection (b) requires definiteness of claim scope and subject matter.[17] Patent definiteness refers to the requirement that a person skilled in the art be able to determine with a reasonable degree of certainty the metes and bounds of the claim.[18] If a claim does not specify the metes and bounds, it is likely to be rejected. If a particular term in a patent claim is disputed and a person having ordinary skill in the art ("PHOSITA") cannot determine the meaning of the term, then the claim is likely to be held indefinite.

B. Amenable to Construction or Insolubly Ambiguous

Before *Nautilus*, the standard used by the Federal Circuit stated that "only claims not 'amenable to construction' or 'insolubly ambiguous' are indefinite."[19] Under this standard, a claim was insolubly ambiguous and invalid for indefiniteness "if reasonable efforts at claim construction result[ed] in a definition that [did] not provide sufficient particularity and clarity to inform skilled artisans of the bounds of the claim[.]"[20]

According to the "amenable to construction or insolubly ambiguous" standard, the claim terms need not have been absolutely clear, so long as a PHOSITA could determine the meaning. One of the challenges software patent examiners face under this standard is that software patents are constructed in a deliberately broad and ambiguous manner, and the threshold for the ""PHOSITA for software patents is very high.

C. Nautilus, Inc. v. Biosig Instruments, Inc.

In *Nautilus*, the Supreme Court replaced the Federal Circuit's standard with a stricter one.[21] The patent at issue in this case was owned by Biosig

16. *Id.*

17. *Id.*

18. *See* Halliburton Energy Servs. V. M-I LLC, 514 F.3d 1244, 1249 (Fed.Cir. 2008) (holding that "[p]roof of indefiniteness . . . . . .is met where an accused infringer shows by clear and convincing evidence that a skilled artisan could not discern the boundaries of the claim based on the claim language, the specification, and the prosecution history, as well as her knowledge of the relevant art area." Halliburton sued M-I LLC for infringing on its patent by using similar gel drilling fluid in its operations. M-I LLC fired back by arguing that Halliburton's patent was invalid for indefiniteness because it did not distinguish the term "fragile gel" used in its patent claim to describe the subject matter of the patent, from prior art in the area.).

19. *Id.* at 1250.

20. Biosig Instruments, Inc. v. Nautilus, Inc., 715 F.3d 891, 898 (Fed. Cir. 2013).

21. *Compare* Nautilus, Inc. v. Biosig Instruments, Inc., 134 S. Ct. 2120, 2124 (2014)*with Halliburton*, 514 F.3d at 1249 (noting that under the old standard "claims were held indefinite only where a person of ordinary skill in the art could not determine

and described "a heart-rate monitor contained in a hollow cylindrical bar that a user grips with both hands, such that each hand comes into contact with two electrodes, one 'live' and one 'common.'"[22] The cylindrical bar mentioned in the patent claim contained "'electronic circuitry including a difference amplifier'; and, on each half of the cylindrical bar, a live electrode and a common electrode 'mounted . . . in spaced relationship with each other.'"[23] Biosig argued that the term "spaced relationship" "referred to the distance between the live electrode and the common electrode in each electrode pair."[24] The district court held that the term "spaced relationship" "'did not tell [the court] or anyone what precisely the space should be,'" or even supply 'any parameters' for determining the appropriate spacing."[25] After the district Court found for Nautilus, the Federal Circuit reversed and remanded. The court stated that the crux of the argument was "just how much imprecision § 112 tolerates."[26] The Supreme Court then vacated the Federal Circuit's decision, stating that the Federal Circuit's use of the "amenable to construction or insolubly ambiguous" test was incorrect, and that "those formulations can breed lower court confusion, for they lack the precision § 112, ¶ 2 demands."[27]

D. *Federal Circuit Decisions Since* Nautilus

Since *Nautilus*, many district courts have decided cases that involved a determination of patent definiteness.[28] Since the Supreme Court has only provided a guideline on definiteness, it remains up to the Federal Circuit to interpret the *Nautilus* standard. By analyzing the decisions since *Nautilus*, we can get a better idea of how narrowly or broadly courts are interpreting that decision. The Federal Circuit has decided one case so far under the *Nautilus* standard. In *Interval Licensing LLC v. AOL, Inc.*, the Federal Circuit affirmed a 2012 decision of the District Court of the Western District of Washington.[29] The Federal Circuit reviewed the district court's decision de novo, and applied the stricter *Nautilus* standard for

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the bounds of the claims, i.e., the claims were insolubly ambiguous.").

22. *Nautilus*, 134 S. Ct. at 2126–2127.

23. *Id.*

24. *Id.*

25. *Id.* at 2127.

26. *Id.* at 2128.

27. *Id.* at 2130.

28. *See, e.g.*, Freeny v. Apple Inc., 2014 U.S. Dist. LEXIS 167888 (E.D. Tex. 2014); Depomed, Inc. v. Actavis Elizabeth LLC, 2014 U.S. Dist. LEXIS 118096 (D. N.J. 2014).

29. *See* Interval Licensing LLC v. AOL, Inc., 766 F.3d 1364, 1366 (Fed. Cir. 2014).

definiteness, achieving the same result as the district court.[30] The court found the phrase "unobtrusive manner," the term at issue in the patent claim, to be subjective and looked to the written description for guidance regarding a standard for determining the scope of the term.[31] Ultimately, the court did not find sufficient guidance in the written description of the patent.[32] This was the first time that the Federal Circuit addressed the Supreme Court's rejection of its previous standard for determining patent indefiniteness.[33] Because the decision in *Nautilus* sets a lower threshold for proving indefiniteness under Section 112, it is easier to reject or invalidate a patent claim for indefiniteness. It will be interesting to see the Federal Circuit's application of the stricter standard for patentees in a case in which it upholds a patent claim as sufficiently definite.

II. IMPACT OF *NAUTILUS V. BIOSIG* ON THE SOFTWARE PATENT INDUSTRY

From *In re Bilski* to *Nautilus v. Biosig*, decisions in the field of software patents show a trend toward increasing limitations on patentability.[34] This trend reflects the judiciary's response to the growing movement of legal practitioners, academics, and business professionals in favor of restricting software patents.[35] The stricter standard set by the Supreme Court in *Nautilus* leaves little room for ambiguity in patent claim drafting, making such drafting particularly challenging for software patent developers.[36]

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30. *Id.* at 1373 (finding that the phrase "unobtrusive manner" "has too uncertain a relationship to the patents' embodiments." Furthermore, it found the claim language to be "facially subjective" and "without an objective boundary.").

31. *Id.* at 1371 (noting that "Where, as here, we are faced with a 'purely subjective' claim phrase, we must look to the written description for guidance").

32. *Id.*

33. *See* David Mika, *Intellectual Property Report*, BAKER BOTTS (Nov. 2014), http://www.bakerbotts.com/file_upload/IPReport201411-IntervalLicensingDeterminingIndefinitenessPost-Nautilus.htm (noting that the court in *Interval Licensing* "applied the new indefiniteness standard for the first time and indicated a rebalancing of the indefiniteness standard in favor of the accused infringers.").

34. *See* Nautilus, Inc. v. Biosig Instruments, Inc., 134 S. Ct. 2120 at 2124 (2014); In re Bernard L. Bilski and Rand A. Warsaw, 545 F.3d 943 at 954 (Fed. Cir. 2008).

35. *See Should Patents Be Awarded to Software?*, WALL ST. J., (May 17, 2013 4:03 PM), http://www.wsj.com/articles/SB10001424127887323335404578444683887043510 (expressing that "There are those who believe software patents actually stifle innovation and therefore should be eliminated altogether. They argue that companies would have a lot more money to spend researching and developing new products if they didn't have to acquire and defend patents.").

36. *See* Nicholas B. Trenkle, *Patent Claims More Vulnerable to Invalidity Attacks After Supreme Court Holds Standard for Determining Definiteness of Claim Language to be Amorphous and Indefinite*, STITES & HARBISON PLLC (Apr. 17, 2013), http://www.stites.com/learning-center/legal-updates/patent-claims-more-vulnerable-to-

Under the previous *Halliburton* standard,[37] if a claim's scope could have had multiple interpretations by a PHOSITA, it would have been acceptable and would not have been held invalid for indefiniteness merely because of differing interpretations. The new *Nautilus* standard, however, holds a patent indefinite when there is ambiguity in a claim that could lead to varying interpretations of its scope by a PHOSITA. This is a particular challenge for software companies and all companies that rely on software technology because software patents have historically been ambiguous and deliberately broad.[38] Software technology is a field that faces a rapid rate of development. This rapidity forces patent claim constructors to draft broad claims that could potentially cover future software innovations.[39] "Most software programs, and features of those programs, have an effective commercial life of only a few years."[40] And "new software developments quickly render prior innovations obsolete."[41] Furthermore, "the commercial lifespan of a software program or feature . . . is usually shorter than the time it takes the U.S. Patent & Trademark Office to resolve a patent application – a process that often takes 4 years or more"[42] A software patent's' validity is now more likely to be challenged on indefiniteness grounds, and claim drafters will need to be more diligent going forward.[43] Seeing a need to address the issue of software patents that rely on technology that is difficult to explain, the United States Patent and Trademark Office ("USPTO") launched a Glossary Pilot Program in 2014 to promote clarity in claims.[44]

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invalidity-attacks-after-supreme-court (explaining that "for patent applicants looking to ensure the claims of their eventual patent will not be susceptible to invalidity attacks on grounds of indefiniteness, the Court's decision in *Nautilus* provides a clear reminder of the importance for both the specification and the claims of a patent application to use terminology that is clear to those skilled in the art, and also casts a shadow on the practice of using 'wiggle words' in claims for the advantages of flexibility through deliberate ambiguity.").

37. Halliburton Energy Servs. V. M-I LLC, 514 F.3d 1244, 1249 (Fed.Cir. 2008).

38. *See* Eric Goldman, *The Problems with Software Patents*, FORBES (Nov. 28, 2012 2:53 PM), http://www.forbes.com/sites/ericgoldman/2012/11/28/the-problems-with-software-patents/.

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *USPTO Launches New Glossary Pilot Program to Promote Patent Claim Clarity*, USPTO (Mar. 26, 2014), http://www.uspto.gov/news/pr/2014/14-08.jsp ("Participation in the Glossary Pilot Program requires an applicant to include a glossary section in the patent application specification to define terms used in the patent claims. Applications accepted into this pilot program will receive expedited processing and be placed on an examiner's special docket prior to the first office action, and will have

Since *Alice*, many cases dealing with software patents have gone before the Federal Circuit and district courts, and as a result of *Alice*, many software patents have been rejected.[45] Reflecting on these decisions, practitioners agree that the landscape for software patents has changed significantly.[46] The same will likely be true with regard to the *Nautilus* decision; even though some believe the significance of the decision is not great, time may prove the opposite.[47]

After *Nautilus*, the added challenge to software patent eligibility is that claim drafters need to be much clearer about the scope of the patent. This is a major problem due to the inherent ambiguity in the terms and phrases used by the industry. Software patent drafters seem to have both a beneficial and contentious relationship with ambiguity. The more ambiguously they construct a claim, the broader and more encompassing it will be. And the broader a claim is, the more successful it is likely to be because broad and ambiguous claims can be interpreted to cover new technologies and innovations. However, the more ambiguity in a claim, the less likely the applicant will be granted a patent in the first place.

Patents are limited monopolies because they give the patentee the right to exclude others from making, using, or selling an invention for a set period of time. Patent examiners try to balance protection for innovators and the interest of the public by making sure that patent claims state with precision the functions of the new product or technology. For software patent claim drafters, expressing that precision is a double-edged sword

special status up to issuance of a first office action.").

45. *See* Brian McCall, *Lessons from Four Months of Post-Alice Decisions*, LAW360 (Oct. 31, 2014 10:18 AM) ("As of Oct. 20, 2014, 18 courts have directly relied upon Alice in deciding whether claims were invalid under § 101: 15 district court decisions and three Federal Circuit decisions. Of those, 14 decisions invalidated claims by applying Alice. Thus, almost 78 percent of the decisions that have applied Alice have been invalidated claims.").

46. *See* Emily Kokoll, *Lawyers Weigh in on High Court's Software Patent Ruling*, LAW360 (June 19, 2014 8:07 PM) http://www.law360.com/articles/549820/lawyers-weigh-in-on-high-court-s-software-patent-ruling (referring to Scott Alter of Faegre Baker Daniels who states that "*Alice* will not only make it more difficult to protect and enforce innovative software-related inventions, but provides little guidance on the bounds of patent eligibility. . .With little concrete guidance being given to this step, the scope of what the abstract idea could encompass – for nearly any technology – is potentially quite broad.").

47. *See* Julia Revzin, *Lawyers Weigh in on High Court's Patent Indefiniteness Ruling*, LAW360 (June 2, 2014 7:35 PM) http://www.law360.com/articles/543889/lawyers-weigh-in-on-high-court-s-patent-indefiniteness-ruling (David Levy of Morgan Lewis & Bockius LLP stated that "[p]atent claims will now be more vulnerable to attacks on their validity, because the Supreme Court has lowered the bar for proving that claim terms are 'indefinite' . . . . . .[e]xpect more indefiniteness arguments at the claim construction phase of cases").

because of the desire to keep claims as broad as possible. Through the Court's decision in *Nautilus* it seems that claim drafters no longer have the option of drafting broad and ambiguous claims, leaving room only for well-delineated claims that are more likely to be granted a patent and less likely to be challenged later.

The companies likely to be the most severely impacted by the decision in *Nautilus* will be the same as those affected by the decision in *Alice*. Both cases deal with patent eligibility, and even though they deal with different elements of that requirement — scope and subject matter respectively — the impact they have on software patents and the companies that rely on them is similar. After the Supreme Court's decision in *Alice*, nine software patent claims were rejected in federal district courts and three were rejected by the Federal Circuit.[48] Large technology companies such as Microsoft, Google, IBM, and Apple faced huge losses after *Alice*[49] and will probably face more losses due to the greater likelihood of losing their patents after *Nautilus*.

While some patent practitioners are happy about the decision in *Alice*, because it keeps patent trolls in check, others worry that many legitimate patents in fields like biotechnology and medical diagnostics may be rejected on the same grounds as frivolous claims.[50] After *Nautilus*, software patents in these particular fields are at further risk of being invalidated or rejected.

Another impact of the *Nautilus* decision will be on the use of expert testimony in litigation. The use of expert testimony in software patent litigation was already fairly frequent, but will further increase now as a result of *Nautilus*. The reason for this is the requirement under the new standard that patent claims "inform, with reasonable certainty, those skilled in the art about the scope of the invention."[51] In order to resolve uncertainties or ambiguity in scope, patent drafters will bring in more

48. *See* Ashby Jones, *Courts Nix More Software Patents: Decisions Follow Supreme Court Ruling on Intellectual-Property Protection*, WALL ST. J. (Sept. 21, 2014 7:48 PM), http://online.wsj.com/articles/federal-courts-reject-more-software-patents-after-supreme-court-ruling-1411343300.

49. *See* Jeff Wild, *Big US Tech Companies Face Major Patent Losses in the Post-Alice World, IAM Research Reveals*, IAM MEDIA (Sept. 27, 2014) http://www.iam-media.com/Blog/Detail.aspx?g=2028b324-2d4a-4523-9f0d-f0773b8b3fa1 ("49% of all IBM's US patent holdings could be affected by the *Alice* decision, as could 58% of Google's, 55% of Microsoft's and a whoping [sic] 76% of Oracle's").

50. *See* Jeremy Lowe, *A Recent Supreme Court Decision Made it Easier to Invalidate Vague Medical Device Patents*, MEDICAL DEVICE AND DIAGNOSTIC INDUSTRY – DEVICE TALK (July 9, 2014), http://www.mddionline.com/blog/devicetalk/recent-supreme-court-decision-made-it-easier-invalidate-vague-medical-device-patents-07-09-2014.

51. Nautilus, Inc. v. Biosig Instruments, Inc., 134 S. Ct. 2120, 2123 (2014).

experts to define terms and phrases, whereas opponents will bring in experts to try to prove ambiguity and multiple claim interpretations.[52] While it remains to be seen exactly how the Federal Circuit will apply *Nautilus*, it seems that the cost of litigation will go up. It appears that the goal of the Supreme Court was to prevent such broad claims from being included in patents in the first place and to avoid such litigation completely.

A. Enablement Doctrine and the Doctrine of Equivalents

When dealing with patent scope or claim breadth, two particular doctrines are relevant: (1) the enablement doctrine and (2) the doctrine of equivalents. The enablement doctrine requires that a patent claim specify how to make and use the claimed invention.[53] The doctrine of equivalents takes patent scope a step further and expands it beyond the literal words of the claim.[54]

Before a court determines whether the doctrine of equivalents applies to a particular claim, it asks whether or not there was literal infringement. Only when that question is answered in the negative does a court ask whether the accused product or process can be considered essentially the same as the patented product or process.[55] Under this doctrine, if "two devices do the same work in substantially the same way, and accomplish substantially the same result, they are the same, even though they differ in name, form, or shape."[56]

Historically, courts determined the scope of a claim under the doctrine of

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52. *See Supreme Court Adopts New Indefiniteness Standard*, HAYNES AND BOONE, LLP (June 2, 2014), http://www.haynesboone.com/news-and-events/news/alerts/2014/06/02/supreme-court-adopts-new-indefiniteness-standard ("It is likely that claim construction proceedings (and the corresponding indefiniteness challenges) will see more expert declarations and/or reports submitted given the focus of the test on 'those skilled in the art.'"); *see also* John T. Gutkoski, *Post-Nautilus Most Indefinite Patent Challenges Fail*, LAW360 (Sept. 16, 2014 10:56 AM), http://www.law360.com/articles/577014/post-nautilus-most-indefinite-patent-challenges-fail ("In announcing the Nautilus standard, the Supreme Court suggested a potentially greater role for experts . . . . . .the court in Mycone Dental Supply Co. v. Creative Nail Design Inc., granted a motion to supplement claim construction briefs with expert disclosures, finding that Nautilus 'changed the standard for indefiniteness such that there is a new standard of proof and a new role for someone skilled in the art; because the district court must consider whether a claim term informs, with reasonable certainty those of skill in the art about the scope of the invention, expert testimony is especially relevant.'").

53. *See* Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 853 (1990).

54. *Id.*

55. *See Patent Infringement*, O'BANION & RITCHEY LLP (last visited Mar. 5, 2015), http://www.intellectual.com/infringement.htm.

56. Merges & Nelson, *supra* note 48 at 853.

equivalents based on the "degree of advance over the art the original patent represents."[57] However, courts have not been consistent in their application of the doctrine of equivalents.[58] While the ruling in *Nautilus* may impact the application of the doctrine, it will depend on how the lower courts interpret and apply that decision.

The ruling in *Nautilus* seems to restrict application of the doctrine of equivalents by requiring more clarification in claim drafting. The new standard does not allow for varying interpretations of the scope by a PHOSITA.[59] The doctrine of equivalents expands the scope of a patent claim, but after *Nautilus*, claims will need to be clearer and more precise, meaning they will be narrower. The doctrine of equivalents comes into play when there is an accusation of infringement, however, if claims are narrower to begin with, there are going to be fewer instances of infringement. Although the new standard is more in line with the constitutional purpose of the Patent Act,[60] it may be more difficult now for patentees to use the doctrine of equivalents as a defense to indefiniteness or invalidity challenge because a claim cannot simultaneously be clear/precise and indefinite.

B. *Pre vs. Post-Issuance Claims*

One of the questions raised by *Nautilus* is whether the new indefiniteness standard to be applied during litigation will also be applied in the examination context. Historically, claims under examination at ""USPTO were evaluated under a stricter indefiniteness standard than granted claims.[61] The reason for this was that pre-issuance claims could easily be amended, thus encouraging applicants to fix claims at an earlier stage.[62]

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57. *Id.* at 854.

58. *See, e.g.*, Warner-Jenkinson Co., Inc. v. Hilton Davis Chemical Co., 520 U.S. 17 (1997) (limiting severely the broad power of the doctrine of equivalents by ruling that instead of focusing on the claim as a whole, the equivalents test must be done on an element by element basis.).

59. Nautilus, Inc. v. Biosig Instruments, Inc., 134 S. Ct. 2120, 2128 (2014).

60. *See Manual of Patent Examining Procedure – Introduction*, USPTO (Mar. 27, 2014), http://www.uspto.gov/web/offices/pac/mpep/mpep-0020-introduction.html (stating that the U.S. Patent Act was enacted by Congress under its Constitutional grant of authority to "promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.").

61. *See generally* Lisa Larrimore Ouellette and Jonathan Masur, *How Will Nautilus Affect Indefiniteness at the PTO?*, PATENTLYO (June 5, 2014), http://patentlyo.com/patent/2014/06/nautilus-affect-indefiniteness.html.

62. *See* Dennis Crouch, *Federal Circuit Implements Low Standard for Prima Facie Indefiniteness Rejection*, PATENTLYO (May 6, 2014), http://patentlyo.com/patent/2014/05/implements-indefiniteness-rejection.html.

Through its decision in *Nautilus*, the Supreme Court addresses the discrepancy between pre and post-issuance claims. Prior to *Nautilus*, the USPTO applied a lower threshold of ambiguity for patent claims in the examination process.[63] The new standard, if applied to pre- and post-issuance claims, will remove this inconsistency in determining patent validity with regard to indefiniteness.

C. *Broader Economic Implications of* Nautilus v. Biosig

As previously discussed, the question of whether software should be granted patent protection has been long disputed, and the *Nautilus* decision has sparked that debate once again. Those in favor of protection for software argue that patent protection supplies the necessary incentive for innovation.[64] They assert that without this protection, and the return on investment that it insures, innovators will not risk the millions and/or billions of dollars on research and development.[65] And finally, they argue that patent disclosures serve to inform the public and help spread knowledge.[66]

Several studies about the economic impact of patent scope reveal that greater patent scope has a positive effect, similar to that of greater patent duration, in terms of its incentive effect on initial invention.[67] Additionally, it is also true that broad scope leads to ambiguous patents, greater likelihood of infringement, and excessive litigation.[68] When boundaries of patents are uncertain, it becomes difficult to determine whether a prospective technology might infringe on an existing patent. Companies face a risk of inadvertent infringement, and that risk is weighed against potential benefits when making decisions about investing in particular

63. *See* Ouellette, *supra* note 54.

64. *See* Leonid Kravets, *Do Patents Really Matter to Startups?*, TECHCRUCH (June 21, 2012), http://techcrunch.com/2012/06/21/do-patents-really-matter-to-startups-new-data-reveals-shifting-habits/

65. *Id.*

66. *Id.*

67. *See* Merges & Nelson, *supra* note 48 at 869. (Greater scope means the patent will cover a larger number of inventions. A longer duration means that the patent owner will have exclusive rights over the patented invention for a longer period. Therefore, the greater the scope and/or duration of a patent, the more valuable it will be to an investor).

68. *See* Matt Dunning, *Supreme Court Rulings Could Boost Protection from Patent-Infringement Claims*, BUS. INSURANCE (June 22, 2014), http://www.businessinsurance.com/article/20140622/NEWS07/306229968/supreme-court-rulings-could-boost-protection-from-patent (noting that while broad patents might allow companies to maximize their enforceability against other companies, that will breed excessive litigation and encourage patent trolls).

innovations.[69]

1. Non-Practicing Entities ("NPEs") or "Patent Trolls"

Over the last decade, there has been an explosion in frivolous lawsuits by NPEs, which are individuals and firms who own patents and use them solely for the purpose of asserting infringement claims against companies that do produce goods and services.[70] The main area of patent law that is implicated in NPE litigation is that of notice. Notice is a key function of patent law and its purpose is to inform the public about the subject matter and scope of a patent in order to avoid infringement.[71] The reason that software patents are much more heavily targeted by NPEs is that software patents have unclear boundaries and therefore do not successfully notify the public of the scope of the invention. Failure to provide notice will likely be read by the courts as a lack of claim definiteness, leading them to hold the patent invalid. Through *Nautilus*, the Supreme Court has taken a step toward eradicating the system of patent trolls.[72] This move will save numerous businesses, particularly those in the software industry, billions of dollars by diminishing the volume of frivolous lawsuits.

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69. *See* James Bessen, *A Generation of Software Patents*, 18 B.U. J. SCI. & TECH. L. 241, 249 (2012) (noting that for "firms in the chemical and pharmaceutical industries, the positive incentives substantially outweigh the disincentives from litigation . . . "Furthermore, "software patents are nearly five times as likely to be in a lawsuit than are chemical patents; business method patents are nearly fourteen times as likely to be litigated." And "financial patents are from 27 to 39 times more likely to be litigated than are other patents").

70. *See* James Bessen & Michael J. Meurer, *The Direct Costs from NPE Disputes*, 99 CORNELL L. REV. 387, 388 (2014).

71. *See* 35 U.S.C. § 287 (2012) (Under 35 U.S.C. § 287, a patent owner can only collect damages for an infringing product if adequate notice is given of the patent at issue. A patent owner can meet this requirement by providing either actual or constructive notice. Actual notice involves directly informing the alleged infringer of the infringement. Constructive notice can be satisfied by labeling a product with the word "patent" or the abbreviation "pat." along with the associated patent number).

72. *See Supreme Court Aiding Fight Against Patent Trolls: Alice, Nautilus, Limelight, Octane Fitness and Highmark*, VENABLE LLP (June 30, 2014) https://www.venable.com/supreme-court-aiding-fight-against-patent-trolls-alice-nautilus-limelight-octane-fitness-and-highmark-06-30-2014/ ("Patent trolls have conventionally used patent claim uncertainty to their advantage to increase the likelihood of settlements . . . . . .The Federal Circuit's test for determining indefiniteness. . .had fostered this practice by making it difficult to prove that a patent claim is indefinite False . .The Supreme Court, in an apparent attempt to prevent the very uncertainty that is favorable to patent trolls, rejected the Federal Circuit's insolubly ambiguous test . . . . . .[and eliminated] the temptation for an applicant to inject ambiguity into its claims, which has led to the exploitation of ambiguous patent claims by patent trolls.").

2. *Impact on Business*

The decision in *Nautilus* can be seen as having both a positive and negative effect on all kinds of businesses, but particularly affects those that rely on software patents. The positive effect is the likely reduction in litigation and related expenses. However, the fact that it will now be easier to find patents invalid for indefiniteness also means that legitimate patents might be at risk simply due to ambiguity in the claims.

Firms in the financial, information technology, chemical, and pharmaceutical industries are only a few examples of the businesses that are at risk. The risk of litigation can deter innovation, therefore, by reducing the likelihood of frivolous and excessive litigation, the *Nautilus* decision will promote innovation. Businesses in these industries rely heavily on software patents and some of them have long urged for patent reform.[73] While this decision may be an adjustment for some, in the long run it will likely benefit all businesses and the patent system overall.

III. RECOMMENDATIONS FOR SOFTWARE PATENT CLAIM DRAFTERS

In the post-*Nautilus* world, software patent claim drafters must be more diligent in their claim drafting because it will be easier to prove indefiniteness if terms are ambiguous. Claim drafters should provide definitions within claims in order to avoid multiple interpretations. The use of examples in claims can also help with clarity and reducing ambiguity.

A. *Describe Clear Use of Machine or Transformation*

Although the importance of the machine-or-transformation test has been reduced through some recent Supreme Court decisions, it remains the leading test used by the USPTO to determine patent eligibility.[74] Therefore, patent drafters should try to avoid insufficient recitation of a machine or transformation. The involvement of a machine or the existence of some transformation must be more than "merely nominally, insignificantly, or tangentially related to the performance of the steps, e.g., data gathering, or merely recites a field in which the method is intended to

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73. *See Startup and Innovator Advocates Urge Rapid Patent Reform Action*, APPLICATION DEVELOPERS ALLIANCE (Feb. 12, 2015), http://www.appdevelopersalliance.org/press-releases/startup-and-innovator-advocates-urge-rapid-patent-reform-action.

74. *See, e.g.*, Bilski v. Kappos, 561 U.S. 593, 604 (2010) (noting that "the machine-or-transformation test is a useful and important clue, an investigative tool, for determining whether some claimed inventions are processes under § 101. The machine-or-transformation test is not the sole test for deciding whether an invention is a patent-eligible 'process'").

be applied."[75]

B. Cautious Use of Means-Plus-Function Claims

The Supreme Court's tightening of patent claim definiteness will inevitably lead patent drafters, particularly software patent drafters, to search for ways to keep their claims as broad as possible without the risk of being invalidated for indefiniteness. One of the methods frequently used in the software patent industry that will be affected is the use of functional claiming. Functional claiming describes what something does, rather than what it is.[76]

To get around this problem, however, software patent claims can be drafted as means-plus-function claims.[77] Means-plus-function claims rely on the connection between the claimed function and a structure that performs the claimed function. Claim drafters can turn to functional claiming, but must be careful in their usage of functional language. While Section 112 permits the use of functional language in a claim, it does so with certain limitations. A means-plus-function claim must recite either the means or steps for performing a specified function, and will be construed to cover the structure, material, or acts described in the claim.[78]

C. Avoid Use of Relative Terminology

Two of the potential pitfalls that patent drafters face, particularly in the field of software, deal with the use of relative terminology and the failure to define coined terminology.[79] The use of terms such as "about," "approximately," "close," "generally," and "relatively" can be beneficial to patent drafters because they prevent them from being bound to a fixed number or limit, thus allowing flexibility and potentially more success during litigation. However, the reverse can also be true. Such terms are open to interpretation, and therefore, may be interpreted by a court more narrowly than the drafter intended. In order to avoid problems of this

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75. Morgan D. Rosenberg & Richard J. Apley, BUSINESS METHODS AND SOFTWARE PATENTS: A PRACTICAL GUIDE, 480 (2012).

76. *See* Jeff Blagdon, *Google's Solution to Software Patents: Treat Them Like Any Other Patent*, THE VERGE (Apr. 17, 2013), http://www.theverge.com/2013/4/17/4233818/google-submits-public-comments-on-software-patent-reform.

77. *See* Mark A. Lemley, *Software Patents and the Return of Functional Claiming*, 8 WIS. L. REV. 905, 905 (2013).

78. *See* Gregory Stobbs, SOFTWARE PATENTS, 232 (1995).

79. *See* AMERICAN BAR ASSOCIATION SECTION OF INTELLECTUAL PROPERTY LAW, DRAFTING PATENTS FOR LITIGATION AND LICENSING, 147, 153 (Bradley C. Wright ed., 2nd ed., 2013).

nature, drafters can provide examples within the patent specification.[80]

CONCLUSION

The Supreme Court's decision in *Nautilus, Inc. v. Biosig Instruments, Inc.* will likely impact the software patent industry, but exactly to what extent remains to be seen. The new standard for patent indefiniteness lowers the threshold for proving indefiniteness and will lead to increased validity challenges for software patents.

In light of this decision, software patent claim drafters need to draft more precise and narrow claims in order to avoid rejection. It will be interesting to see how the Federal Circuit applies the new standard to the remanded *Nautilus* case and other cases in the future. The new standard is likely to impact not only patent claim drafting, but also the way examiners inspect claims at the USPTO and how courts will construe claims in litigation.

80. *Id.* at 148.

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