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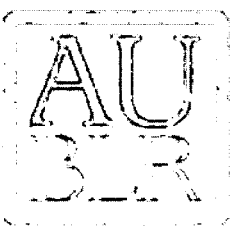

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ARTICLES

CROWDFUNDING IN WONDERLAND: ISSUER AND INVESTOR RISKS IN NON–FRAUDULENT CREATIVE ARTS CAMPAIGNS UNDER THE JOBS ACT

MICHAEL M. EPSTEIN* AND NAZGOLE HASHEMI**

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* Michael M. Epstein is Professor of Law and Director of the Amicus Project, Southwestern Law School, and is the Supervising Editor of the Journal of International Media and Entertainment Law, published by the Donald E. Biederman Entertainment and Media Law Institute, with the participation of the American Bar Association.

** Nazgole Hashemi is the co–founder and CEO of LegalAxxis, Inc. The authors thank Natasha Mehlum, a Biederman Scholar at Southwestern, and Professor Warren Grimes for assistance in the preparation of this Article.

INTRODUCTION

Consider the following scenario: a down–on–his–luck Broadway producer seeks funds from elderly ladies to finance a theatrical production. The elderly ladies are not sophisticated, and the producer comes up with a scheme to defraud them. In each case, the producer seduces the woman into investing a 100% share in a new production. The problem, of course, is that the producer is overselling the show. Only one woman can purchase 100% of the production, but he seeks that same amount from many investors. The first part of this scheme was a common practice in the 1920s. Some say it helped precipitate the stock market crash of 1929. Even in a film like *The Cocoanuts*, Groucho Marx is selling the same piece of real estate in Florida over and over again. But the scheme hatched by our Broadway producer, inspired by the musings of his sidekick accountant, has an especially interesting twist. Instead of simply running away with all of the money invested by the elderly women, the producer and his sidekick decide that they can avoid the appearance of fraud by mounting a show that would be so unappealing to audiences so as to represent a total loss of each woman's investment. Since the women do not know about each other, each investor will think that she lost all of the money that she put into the show and walk away. And since there were no profits flowing from the Broadway flop, the producer and the accountant can simply split the remainder of the capital invested by the women.

By now, you can see that this is the plot of Mel Brooks' 1968 film *The Producers*, which, perhaps ironically, was later adapted into a smash hit on Broadway. The plot twist that makes *The Producers* a brilliant comedy is that the performance that producer Max Bialystock chooses as his intended flop turned out to be a great success as a campy farce. It is this last element of Mel Brooks' plot that reveals a pressing challenge for regulating the sales of securities when it comes to creative artistry, such as theatrical or filmic productions. The comedy of *The Producers* is ultimately predicated on the reality that art is subjective. No one can tell you what is good art or not good art, and it is difficult to tell if a producer's effort is worthwhile or lackluster in the production of that art.

Enter the Jumpstart Our Business Startups ("JOBS") Act of April 5, 2012, which Congress passed to spur investment in creative content and ultimately help create jobs in our economy.[1] Indeed many independent producers in the entertainment industry have been awaiting the opportunity to solicit capital from the public for their projects. On October 23, 2013,

1. Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112–106, 126 Stat. 306 (2012) [hereinafter JOBS Act].

the Securities & Exchange Commission ("SEC") proposed new rules and forms to implement Title III of the JOBS Act.[2] Finally, on October 30, 2015, after years of anticipation and commentary on the proposed rules, the SEC promulgated the final rules, known as "Regulation Crowdfunding," which went into effect on May 16, 2016.[3] Title III of the JOBS Act added section 4(a)(6) to the Securities Act of 1933.[4] Section 4(a)(6) provides a registration exemption for crowdfunding offerings up to $1 million per year.[5] Crowdfunding is a fundraising method where small amounts of capital are raised from a large number of accredited and non–accredited investors to finance a new business venture through authorized intermediaries, such as funding portals.[6] Prior to the JOBS Act, the only way to sell interests in creative content was through a public offering or a private placement under section 4(a)(2) of the Securities Act of 1933.[7] Companies and investors could also rely on the safe harbor provided by Regulation D, which set forth a number of rules that sophisticated companies and investors could follow to avoid an action by the SEC. Post–JOBS Act, subject to certain conditions and depending on the amount of the offering, issuers of crowdfunded campaigns are exempt from registration and there are decreased disclosure requirements.[8] Now,

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2. JOBS Act, Title III, Pub. L. No. 112–106, § 302, 126 Stat. 306, 315 (2012) (codified as amended at 15 U.S.C. 77d(a)(6)).

3. Crowdfunding Final Rules for SEC, 80 Fed. Reg. 71387, 71387–71615 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274). The forms enabling funding portals to register with SEC went into effect on Jan. 29, 2016. *Id.*

4. *Id.*

5. Crowdfunding Final Rules for SEC, *supra* note 3.

6. 80 Fed. Reg. at 71388–71615 (stating that the following issuers are prohibited from taking advantage of the crowdfunding exemption under section 4(a)(6): (1) issuers that are not organized under the laws of a state or territory of the United States or the District of Columbia; (2) issuers that are subject to Exchange Act reporting requirements; (3) investment companies as defined in the Investment Company Act of 1940 (the "Investment Company Act") or companies that are excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act; (4) issuers that are disqualified from relying on Section 4(a)(6) pursuant to the disqualification provision in Rule 503(a) of Regulation Crowdfunding; (5) issuers that have sold securities in reliance on Section 4(a)(6) if they have not filed with the Commission and provided to investors, to the extent required, the ongoing annual reports required by Regulation Crowdfunding during the two years immediately preceding the filing of the required new offering statement; and (6) issuers that have no specific business plan or that have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies; and (7) any other issuer that the Commission, by rule or regulation, determines appropriate).

7. Formerly, section 4(2), but re–designated as section 4(a)(2) by the JOBS Act.

8. *See* 80 Fed. Reg. 71387, 71387–71615 (providing that for offerings up to $100,000, issuers must "file with the Commission and provide to investors and the relevant intermediary income tax returns filed by the issuer for the most recently

issuers may seek:

> 1) the greater of: $2,000 or 5 percent of the lesser of the investor's annual income or net worth if either the investor's annual income or net worth is less than $100,000; or 2) 10 percent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of $100,000, if both the investor's annual income and net worth are equal to or more than $100,000.[9]

Implementation of the JOBS Act has caused crowdfunding and the number of funding platforms to consistently grow in numbers year by year.[10] Today, there are nearly 200 platforms in the United States alone.[11]

Now imagine that Max Bialystock and his sidekick had engaged in the same scheme, except that there was no evidence of fraudulent intent. Imagine that they had solicited, without overselling, funds from multiple women to create a hit show, but the show just happened to be a flop based on their arrogance, incompetence, or inexperience, or simply because their work was misconceived or undervalued. At the end of the day, the JOBS Act, despite its good intentions for artists, invites unsophisticated industry outsiders to entrust their money on websites in the hopes that content creators will develop some type of artistic product that will give them a return, whatever that may be, on their investment. Part II of this article argues that although fraud is a likely consequence of the JOBS Act, investors of fraudulent campaigns are protected under federal and state laws. The difficult cases are those that are just short of fraud. Part III examines those cases where the investor does not feel that the producer put enough effort into creating the production or the content simply turns out not to be "good enough." There, we explore the potential recourse an investor has against a diligent and honest issuer who only partially performs or creates an unprofitable project, and we examine the risk of unjust litigation against these issuers. We analyze how federal or state

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completed year (if any) and financial statements that are certified by the principal executive officer to be true and complete in all material respects." For offerings greater than $100,000 but less than $500,000, the issuer must "file with the Commission and provide to investors and the relevant intermediary financial statements reviewed by a public accountant that is independent of the issuer." For offerings greater than $500,000, the issuer must "file with the Commission and provide to investors and the relevant intermediary financial statements audited by a public accountant that is independent of the issuer").

9. 80 Fed. Reg. 71387, 71387–71615.

10. Chance Barnett, *Trends Show Crowdfunding to Surpass VC in 2016*, FORBES (Jun. 9, 2015, 5:33 PM), http://www.forbes.com/sites/chancebarnett/2015/06/09/trends-show-crowdfunding-to-surpass-vc-in-2016.

11. Salvador Briggman, *The History of Crowdfunding and the JOBS Act*, CROWD CRUX (last visited Aug. 3, 2016), http://www.crowdcrux.com/the-history-of-crowdfunding-and-the-jobs-act.

regulators can impose liability on an artist's creative process or the content itself absent fraud, and how artists can protect themselves against unwarranted litigation. Part IV examines potential content–based regulations that the SEC could promulgate and questions whether such regulations would run afoul of the First Amendment right to free speech. Part IV also explores alternative regulations that would impose greater requirements on the funding portals, rather than the work–product.

This article argues that the JOBS Act may ultimately open the doors to investors being attracted to, and artists being burdened by, the subjective appeal of artistic production, just as those elderly women (and Max) were seduced by the lights of Broadway in *The Producers*, and that these investors will have limited remedies, if any, against issuers of failed, yet non–fraudulent creative arts campaigns. For the SEC, this may be more than an occasional case of a savvy investor seeking redress for an artist's egregious underperformance. As equity crowdfunding grows in popularity, less sophisticated investors may flood the agency with subjective complaints that they were the victims of artistic underperformance, creating a system–wide problem that affects not only the disappointed investor who was looking for a bargain, but also the undervalued artist who performed competently and in good faith.

II. INVESTOR RISKS AFTER THE JOBS ACT: FRAUD IS THE "EASY CASE"

Many authors have written that fraud is a major potential consequence of the JOBS Act based on the naive nature of crowdfunding investors, most of whom are non–accredited, "financially illiterate and in need of the protections provided by state and federal securities laws."[12] As Benjamin P. Siegal wrote, the JOBS Act "allow[s] unsophisticated investors to participate in unregistered crowdfunding opportunities" and "distribut[e] the reduced number of issuer disclosures to investors in a dense and difficult–to–understand way, thus decreasing issuer transparency." Van S. Wiltz has stated that "[b]ecause crowdfunding is transacted online, it is difficult for investors to know whether a start–up company is legitimate."[13] "[I]nvestor[s] must rely on the transparency and accuracy of the project creators' voluntary disclosures to determine if a funded project will actually be followed through to completion."[14] There is a greater need for disclosure requirements and transparency for these non–accredited

12. Benjamin P. Siegel, Note, *Title III of the JOBS Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 794 (2013).

13. Van S. Wiltz, *Will the JOBS Act Jump–Start the Video Game Industry? Crowdfunding Start–Up Capital,* 16 TUL. J. TECH. & INTELL. PROP. 141, 161 (2013).

14. *Id.* at 162.

investors, but the JOBS Act dismisses this fact, hopeful for an improved economy. While fraud is a likely consequence of the JOBS Act, outright fraud may not be as big an issue as others have suggested. Investors of plainly fraudulent campaigns are entitled to legitimate protections and remedies under federal and state laws.

A. Established Protections and Recourse Against Fraudulent Campaigns

Besides being allowed to establish their own criteria or algorithms to identify and monitor fraud, the funding portals, which behave as the intermediaries between the investors and the business, are subject to various SEC promulgated rules in an effort to minimize the risk of fraud in crowdfunding. The portals are required to register with the SEC and the relevant self–regulatory organization ("SRO"), and ensure that proceeds are only offered to the issuer when the target amount is reached.[15] They must obtain basic identifying contact information, at the very least, from each start–up company, which cannot use more than one portal for each offering.[16] Portals must deny access if there is a reasonable belief that they cannot "adequately or effectively assess the risk of fraud of the issuer or its potential offering."[17] The portals must conduct a background check on the start–up company's management and twenty percent beneficial owners to view their financials and ensure past compliance with securities laws and regulations.[18] Portals must also make available to the SEC and potential investors information provided by the issuer.[19] They must provide a means for communication among the entire general public on their platforms, but only those who have actually opened accounts may post comments.[20]

Funding portals must ensure that investors understand the risk of the loss of their entire investment by requiring each to read education materials that comply with SEC standards before accepting any commitment, which must be subject to cancellation until 48 hours prior to the campaign's deadline.[21] The educational materials must communicate "effectively and accurately" and explain in plain language the mechanism for purchasing stock of the issuer; the risks of purchasing stock; the types of securities offered on the

15. 80 Fed. Reg. 71387, 71387–71615.
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*

platform and the risks of each type; the restrictions on resale imposed by law or contract; the kinds of information the issuer is required to provide; the per–investor limitations on investment; the investor's right to cancel the investment, and the limitations on those rights; the need for the investor to think about whether the investment is appropriate; and that following the investor's purchase of stock, there might be no further relationship between the investor and the portal.[22] Where an issuer fails to complete an offering, the portal must give each inventor a notification within five business days disclosing the cancellation, the reason therefor, and the refund amount the investors should expect.[23] Any material changes to the campaign must also be disclosed to the investor, who has at least five business days to reconfirm the commitment.[24]

As Jacques F. Baritot points out, the new SEC rules offer education materials for investors, increased due diligence, interactive investor communities, SROs, and intermediary escrow accounts.[25] In addition, investors of fraudulent campaigns have remedies under both federal and state laws. These investors can enjoy the safeguards of Rule 10b–5,[26] commerce protection laws, consumer trade laws, and anti–fraud statutes. Unscrupulous issuers could be punished both civilly and criminally under most of these laws. Thus, while fraud is a potential consequence of the JOBS Act, there are avenues for protection and resolution.

B. The Relatively Easy Case of "The Doom That Came to Atlantic City!"

As illustrated in the case of the crowdfunded board game "The Doom That Came to Atlantic City!", where a campaign is an outright scheme to defraud, investors will have a less difficult time establishing anti–fraud statutes' element of scienter, e.g., deceitful or manipulative intent.[27] This was a donation–based campaign, thereby creating different expectations and obligations than in an equity–based campaign. The latter "appeals to investors interested in contributing to commercial ventures in exchange for a share of the financial reward."[28] The former "appeals to people who are

22. *Id.*

23. *Id.*

24. *Id.*

25. Jacques F. Baritot, *Increasing Protection for Crowdfunding Investors Under the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 259, 275–80 (2013).

26. 17 C.F.R. § 240.10b–5 (2015).

27. *See generally* Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990).

28. Shahrokh Sheik, *Fast Forward On Crowd Funding, Although Donation–Based Crowdfunding Has Experienced Some Success, Questions Remain About the Practicality of Equity–Based Crowdfunding*, 36 L.A. L. 34, 39 (2013).

motivated to donate based on the artistic or humanitarian nature of the project and have no expectation of financial return."[29] Unlike an equity–based offering, a donation–based offering "allow[s] people to donate in return for nonmonetary consideration."[30] For this reason, the participants are not considered "investors" in the true sense of the term; rather, they are "donators." While this article is written in the context of equity–based crowdfunding, this particular campaign provides a useful analog for the underlying issue of fraud. The case of "The Doom That Came to Atlantic City!" illustrates the availability of a greater opportunity for relief against a deceitful issuer, whether an equity– or donation–based offering.

In this case, the issuer, Erik Chevalier, "represented to consumers that they would receive certain reward deliverables, such as a copy of the board game and certain figurines, if the campaign reached its funding goal of $35,000."[31] Chevalier "represented that money raised would be used primarily for the development, production, completion, and distribution of the board game . . . ."[32] Chevalier "raised nearly four times his original goal for a total of over $122,000."[33] However, "[i]nstead of producing the game or providing the reward deliverables to consumers, [he] announced that the game would not be produced and that refunds would be issued."[34] Few, if any, investors were issued refunds.[35] The Federal Trade Commission ("FTC"), an independent federal agency created by statute[36] to monitor unfair or deceptive acts or practices in or affecting commerce,[37] brought a civil action against Chevalier requesting restitution, disgorgement of ill–gotten gains, and a permanent injunction against future violations of the FTC Act.[38] It became clear in the FTC's complaint that Chevalier had "never hired artists for the board game and instead used the consumers' funds for miscellaneous personal equipment, rent for a personal residence, and licenses for a separate project."[39]

Chevalier and the FTC eventually came to a settlement agreement, prohibiting him from making misrepresentations about crowdfunding

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29. *Id.*
30. *Id.*
31. FTC v. Chevalier, No. 3:15–cv–01029–AC (D. Or. June 10, 2015).
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. 15 U.S.C. §§ 41–58 (2012).
37. *Id.* § 45(a).
38. *Chevalier*, No. 3:15–cv–01029–AC (D. Or. Jun. 10, 2015).
39. *Id.*

campaigns and failing to honor refund policies in the future.[40] Chevalier was also ordered to pay about $112,000 in restitution, but that order was suspended based on his inability to pay.[41] According to a press release by the FTC, "[t]he full amount will become due immediately if he is found to have misrepresented his financial condition."[42] Notably, Chevalier was never required to admit guilt as a part of the settlement.[43] This was the FTC's "first ever enforcement action against a crowdfunded project," but it took years to play out.[44] The project was launched by Chevalier in May 2012 and suspended by Chevalier in June 2013.[45] The complaint was filed in June 2015, and the settlement occurred immediately thereafter.[46] Chevalier could have produced a prosaic, amateur game and thereafter closed the campaign. He could have engaged in a scheme similar to *The Producers*. Realistically, Chevalier's visions for the board game could have been far less impressive than those of his investors and potential consumers. However, this is a relatively simple case where the issuer's fraudulent intent was readily apparent via an investigation of campaign's allocation of funds and progress, or lack thereof. Admittedly, the remedy was imperfect, as Chevalier was not financially apt to restitute the victims. However, a viable road for recovery still existed. The victims complained, the government stepped in, and restitution was ordered.

The bigger concern appears in those cases that are just short of fraud. The issue with the securities laws is that they are scienter–driven protections.[47] According to James J. Barney, the securities laws "are based on the ability to restrict untruthful statements."[48] Therefore, in the context

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40. Andrea Peterson, *Game Over: FTC Goes After Board Game Campaign Gone Wrong in First Crowdfunding Case*, WASH. POST (Jun. 11, 2015), https://www.washingtonpost.com/news/the-switch/wp/2015/06/11/the-ftcs-first-crowdfunding-enforcement-is-over-a-failed-board-game-on-kickstarter.

41. *Id.* ("Eventually, after numerous complaints from the backers and the artistic creators of the game, another game developer stepped in and published the game and gave all backers a copy of the board game but not the other, highly–prized deliverables, such as the promised pewter figurines."); *Chevalier*, No. 3:15–cv–01029–AC (D. Or. Jun. 10, 2015).

42. Peterson, *supra* note 40.

43. *Id.*

44. *Id.*

45. *Id.*

46. Press release, FTC, Crowdfunidng Project Creator Settles FTC Charges of Deception (June 11, 2015).

47. *See, e.g.*, William E. Aiken, Jr., *Element of Scienter as Affecting Action to Enjoin Violation of Federal Securities Laws*, 21 A.L.R. Fed. 582 (1974); Shaun Mulreed, *Private Securities Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 From Achieving Its Goals*, 42 SAN DIEGO L. REV. 779 (2005).

48. James J. Barney, *The Mixed Message: The Supreme Court's Missed*

of crowdfunding under the new exemption, there could be little recourse against an issuer of a failed project where there is no scienter or untruthful conduct. The specific focus of this article is on the grey area in which an artist, without having any fraudulent intent, does not or appears not to complete performance.

III. RISKS TO ISSUERS AND INVESTORS AFTER THE JOBS ACT: THE HARDER CASE OF NO FRAUD

Rather than scrutinize the unscrupulous issuer or the unsophisticated investor, this article focuses on those cases where an investor of creative artistry loses, but not as a result of any fraudulent intent of the issuer or lack of sophistication of his or her own. Where investors are misled by the solicitor's subjective artistic vision/process or disappointed by under–produced content, it is likely that they would merit the protections of anti–fraud statutes. However, investors cannot establish a fraud claim without scienter. Without any evidence of scienter, the road to recovery against honest, yet failed, projects will be rocky. With a content–based product, benchmarks of success can be elusive. A pompous or disorganized filmmaker can spend the investment legitimately, but still run out of money before completing the film. Or a minimalist artist can in good faith and in little time create a "magnificent" painting, which others actually view as dull. Congress did not intend to flood the courts with litigation against issuers whose artistic vision is misunderstood or underappreciated. Nor did Congress intend to prevent investors from seeking redress from arrogant or incompetent creative artists, but absent scienter there would be no restitution or disgorgement of profits under anti–fraud statutes. This section discusses the risk of unfair litigation against skillful and honest artists, especially those with original sensibilities, while questioning whether an investor has any feasible recourse against an issuer who does not intend any harm, but only partially performs or creates an unprofitable project.

In the crowdfunding context, non–performance or under–performance without scienter could be deemed an issue of day–to–day corporate governance that is unrelated to the sale of a security under federal law. If Erik Chevalier never had any intention during the offering to misappropriate investments, but later behaved negligently in expending the funds on objects or services actually related to the board game, the focus would shift from Chevalier's good faith intentions and disclosures during

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Opportunity to Address the Confused State of Commercial Speech in Nike, Inc. v. Kasky*?*, 37 U. WEST. L.A. L. REV. 1, 26, n.156 (2004).

the offering to Chevalier's promises, if any, regarding his post–sale efforts and the work–product. The analysis would hinge on whether there has been a breach of a promise or a duty, not during the solicitation, but at the time of performance, i.e., during the issuer's creative process. After all, investors entrust their money to issuers expecting a return, thereby imposing some sort of trustee relationship between them after the point of sale.

A. Imperfect Contract Law Remedies

Without evidence of fraudulent intent, investors of failed projects may seek redress under contract law for a more positive outcome, but a closer look reveals that such optimism may be misplaced. The Contractarian theory relies on the notion that there is a separation of ownership and control between investors and officers, respectively, of a public corporation.[49] Although in the crowdfunding context the offering is treated as a private placement, the structure of the offering is similar to that of a public corporation because it is made available to the general public and could involve a large number of people. The Contractarian theory therefore provides a useful understanding of the effect of non–fraudulent crowdfunding campaigns under principles of contract law. While there are various interpretations of the theory,[50] the Contractarian theory of corporate law, in particular, holds that the relationship between the shareholders and managers of a public corporation is contractual in nature.[51] Some Contractarians believe that managers adopt default rules via incorporation in a particular state and then customize these rules via "promises in the articles of incorporation."[52] Shareholders thereafter accept these rules "by buying shares in the company and implicitly pricing the quality of the firm's governance commitments."[53]

According to Michael Klausner, while plausible, the Contractarian theory of corporate law "has turned out to be based largely on an . . .

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49. Steven Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 862 (1997).

50. Ann Cudd, *Contractarianism*, STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Aug. 2, 2012), http://plato.stanford.edu/entries/contractarianism; Minka Woermann, *In Corporations We Trust? A Critique of Contractarian–Based Corporate Social Responsibility Models*, AFRICAN J. BUS. ETHICS (2011); Luke Mastin, *The Basics of Philosophy* (last visited July 27, 2016), http://www.philosophybasics.com/branch_contractarianism.html.

51. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 782 (2006).

52. *Id.* at 782–83

53. *Id.* at 783.

imaginary world of contracting."[54] Sure, "there is 'wonderful diversity' among firms with respect to . . . certain corporate governance mechanisms and management structures."[55] "These arrangements and others are important elements in a firm's governance structure."[56] However, these arrangements are not contractual, "in the sense the term is used by [C]ontractarians," between the management and shareholders.[57] The theory does not account for matters of governance that "are excluded from the corporate contract and left to non–legal enforcement."[58] Though "[f]irms innovate and customize non–legal governance arrangements . . . they do not do so in the corporate contract."[59] Managers "do not subject their innovation and customization to legal enforcement by shareholders."[60]

Similarly, in the crowdfunding context, where investors are unhappy with an issuer's creative process or the final product, the actual obligations accepted by the issuer will probably be insufficient to provide any real insight or remedy. To create an enforceable contract, there must be "adequate consideration" and "mutual assent." Adequate consideration requires a bargained–for exchange, meaning that one side's promise cannot be illusory. An "illusory promise" is one that "appears on its face to be so insubstantial as to impose no obligation on the promisor; an expression cloaked in promissory terms but actually containing no commitment by the promisor."[61] A promise does not qualify as consideration if by its terms the promisor reserves a choice of alternative performances,[62] or an "unlimited right to determine the nature or extent of its performance . . . ."[63] An illusory promise leaves future action subject only to the promisor's own will.[64] Consideration, however, requires a binding obligation.[65] Sometimes, if only one promise is illusory, the court will still find a unilateral contract.[66] In such case, the non–illusory promise serves as the

54. *Id.* at 784.

55. *Id.*

56. *Id.*

57. *Id.* at 785.

58. *Id.*

59. *Id.* at 786.

60. *Id.*

61. *Illusory Promise*, BLACK'S LAW DICTIONARY (2d ed. 2016).

62. Crewzers Fire Crew Trans., Inc. v. United States, 741 F.3d 1380, 1382 (Fed. Cir. 2014).

63. Source Assocs., Inc. v. Valero Energy Corp., No. 1:05CV2526, 2007 WL 1235997, at *4 (N.D. Ohio Apr. 26, 2007), *aff'd* 273 F. App'x 425 (6th Cir. 2008).

64. Stinger Indus., LLC v. Hill–Rom Co. Inc., 23 F. App'x 472, 474 (6th Cir. 2001).

65. Howard v. King's Crossing, Inc., 264 F. App'x 345 (4th Cir. 2008).

66. Talent Tree, Inc. v. Madlock, No. 4:07–cv–03735, 2008 WL 4104163, at *4

offer, "which the promisor who made the illusory promise can accept by performance."[67] Moreover, mutual assent requires the parties to have a "meeting of the minds," or same understanding, regarding the essential terms and conditions of their agreement.[68] It is based on the objective conduct of the parties,[69] and determined from the reasonable meaning of the words and acts of the parties, not from their unexpressed intentions or understandings.[70] The parties' "[s]ecret hopes and wishes count for nothing because the status of a document as a contract depends on what the parties express to each other and to the world, not on what they keep to themselves."[71]

In the crowdfunding context, courts could find that a creative arts campaign does not impose an enforceable contract between the issuer and investor with respect to the issuer's creative process or the final product. This is because issuers of crowdfunding campaigns do not subject their innovation and creativity to legal enforcement by investors. An example would be an issuer's promise to create a piece of contemporary rock music. The courts could deem this an illusory promise since the issuer has no objective duty with respect to the composition's attributes, such as the harmony, melody, form, or rhythm. The issuer's promise is not restricted, except perhaps as to the subject matter of the music, and he or she asserts full control over the project. The issuer has an unlimited right to determine the nature and extent of the project. The issuer will suffer no legal detriment no matter the quality of the composition because there was never any explicit promise. Conceivably, the courts could find adequate consideration via a unilateral contract to be accepted by the issuer upon completion of the rendition, or alternatively, in the issuer's implied promise to use reasonable efforts to complete the project.[72] Regardless, the parties would likely still have a hard time showing mutual assent, as there is no meeting of the minds regarding the essential characteristics of the composition. Even more troubling would be those cases where an issuer explicitly discloses that investors may not be happy with his or her creative process or the work–product. In such cases, investors would not be able to

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(S.D. Tex. 2008).

67. *See Source Assocs.*, 273 F. App'x at 427–29.

68. T & B General Contracting, Inc., 833 F.2d 1455, 1459 (11th Cir. 1987).

69. Laserage Tech. Corp. v. Laserage Labs., Inc., 972 F.2d 799, 804 (7th Cir. 1992).

70. Netbula, LLC v. BindView Dev. Corp., 516 F. Supp. 2d 1137, 1155 (N.D. Cal. 2007).

71. *Laserage Tech. Corp.*, 972 F.2d at 802.

72. *See* Wood v. Lucy, Lady Duff–Gordon, 118 N.E. 214, 215 (N.Y. Ct. App. 1917).

assert any legitimate expectations regarding the outcome of the project. Without any indications in the issuer's disclosure statements or representations enumerating the specific qualities of the product, the issuer would be free to create any final product.

Without specificity, not only is the unhappy investor stripped of any potential remedies under contract law, but the legitimate artist could also be at risk. This is because an investor owes no duty to the issuer and may initiate legal proceedings if the work product is unsatisfactory. It is important to note that most investors of crowdfunded projects do not have the capital to initiate litigation.[73] In addition, the issues may be too clouded and expensive to attract a securities litigation practice, especially if the probability of a successful outcome is difficult to ascertain. Perhaps if enough online investors come forward to complain, a class of complainants could hire a plaintiffs' securities firm to litigate the case on contingency. Some investors could use their social media presence and established online profiles to solicit and form the class. Even so, most plaintiffs' securities firms would not risk such an investment absent knowledge of a strong probability of success. Alternatively, enough outrage on social media could also facilitate government interest and intervention.

Where investors are able to initiate some sort of litigation, the legitimate artist will be subjected to unfair legal fees and processes. What is particularly troubling about this litigation is that the artists with avant–garde sensibilities will probably carry greater risks than the artists with mainstream ideas. Investors may have an easier time accepting the more conventional projects that conform to society's expectations, as compared to the more innovative undertakings that society has yet to experience. Imagine that Max Bialystock produced in good faith an innovative production that alienated investors, critics, and fans. His conduct would necessarily risk litigation merely because his work was misunderstood. An artist could attempt to minimize these risks by disclosing any creative processes and benchmarks that investors should expect. Although more disclosures could limit artistic freedom by stifling innovation during the creative process, there will be greater protections for all parties. If, for example, a filmmaker is a minimalist, then the amateur effect of the production should be made known to any investor. The artist could also provide disclaimers or guarantees as to the project's turn–around time. While the disappointed investor may still initiate litigation, the artist will have a valid defense and could ultimately prevail earlier in the proceedings. Without these types of disclosures, neither party will have adequate protection under contract law. The investor will have a hard time

73. Siegel, *supra* note 12, at 794.

establishing the contracted–for expectations, and the artist will have a difficult time rebutting any such expectations.

B. Traversing the Logic of Fiduciary Duty

An alternative for the unhappy investor would be to show a breach of fiduciary duty via an analysis of the issuer's performance or the work–product in light of the issuer's particular circumstance. The securities and corporate laws recognize as tantamount fiduciary duties, the primary purpose of which is to protect investors.[74] Every action taken by a corporate director or officer, or an individual in a similar position, implicates a fiduciary duty.[75] Although there is disagreement as to whether the Contractarian theory provides a real recourse for shareholders who are dissatisfied with a corporate manager's administrative process, commentators generally agree that corporate managers are subject to the fiduciary duties of loyalty and, particularly relevant, due care.[76] The duty of due care/diligence refers to the level of judgment that a person would reasonably be expected to exercise under particular circumstances. Due care is the degree of care, effort, or caution in which a person of ordinary prudence would exercise under similar circumstances. In the corporate context, the duty of due care concerns the decision–making process of officers and directors.[77] Directors and officers must exercise good judgment, using ordinary care and prudence in the operation of the business.[78] "More specifically, 'directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them.'"[79] After becoming so informed, "they must then act with requisite care in the discharge of their duties."[80] Their actions are typically protected by the business judgment rule, which prevents or dismisses shareholder derivative suits for management decisions and processes undertaken in the absence of another breach, gross negligence, or corporate waste.[81] In the securities context, the concept of negligent oversight suggests that even where there is a system of control, conscious

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74. *See* Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1234 (2010).

75. *Id.* at 1236–37.

76. David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 2, 491–516 (2005).

77. Velasco, *supra* note 74, at 1238.

78. Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

79. *See* Velasco, *supra* note 74, at 1238.

80. *Id.*

81. Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979); Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114 (Del. 2006); *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

failure to monitor or to oversee its operations creates liability.[82] One cannot prevent liability merely by saying that there are supervisory procedures in place and that he or she has therefore fulfilled the duty to supervise.[83] Instead, one must prove that he or she "'maintained and enforced a reasonable and proper system of supervision and internal control.'"[84]

Where a crowdfunded campaign is short of fraud or disloyal behavior, investors may have a bigger door for recovery by establishing negligent or careless conduct by the issuer. Although governed by objective standards, the breach of the duty of care analysis is fact driven, determined on a case–by–case basis.[85] While most crowdfunding investors do not have the capital for civil litigation,[86] where they are able to facilitate litigation or obtain the government's support, extensive discovery and perhaps even trial would be required to determine the presence and extent of any alleged breach. The loss caused by a prominent painter's arrogance may not be considered a breach, but the loss caused by an inexperienced painter's might. Some expenses may be deemed wasteful in a particular offering, even if others are reasonable. An issuer could attempt to thwart or reduce liability by providing specific disclosures about his or her experiences, rather than promises about his or her intentions, thereby adjusting the threshold of reasonable judgment in that particular offering. In such a scenario, the day–to–day operations of the corporation would directly relate to the offering itself, raising the question of how much information issuers of creative arts projects should provide in their disclosure statements, which ultimately govern investors' expectations relevant to an issuer's creative process. Admittedly, issuers will not have an easy time conceptualizing their experiences so as to establish the degree of care that is supposedly implicit in their disclosure statements. Where this hurdle is overcome, an issuer who, for example, discloses ample information about his or her inexperience may be subject to less or no liability should it result in investor loss versus an issuer who discloses modestly. Of course, where the issuer misrepresents himself, investors can show scienter and argue

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82. Stone v. Ritter, 911 A.2d 362 (Del. 2006).

83. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1576 (9th Cir. 1990) (citing Zweig v. Hearst Corp., 521 F.2d 1129, 1134–35 (9th Cir. 1975), *cert. denied*, 423 U.S. 1025, and Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980)).

84. *Id.* (quoting *Zweig*, 521 F.2d at 1134–35).

85. *See* Mark Klock, *Lighthouse or Hidden Reef? Navigating the Fiduciary Duty of Delaware Corporations' Directors in the Wake of Malone*, 6 STAN. J.L. BUS. & FIN. 1, 13 (2000) (stating that fiduciary duty "needs to be addressed in the context of specific facts").

86. Siegel, *supra* note 12, at 794–98.

fraud. The harder cases are those where the disclosures are not fraudulent because they require a detailed, objective analysis of the relevant subjective capabilities and circumstances of each issuer/project. Thus, while fiduciary duty claims create recourse against incompetent artists, they could also lead to lengthy and expensive litigation against competent artists.

But the analysis changes where the investor is unhappy with the work product itself, rather than the issuer's efforts and diligence in creating the work. In the case of *The Producers*, if Max Bialystock and his sidekick had honestly tried to create a profitable film and exercised the proper degree of care in production, but still happened to create a flop, the focus would shift away from their efforts and instead to the creative content of their film. The same shift would also occur if they had made an unprofitable film, but had not oversold 100% of the production, thereby shielding any evidence of fraudulent intent. These are the most difficult cases because the focus shifts to the subjective creative vision of the artist. This will create a huge obstacle for investors of failed, yet diligently produced projects.

The breach of the duty of due care is obvious where an issuer manipulates the collection of investments to serve as a mere pretext for self–enrichment. Manipulation would likely bring one back to the relatively easy case of fraud. The harder case arises where an issuer honestly and diligently tries but ultimately fails to complete a project or make a profitable one. Or where an issuer intends not to complete a project or make a profitable one, but exercises due care and is sufficiently sophisticated to shield any evidence of deceitful intent. Obtaining relief against these issuers is a much murkier road. Where investors are unhappy with the quality of the work, but nevertheless cannot establish an improper degree of care by the issuer, they will be left in the dark, with no other recourse. One must not forget that every investment is a market risk. In the crowdfunding creative arts context, the risk is system–wide. Not only is there a risk of loss for the investor, but there is also a risk of unwarranted litigation for the ethical and careful issuer. Detailed disclosure statements could help to eliminate, or at least minimize, some of these risks pursuant to the principles of fiduciary duty law.

IV. IMPROVING THE JOBS ACT: MORE REGULATIONS, MORE PROBLEMS?

The crowdfunding provisions of the JOBS Act behave as a safe harbor.[87] While these provisions remove the formalities related to government

87. *See generally* Crowdfunding Final Rules for SEC, 80 Fed. Reg. 71387, 71387 –71615 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274).

intervention and regulation, the shortcomings of this informality are becoming increasingly apparent. This is especially true in the context of creative artistry, where the success and quality of the work depends on the subjective vision and process of the issuer. The next step may be for the SEC to monitor the arrogant or incompetent issuer by imposing regulations on content–based projects. Such regulations could also offer some protection for the misunderstood artists, while helping to distinguish between the con–artists and the failed artists, i.e., those who never intended to make or complete a profitable project and those who merely failed to do so. However, the SEC must be careful because such regulations may run afoul of the First Amendment. Sure, the SEC could attempt to regulate an issuer's good faith efforts. But if the work product is still a flop despite an issuer's good faith effort, then the issue becomes less about effort and more about content and work product. For example, Mozart could develop a masterpiece in just two hours, but a novice might develop a flop over months. As soon as criteria based on finished product are included, it appears as though the SEC is favoring some speech over others. But the government generally cannot question artistic vision or expression. What is dull in the SEC's eyes could have powerful significance for the minimalist artist and his or her audience. This section questions whether content–based regulations of crowdfunded projects, or of funding portals, would violate the First Amendment.

A. Government Imposition of Criteria on the Work Product

All speech is either commercial or noncommercial.[88] If the SEC were to impose criteria on the work product, the constitutionality of these criteria would hinge on whether a crowdfunding campaign constitutes commercial or noncommercial speech.[89] Commercial speech is directed to an audience and "makes representations of fact about the speaker's business operations for the purpose of promoting sales of its products."[90] Where there is both economic motivation and reference to a specific product, there is strong support that the speech is commercial.[91] Economic motivation by itself, however, is insufficient to render speech commercial.[92] For example, books,[93] motions pictures,[94] and religious literature[95] are considered

88. Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n of NY, 447 U.S. 557, 562–63 (1980).

89. *See id.* at 563.

90. Nike, Inc. v. Kasky, 539 U.S. 654, 657 (2003).

91. Bolger v. Youngs Drug Prods. Corp., 463 U.S. 60, 67 (1983).

92. *See* Bigelow v. Virginia, 421 U.S. 809, 818 (1975).

93. Smith v. California, 361 U.S. 147, 150 (1959).

94. Joseph Burstyn, Inc. v. Wilson, 343 U.S. 495, 501 (1952).

noncommercial speech, even though they may involve a solicitation to purchase or to otherwise pay or contribute money.[96] Reference to a specific product by itself is also insufficient to render speech commercial.[97] The U.S. Supreme Court has established different tests for regulations affecting commercial versus noncommercial speech. These different tests are based on "the informational function of advertising" versus the expressive nature of noncommercial speech.[98] Where the government bans commercial speech more likely to deceive the public than to inform it, or commercial speech related to illegal activity, lenient review is justified.[99] Where commercial speech is constitutional, i.e., it concerns lawful activity and is truthful, the government's power is more circumscribed.[100] Where the government "entirely prohibits the dissemination of truthful, non–misleading commercial messages for reasons unrelated to the preservation of a fair bargaining process, there is far less reason to depart from the rigorous review that the First Amendment generally demands."[101] The same goes for regulations affecting misleading, noncommercial speech. Because these regulations foreclose channels of communication, more careful review is appropriate.[102]

According to Antony Page and Katy Yang, plaintiffs rarely, if ever, challenged the securities laws under First Amendment grounds when they first emerged.[103] It seemed inherent that "preserving the integrity of the capital markets" relied on "the government's ability to mandate the full and fair disclosure of information by a company."[104] More recently, First Amendment jurisprudence has been expanded into the realm of securities regulations.[105] Page and Yang base this on a "variety of factors, including a willingness by scholars and the courts to recognize that economic rights can be closely aligned with the traditional rights protected by the First Amendment."[106] The U.S. Supreme Court first considered applying the

95. Murdock v. Pennsylvania, 319 U.S. 105, 111 (1943).

96. New York Times Co. v. Sullivan, 376 U.S. 254 (1964).

97. Assoc. Students v. Attorney Gen., 368 F. Supp. 11, 24 (C.D. Cal.1973).

98. *See* First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 783 (1978).

99. Cent. Hudson Gas & Elec. Corp.v. Pub. Serv. Comm'n of N.Y., 447 U.S. 557, 563–64 (1980).

100. *Id.*

101. 44 Liquormart, Inc. v. Rhode Island, 517 U.S. 484, 503 (1996).

102. *Id.*

103. Antony Page & Katy Yang, *Controlling Corporate Speech: Is Regulation Fair Disclosure Unconstitutional?*, 39 U.C. DAVIS L. REV. 1, 33–34 (2005).

104. *Id.* at 34.

105. *Id.*

106. *Id.*

First Amendment to federal securities laws in *Lowe v. SEC.*[107] The SEC sought to enjoin publishers of investment material from continuing to publish the material.[108] The Supreme Court granted certiorari to determine whether the First Amendment prohibits injunctions against the publication and distribution of petitioners' newsletters.[109] The Supreme Court, in an opinion delivered by Justice Stevens, ultimately decided the issue on other grounds without addressing the constitutional question.[110] The Court did note, however, that because "expression of opinion about a commercial product such as a loudspeaker is protected by the First Amendment, [internal citation omitted] it is difficult to see why the expression of an opinion about a marketable security should not also be protected."[111] In Justice White's concurring opinion, joined by Chief Justice Burger and Justice Rehnquist, the Court reasoned that the injunction violated the First Amendment because it "banned legitimate, disinterested investment advice, as well as fraudulent, deceptive, or manipulative advice."[112] This constituted a presumptively invalid prior restraint on fully protected speech.[113]

Three years following the *Lowe* decision, in *SEC v. Wall Street Publishing Institute,*[114] the District of Columbia Circuit Court found that profiles of specific investment prospects featured in a monthly stock market magazine were not commercial speech.[115] The featured articles focused primarily on individual companies and portrayed them as appealing investment prospects because of their "market position, product offering, or management strategy."[116] The Circuit Court found that the articles, generally two or three pages long, were not commercial speech because they were "not in an advertisement format."[117] The articles were "indistinguishable from run–of–the–mill newspaper or magazine stories."[118] Although "most of the articles specifically mention the [featured] company's stock along with its price history, not all do this, and

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107. *Id.* at 35–36 (citing Lowe v. SEC, 472 U.S. 181 (1985)).
108. *Lowe*, 472 U.S. at 184–185.
109. *Id.* at 188.
110. *Id.* at 211.
111. *Id.* at 210, n.58.
112. Page & Yang, *supra* note 103, at 37 (citing *Lowe*, 472 U.S. at 234).
113. *Id.*
114. 851 F.2d 365 (1988).
115. *See, e.g., id.*
116. *Id.* at 366–367.
117. *Id.* at 372.
118. *Id.*

in none is the reference to the company's stock particularly prominent."[119] The featured articles therefore were not commercial speech.[120] The U.S. Supreme Court denied certiorari.[121]

Ten years later, in *Commodity Trend Services, Inc. v. Commodity Futures Trading Commission*,[122] the Seventh Circuit held that impersonal investment advice regarding commodities trading is not commercial speech.[123] The District Court had held that the publications containing investment advice were commercial speech because the publications themselves were advertised.[124] The Circuit Court disagreed, finding that "[a]n advertisement is a separate publication and does not strip the promoted publication of its First Amendment protection."[125] Otherwise, "even an editorial in *The New York Times* would constitute commercial speech because the newspaper seeks subscribers through advertisements."[126] The Circuit Court believed that the question was better resolved by focusing on the contents of the publications themselves, which were based on impersonal advice and information.[127] "The type of investment advice contained in the defendant's newsletter included, among other things, historical price ranges for various markets, 'hot picks' (impersonal trading recommendations and market commentaries), general instructions on how to trade in the commodities markets, methods of reducing trading risk, and extrapolating useful information from long–term market trends."[128] The Seventh Circuit relied on the narrow definition of commercial speech, namely "speech which does no more than propose a commercial transaction between a speaker and its audience," and found that the publications did not propose such a transaction.[129] The publications provided information on commodity trading in general and left actual trading to other parties.[130] The publications were "more closely analogous to a restaurant or performance review, or a *Consumer Reports* article, in the

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119. *Id.*

120. *Id.*

121. Wall Street Pub. Inst., Inc. v. SEC, 851 F.2d 365 (D.C. Cir. 1988), *cert. denied* 489 U.S. 1066 (1989).

122. 149 F.3d 679 (7th Cir. 1998).

123. *Id.* at 684–85.

124. *Id.* at 685.

125. *Id.*

126. *Id.*

127. *Id.*

128. Page & Yang, *supra* note 103, at 38 (citing *Commodity Trend Servs., Inc.*, 149 F.3d at 684–86).

129. *Id.*

130. *Commodity Trend Servs., Inc.*, 149 F.3d at 686.

context of the commodity markets."[131] Just like a restaurant review, the publications were noncommercial speech because they did not propose any commodity transaction.[132]

Today, although the law is not entirely clear as to whether crowdfunding solicitations will receive limited commercial speech protection or traditional First Amendment protection,[133] the decisions in *Wall Street* and *Commodity Trend Services* suggest that these campaigns are commercial speech because they propose a commodity transaction and are in advertisement format, despite typically being more than a few pages long. There is economic motivation and reference to a specific product. A crowdfunding solicitation attempts to persuade viewers to invest in a particular venture.[134] The issuer is a commercial speaker directing a message to an audience for the purpose of engaging that audience in a commercial transaction. Representations of fact may also be present regarding the work product or process. Even if an issuer includes his or her opinions about the work product or topic, the mere fact that an advertisement links a product to public discussion does not render it noncommercial speech.[135] Whether the campaign is equity or donation based, viewers are presented with some sort of product with the intention of being lured into a transaction.

If a crowdfunding solicitation is deemed commercial speech, then the SEC's regulations must pass the test set forth in *Central Hudson*.[136] Where commercial speech is constitutional, the government must show an actual and substantial governmental interest that is directly advanced by the regulation, which must not be more extensive than necessary to serve that interest.[137] In *Central Hudson*, the New York Commission prohibited utility companies from advertising in a way that urged consumers not to conserve energy.[138] The Court reasoned that the state had a substantial interest in conserving resources, and that the ban materially advanced that interest.[139] Despite this interest, the Supreme Court believed that a total

131. *Id.*

132. *Id.*

133. Page & Yang, *supra* note 103, at 36.

134. *See* Pittsburgh Press Co. v. Human Relations Comm'n, 413 U.S. 376, 385 (1973).

135. Cent. Hudson Gas & Elec. Corp.v. Pub. Serv. Comm'n of N.Y., 447 U.S. 557, 563 n.5 (1980).

136. *See, e.g. id.* at 564.

137. *Id.*

138. *Id.* at 559–60.

139. *Id.* at 568–69.

prohibition was more extensive than necessary.[140] The Commission had not demonstrated that alternatives would be ineffective.[141] Later, this "least restrictive" standard was modified to a "reasonable fit" standard.[142] The Supreme Court modified the "least restrictive" requirement based on the "difficulty of establishing with precision the point at which restrictions become more extensive than their objective requires."[143] The Court also noted that the government needed leeway in the field of commercial speech, which is "traditionally subject to government regulation."[144] Following *Central Hudson*, in *Metromedia Inc. v. City of San Diego*,[145] the Supreme Court struck down an ordinance restricting billboards containing both commercial and noncommercial speech.[146] The Court reasoned that the ordinance restricted too much noncommercial speech, but clearly indicated that it would uphold an ordinance banning only commercial billboards.[147]

Central Hudson and its progeny suggest that the SEC may have trouble restricting truthful, creative arts, crowdfunding solicitations if they are deemed commercial speech, although such solicitations were entirely prohibited until the JOBS Act absent a public offering or private placement. It is true that there are substantial governmental interests, such as the protection of interstate commerce from dishonest issuers, that could likely justify SEC regulations against content–based products. In fact, the U.S. Supreme Court has upheld a regulation of commercial speech even where the government failed to show that it served a substantial interest other than preventing deception.[148] However, the SEC may have trouble creating regulations that are limited enough so as not to impede on the noncommercial speech that is inextricably intertwined in a creative arts solicitation. Where an issuer solicits funds for a creative arts project, such as a book, painting, movie, or board game, then the speech necessarily entangles noncommercial elements of artistic expression. Regulating or preventing these solicitations may in turn impede or ban an issuer's ability to facilitate expression of such content. This may be unacceptable under U.S. Supreme Court standards, where the sale of protected materials is also

140. *Id.* at 570–71.
141. *Id.*
142. Bd. of Trs. of State Univ. of NY v. Fox, 492 U.S. 469, 480–481 (1989).
143. *Id.*
144. *Id.*
145. 453 U.S. 490 (1981).
146. *Id.* at 512–517.
147. *Id.* at 503–512.
148. Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626, 650 (1985).

protected under traditional First Amendment jurisprudence.[149] The Ninth Circuit too has extended traditional First Amendment protection to the "sale of merchandise which is inextricably intertwined with a statement carrying a religious, political, philosophical or ideological message."[150] The business of tattooing[151] and an artist's sale of original work[152] have also received traditional First Amendment protection. The presence of noncommercial expression in a creative arts solicitation therefore may require the SEC to justify any crowdfunding regulations under the standards set forth for noncommercial speech, rather than commercial speech.

If a crowdfunding solicitation is not commercial speech, then courts must turn to the *O'Brien* test.[153] *O'Brien* and its progeny allow the government to enforce a structural regulation that may incidentally restrict noncommercial speech content without violating the First Amendment. Under this test, the regulation must be content–neutral and a time, place, or manner restriction.[154] The regulation must further an actual and substantial governmental interest that is unrelated to the suppression of speech, and must not restrict more speech than necessary to further that interest.[155] In *O'Brien*, the Court reasoned that a law criminalizing the destruction of draft cards "no more abridges free speech on its face than a motor vehicle law prohibiting the destruction of drivers' licenses, or a tax law prohibiting the destruction of books and records."[156] Many purposes for the draft card would be defeated if it were altered, destroyed, or mutilated.[157] Following *O'Brien*, in *Turner v. FCC*,[158] the Court upheld the Must–Carry provisions of the Cable Television Consumer Protection and Competition Act of 1992.[159] The "Must–Carry Rules" required cable systems to allocate a percentage of their channels to local public broadcast stations.[160] The issue was whether the government violated the First Amendment by compelling

149. Lakewood v. Plain Dealer Publ. Co., 486 U.S. 750, 756 n.5 (1988).

150. Gaudiya Vaishnava Soc'y v. City & County of San Francisco, 952 F.2d 1059, 1066 (9th Cir. 1989).

151. Anderson v. City of Hermosa Beach, 621 F.3d 1051, 1063 (9th Cir. 2010).

152. White v. City of Sparks, 500 F.3d 953, 954 (9th Cir. 2007); Bery v. New York, 97 F.3d 689, 695 (2d Cir. 1996).

153. *See, e.g.*, United States v. O'Brien, 391 U.S. 367 (1968).

154. *Id.* at 376–377.

155. *Id.*

156. *Id.* at 375.

157. *Id.* at 378.

158. 512 U.S. 622 (1994) (plurality opinion).

159. *Id.* at 636.

160. *Id.*

cable companies to carry other stations.[161] On their face, the Must–Carry provisions "impose[d] burdens and confer[ed] benefits without reference to the content of speech."[162] The design and operation of the provisions confirmed their content neutrality.[163] The rules were imposed industry–wide, regardless of content; did not require or prohibit any particular point of view; did not penalize based on content; did not compel affirmance of disagreeable points of view; did not decrease the amount of speech; and left open whatever speech the providers wanted on channels not subject to the requirement.[164] In addition to being content–neutral and a proper time, place, and manner restriction, there were three substantial governmental interests that outweighed the minor impact on the cable companies: (1) the preservation of free local broadcast television; (2) the promotion of widespread dissemination of information from multiple sources, rather than just one; and (3) the promotion of fair competition.[165] In *Turner*, the principal opinion applied the *O'Brien* test deferentially to the "predictive judgments" of Congress[166] and determined that "a real threat justified enactment of the Must–Carry provisions."[167]

In the crowdfunding context, the SEC could likely impose regulations on creative arts solicitations without impinging on the issuer's First Amendment rights, in an effort to minimize potential litigation by disgruntled investors and to protect the legitimate artist. Imposing qualitative performance benchmarks on crowdfunding issuers would be similar to the forced conduct in *Turner*.[168] Ultimately, *Turner* rests on the premise that what was being regulated was a pipeline, i.e., broadcast signals, over which speech flowed. The government was not attempting to regulate the content itself. If an investor, in response to a crowdfunding solicitation, buys into a film or other artistic production, the investment product would also necessarily involve expression. The government would need to make a similar distinction by showing that what is being regulated is the channel over which the speech flows, rather than the speech itself.

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161. *Id.*

162. *Id.*

163. *See id.* at 647.

164. *Id.*

165. Turner Broad. v. FCC, 910 F. Supp. 734, 751 (D.D.C. 1995), *aff'd*, 520 U.S. 180 (1997); *Turner*, 520 U.S. at 195.

166. *Turner*, 520 U.S. at 195.

167. *Id.* at 196.

168. *See, e.g.*, Satellite Broad. & Commc'ns. Ass'n v. FCC, 275 F.3d 337, 353 (4th Cir. 2001); Cablevision Sys. Corp. v. FCC, 570 F.3d 83 (2d Cir. 2009) (finding that on the other hand, statutes that discriminate against a small and identifiable number of cable providers have been subject to strict scrutiny); Time Warner Cable, Inc. v. Hudson, 667 F.3d 630, 638 (5th Cir. 2012).

Under *Turner*, the fact that funding portals may themselves be used to convey a message is not relevant:

> That the video signals can only be used to convey a message is of no particular significance. The same is true of printing presses, or broadcast transmitters; loudspeakers, or movie projectors. Yet no one doubts that Congress could regulate a market in those commodities in danger of chaos or capture without being accused of attempting to infringe the First Amendment freedoms of those by whom they will be used to express protected speech.[169]

In circumstances such as those in *Turner*, the First Amendment requires nothing more than a policy supporting content–neutral regulations that is "grounded on reasonable factual findings supported by evidence that is substantial for a legislative determination."[170] In this context, the government would not be regulating or suppressing creative arts solicitations over every channel. Instead, there would be structural, content–neutral regulations related only to the manner in which funding portals operate. For example, the SEC may not be able to prohibit crowdfunding solicitations for minimalist art projects, though the agency could regulate solicitations that are minimal. In the latter instance, the regulation would apply structurally to a broad spectrum of content, including other, more conventional projects. The SEC could also impose specific completion deadlines depending on the nature of the project; e.g., one year for films and six months for paintings. While creating such regulations will probably be a difficult task itself,[171] if accomplished their

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169. *Turner*, 819 F. Supp. at 40.

170. *Turner*, 520 U.S. at 224–25.

171. Although it did not involve content neutral, structural regulation, the *NEA v. Finley* case, which challenged government criteria for issuing grants to artists, illustrates the difficulties of subjecting artistic expression to government regulation and oversight. NEA v. Finley, 524 U.S. 569 (1998). Congress created the National Endowment for the Arts ("NEA") as an independent U.S. agency in 1965. *Id.* The NEA offers support and funding for projects exhibiting artistic excellence. *Id.* The NEA reviews grant applications, fundraising guidelines, and leadership initiatives. *Id.* Subsection (d)(1) of 20 U.S.C. section 954 provides that the NEA Chairperson shall ensure that artistic excellence and artistic merit are the criteria by which applications are judged. *Id.* In 1998, the Supreme Court ruled that section 954(d)(1) is facially valid, as it neither inherently interferes with First Amendment rights nor violates constitutional vagueness principles. *Id.* This case arose from the denial of grants based on subject matter to the "NEA Four," i.e., four artists who claimed that section 954(d)(1) constrains the agency's ability to fund certain categories of artistic expression. *Id.* The Supreme Court, however, found that the provision simply adds "considerations" to the grant–making process. *Id.* "[T]he agency must take 'cultural diversity' into account," and allocate "on the basis of a wide variety of subjective criteria." In addition, the provision "does not preclude awards to projects that might be deemed 'indecent' or 'disrespectful,' nor place conditions on grants, or even specify that those factors must be given any particular weight in reviewing an application." *Id.* The provision "merely admonishes the NEA to take 'decency and respect' into consideration." *Id.* Because there are "varied interpretations of the 'decency and

presence could lead to greater protections for both the issuer and investor.

B. Government Imposition of Criteria on the Funding Portals

A better alternative may be for the SEC to impose conditions on the funding portals, rather than on the work product. Such requirements on the funding portals would be analogous to the mandates of the Telecommunications Act of 1996.[172] Section 551 of the Telecommunications Act requires the V–Chip to be added to all televisions so that parents or other caregivers can block programing that they do not want children to watch.[173] Rather than deciding what is and is not appropriate, the government leaves full control over exposure to content in the hands of the people.[174] What is particularly important about the Telecommunications Act is that it still leaves it to the industry to establish and assign ratings, also known as "TV Parental Guidelines."[175] The Telecommunications Act established a television rating system contingent upon distributors of video programming adopting "voluntary rules" that were "acceptable" to the FCC.[176] Although some Senators were vocal about First Amendment concerns due to the intrusion on content, the media expressed little concern and the Telecommunications Act itself appeared to be conscious of this issue.[177] For example, use of the vague term

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respect' criteria," the Court did "not perceive a realistic danger that it will be utilized to preclude or punish the expression of particular views." *Id.* While crowdfunding is not a government grant program, the SEC could add considerations to the creative arts crowdfunding process. For example, the SEC could create a division responsible for evaluating creative arts campaigns based on certain criteria. The division's purpose would be to determine whether such campaigns may take advantage of the new crowdfunding exemptions. The division would consider cultural diversity and approve campaigns based on a wide variety of subjective criteria, without forgoing "disrespectful" or unconventional content.

172. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified throughout Title 47 of the United States Code ("47 U.S.C.").

173. *The V–Chip: Putting Restrictions on What Your Children Watch*, FCC (Nov. 4, 2015), https://www.fcc.gov/guides/v-chip-putting-restrictions-what-your-children-watch.

174. *See About the TV Ratings and V–Chip*, TV PARENTAL GUIDELINES, http://www.tvguidelines.org (last visited July 27, 2016).

175. *Frequently Asked Questions*, TV PARENTAL GUIDELINES, http://www.tvguidelines.org/faqs.htm (last visited July 27, 2016).

176. *See* Telecommunications Act of 1996, Pub. L. No. 104–104, § 551(e)(1)(A), 110 Stat. 56 (1996) (providing that early First Amendment academic discussion was concerned about the compelled adoption of the rating system, although the rating system does not favor one type of programing over another); *see, e.g.*, Kevin D. Minskyd, Note, *The Constitutionality and Policy Ramifications of the Violent Programming Rating Provision in the Telecommunication Act of 1996*, 47 SYRACUSE L. REV. 1301, 1314, 1316 (1997).

177. *See* Letter from Jack Valenti, President and CEO, Motion Pictures to William

"acceptable" was likely strategic: "more specific language defining the parameters of a rating system could cause the courts to rule the rating system legislation violated the First Amendment."[178] According to a few commentators, the lack of an exact definition of "acceptable" in the Telecommunications Act or its legislative history leads to an application of its general meaning.[179] Congress "did not intend for the Commission to demand that an industry–developed system of guidelines conform to the Commission's own or anyone else's vision of an ideal program."[180] As James T. Hamilton wrote, a more exact definition of the content rating system would open the door to more constitutional challenges.[181] Other policies and statutes that "direct [government] agencies to rely on voluntary standards and avoid the use of government–unique standards" have also been upheld as constitutional.[182]

In the crowdfunding context, the SEC could require funding portals to issue their own objective restrictions meeting some professional standard. This would be similar to the V–Chip, which does not mandate content ratings, but merely requires broadcasters to have a rating system that will work with its technology. Funding portals would be held responsible for creating specific content and work–process guidelines. For example, the filmmaker must enter the work–product into a recognized film festival, or attempt to; an artist must showcase the work in a gallery, or attempt to; or a composer must present the work in a concert. In addition, the SEC could require funding portals to limit the types of projects that they accept. For example, certain portals would accept only low–budget films or minimalist art, while other portals would exist exclusively for high–budget films or extravagant art. Whatever the standard, any benchmarks or requirements imposed by the SEC should probably also be "voluntary" with a heavy recommendation that they be adopted before the SEC needs to impose its own standards. If the SEC requires that the industry design and adopt "acceptable" standards for benchmarks, that vague mandate could similarly convey that the SEC is not demanding guidelines that conform to its own or

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F. Caton (Jan. 17, 1997) [hereinafter Letter from Valenti ET AL., to Caton], https://transition.fcc.gov/Bureaus/Cable/Public_Notices/1997/fcc97034.txt.

178. James T. Hamilton, *Who Will Rate the Ratings?*, *in* THE VCHIP DEBATE: CONTENT FILTERING FROM TELEVISION TO THE INTERNET 133, 133–134 (Monroe E. Price ed., 1998).

179. Letter from Jack Valenti ET AL., to Caton, *supra* note 177.

180. *Id.*

181. Hamilton, *supra* note 178, at 134.

182. *US–EU High–Level Regulatory Cooperation Forum: Report on the Use of Voluntary Standards in Support of Regulation in the United States*, INT'L TRADE ADMIN. 7 (Oct. 2009), http://trade.gov/td/standards/United%20States/Use-of-Voluntary-Standards-in-Support-of-US-Regulation.pdf.

someone else's vision of an ideal product.[183] Even with such a framework, however, the question remains if the SEC would be passing an unworkable responsibility to a non–governmental party. Monitoring and enforcing these or other guidelines could itself prove difficult, expensive, and time–consuming.

CONCLUSION

Though the JOBS Act has worked relatively smoothly thus far, the system is still in its infancy. As issues with crowdfunded campaigns emerge,[184] the optimism that many shared when the JOBS Act was signed into law is slowly diminishing. In addition to concerns surrounding fraud, the JOBS Act could open the floodgates for lengthy, fact–based litigation against honest creative arts projects, creating an uphill battle for issuers and investors. Congress may need to revisit the law's approach to creative arts crowdfunding, in conjunction with industry self–regulation that would require a portal to more clearly specify arts–related risks to all stakeholders in its terms of use. Currently, issuers of, and investors in, good faith, creative arts campaigns are exposed to significant risks — and inadequate remedies — that are not easily resolvable under regulations that are blind to the creative process. Whatever the solution may be, government and industry need to act soon. Since the JOBS Act became law in 2012, crowdfunding has nearly doubled year by year,[185] and the number of crowdfunding platforms has also steadily increased worldwide.[186] If this trend continues, predictions estimate a $90 billion crowdfunding industry by 2017.[187] Although the number of, or increase in, creative arts campaigns alone is unclear, what remains clear is that creative artists have a legitimate need for crowdfunding that the JOBS Act advances effectively but not always fairly.

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183. *See* Letter from Jack Valenti ET AL., to Caton, *supra* note 177.

184. Jordan Goodson, *7 Scam–tastic Crowdfunding Campaigns*, GADGET REV. (last updated Aug. 3, 2015), http://www.gadgetreview.com/7-scamtastic-crowdfunding-campaigns; Catherine Fredman, *Fund Me or Fraud Me? Crowdfunding Scams Are on the Rise*, CONSUMER REPS. (Oct. 5, 2015), http://www.consumerreports.org/cro/money/crowdfunding-scam; Stephanie Grella, *Fraudulent Crowdfunding Campaign Sets Precedent*, OBSERVER INNOVATION (Sept. 14, 2015, 2:32 PM), http://observer.com/2015/09/kickstarter.

185. Barnett, *supra* note 10.

186. Briggman, *supra* note 11.

187. Barnett, *supra* note 10.

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FREE TRADE, THE WASHINGTON CONSENSUS, AND BILATERAL INVESTMENT TREATIES THE SOUTH AFRICAN JOURNEY: A RETHINK ON THE RULES ON FOREIGN INVESTMENT BY DEVELOPING COUNTRIES

ZIYAD MOTALA *

INTRODUCTION

The internationalization of business constitutes one of the dominant features of commerce today. Ever since World War II, the prevailing mantra of trade policy among western countries is free trade.[1] Countries in the developed world are expected to eliminate all restrictions on the free movement of goods across national borders. This is codified in the rules of

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1. RALPH H. FOLSOM ET AL., INTERNATIONAL BUSINESS TRANSACTIONS: FOREIGN INVESTMENT 22 (10th ed. 2009); *Free Trade Protection and Agreements* (last visited June 18, 2016), http://www.referenceforbusiness.com/encyclopedia/For–Gol/Free–Trade–Protection–and–Agreements.

the World Trade organization ("WTO"),[2] which entered into force in 1995 and the predecessor regime under the General Agreement of Trade and Tariffs ("GATT") entered into in 1948.[3] Free trade is complemented by the rules of the International Monetary Fund ("IMF"), which requires countries, particularly those from the developed world, to remove currency restrictions.[4]

The developed world has relentlessly pushed other countries to embrace free trade, as most recently seen in the Washington Consensus.[5] This article considers the trade and monetary policies pursued by South Africa, Africa's most developed if not largest economy in the post 1994 period. In the immediate aftermath of South Africa's first democratic elections, the country embraced the Washington Consensus and the underlying notion of free trade. In addition, it entered into a number of Bilateral Investment Treaties ("BITs") with several European countries.[6] These agreements have proved to be profoundly detrimental to South Africa as a developing country. It has undermined South Africa's ability to nuance its economic policy choices to deal with the legacies of apartheid.

The developed world embraces free trade after it achieves a particular level of development. Countries in the developed world engaged in mutually beneficial free trade when their economies achieved similar levels of sophistication and development. Moreover, their populations function under superior standards of education and high material standards of living. South Africa adopted free trade under circumstances of extreme inequality and abject poverty.[7] Unlike most of the developed world, South Africa has a deficient education system, which suffers from severe impediments, due to decades of apartheid rule.[8] Parts of the economy are highly developed

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2. World Trade Organization, Ministerial Declaration of 14 November 2001, WTO Doc. WT/MIN(01)/DEC/1, 42 ILM 746 (2002) [hereinafter Doha Declaration].

3. FOLSOM, *supra* note 1, at 22–23; *What is the WTO?*, WTO (last visited June 18, 2016), https://www.wto.org/english/thewto_e/whatis_e/wto_dg_stat_e.htm.

4. FOLSOM, *supra* note 1, at 21; *Factsheet*, IMF (Mar. 23, 2016), http://www.imf.org/external/np/exr/facts/glance.htm.

5. *Washington Consensus*, WHO (last visited June 18, 2016), http://www.who.int/trade/glossary/story094/en/.

6. Peter Leon, *Creeping Expropriations of Mining Investments: An African Perspective*, 27 J. ENERGY NAT. RESOURCES & ENVTL. L., 597, 601 (2009).

7. Andrew Friedman, *Flexible Arbitration for the Developing World: Piero Foresti and the Future of Bilateral Investment Treaties in the Global South*, 7 INT'L L. & MGMT. REV. 37, 40 (2010–2011).

8. Lucy Holborn, *Education in South Africa: Where Did it Go Wrong?*, GGA (Sept. 1, 2013), http://gga.org/stories/editions/aif-15-off-the-mark/education-in-south-africa-where-did-it-go-wrong; *see also* Julian Rademeyer, *Is SA Bottom of the Class in Maths and Science? WEF Ranking is Meaningless*, AFR. CHECK (Sept. 3, 2014, 5:54), https://africacheck.org/reports/is-sa-bottom-of-the-class-in-maths-and-scienc

with a minority that lives under "first world" conditions. South Africa assumed largely first world free trade obligations despite the reality of the majority of the population subsisting under conditions of poverty and rampant unemployment unlike any other countries that assumed similar obligations.[9]

The embrace of free trade resulted in the decimation of key sectors of the economy.[10] The liberalization policies also resulted in the movement of major corporate head offices and large amounts of currency out of South Africa. South Africa entered into a number of BITs with developed countries, which constrained its ability to adopt legislative and policy frameworks to advance the public interest.[11] In several instances, the BITs agreements contained provisions inconsistent with constitutional imperatives. It meant that as a sovereign, the country surrendered key aspects of its economic policy. South African representatives failed to appreciate the impact of these measures and its consequences on the ability of the state to fashion progressive policies for the benefit of the disadvantaged.

The difficulty of competing against other developing countries has been compounded by a Constitution and legal order, which guarantees socio–economic and labor rights to its population.[12] The progressive Constitution and the guarantees granted therein are something one expects in the developed world. When compared to other competitive markets in the developing world that do not provide similar legal guarantees, there is an increase in the cost of doing business in South Africa. This makes it difficult to compete with other developing countries that do not have a transparent, rights–based, and democratic constitution.

In hindsight, South Africa, like many developing countries, has soured on free trade and BITs.[13] The South African government has come to the realization that free trade with the developed world and an essentially passive government has adverse consequences for its development and

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e–why–ranking–is–meaningless/.

9. *See* Thabi Mbeki, Former President of South Africa, State of the Nation Speech (Feb. 14, 2003) (describing South Africa as a dual economy with an industrialized and underdeveloped part).

10. Lila J. Truett & Dale B. Truett, *New Challenges for the South African Textile and Apparel Industries in the Global Economy*, 35 J. ECON. DEV. 4 (2010).

11. Mohammed Mossallem, *Process Matters: South Africa's Experience Exiting its BITs*, GLOBAL ECON. GOVERNANCE PROGRAMME (2015).

12. *See* S. AFR. CONST., 1996 §§ 22–27 (containing a myriad of positive rights including: the right to freedom of trade, labour rights, housing, health care, food, water and social security).

13. David Schneiderman, *Promoting Equality, Black Economic Empowerment, and the Future of Investment Rules*, 25 SAJHR 246, 249 (2009).

ability to create an environment that uplifts the material conditions of the majority.[14] There is an emerging consensus that free trade among similarly situated countries in the continent offers better opportunities for the developing world. Free trade with the developed world has not delivered a manufacturing base to most African countries leaving them dependent on the export of raw materials.[15] The BIT agreements, which complement free trade, served as a significant constraint on African governments' ability to shape their public policy.[16]

II. EMBRACE OF FREE TRADE AND THE WASHINGTON CONSENSUS

The idea of free trade finds inspiration in the writings of various economists, such as Adam Smith.[17] After World War II, United States trade policy was shaped by the ideas of free trade.[18] Free trade proponents argued that parochial concerns among nations, favoring their own nationals to the exclusion of others, resulted in protectionism, which was one of the major contributing factors for the Great Depression.[19] Free trade is grounded in the concept of comparative advantage — the idea that consumers across nations will be better off if all restrictions on the sale of goods across national borders are removed.[20] By virtue of market forces, producers will specialize in the production of goods, which they are more efficient in producing.[21] This provides a greater variety and quantity of goods available at a cheaper price, which consumers across national borders will be able to purchase from sellers in other countries. Ultimately, countries will achieve the greatest aggregate wealth and quantitative income.[22] From a historical perspective, the developed countries used various forms of protection and interventions into their economy during the formative stages of their industrialization. These protections are now

14. Jason Brickhill & Max Du Plessis, *Two's Company, Three's a Crowd: Public Interest Intervention in Investor–State Arbitration (*Piero Foresti v South Africa*)*, 27 SAJHR 152, 157 (2011).

15. Rick Rowden, *Africa's Free Trade Hangover*, FOREIGN POL'Y (Aug. 7, 2014), http://foreignpolicy.com/2014/08/07/africas-free-trade-hangover/.

16. Jonathan Klaaren & David Schneiderman, Comment, *Investor–State Arbitration and SA's Bilateral Investment Treaty Policy Framework Review*, MANDELA INST. (Aug. 10, 2009).

17. *Free Trade*, *in* INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL SCIENCES (2008).

18. *Id.*

19. *See generally* FOLSOM, *supra* note 1.

20. *Free Trade*, *supra* note 17 ("The foremost theorist of comparative advantage is David Ricardo.").

21. *US Economy: Production of Goods and Services*, THEUSAONLINE.COM (last visited June 18, 2016), http://www.theusaonline.com/economy/production.htm.

22. *Free Trade*, *supra* note 17.

deemed contrary to the idea of the free market.[23]

The phrase "Washington Consensus" is viewed as the equivalent of "neoliberalism" and "globalization."[24] The originator of the phrase, John Williamson, used the phrase in 1990 "to refer to the lowest common denominator of policy advice being addressed by the Washington–based institutions to Latin American countries as of 1989."[25] The policies included:[26]

- Fiscal discipline — strict criteria for limiting budget deficits
- Public expenditure priorities — moving them away from subsidies and administration towards previously neglected fields with high economic returns
- Tax reform — broadening the tax base and cutting marginal tax rates
- Financial liberalization — interest rates should ideally be market–determined
- Exchange rates — should be managed to induce rapid growth in non–traditional exports
- Trade liberalization
- Increasing foreign direct investment (FDI)– by reducing barriers
- Privatization — state enterprises should be privatized
- Deregulation — abolition of regulations that impede the entry of new firms or restrict competition (except in the areas of safety, environment, and finance)
- Secure intellectual property rights (IPR) without excessive costs and available to the informal sector
- Reduced role for the state

The "Washington Consensus" has proved to be a point of contention and has emerged to reflect deep grievances among developing countries.

III. SOUTH AFRICA AND FREE TRADE

South Africa embraced the Consensus in the aftermath of apartheid rule at a time when their objective realities were worse than anything posed by the global financial crisis of 2008 in the western world. Unemployment by conservative estimates was in excess of thirty percent of the population.[27] The majority of the population existed and continues to reside in conditions

23. Rowden, *supra* note 15.

24. *Washington Consensus*, GLOBAL TRADE NEGOT. (Apr. 2003), http://www.cid.harvard.edu/cidtrade/issues/washington.html.

25. *Id.*

26. John Williamson, *A Short History of the Washington Consensus*, FUNDACIÓN CIDOB (Sept. 24, 2004), http://www.iie.com/publications/papers/williamson09042.pdf; *Washington Consensus*, *supra* note 5.

27. *South Africa Economic Policy and Trade Practices*, U.S. DEP'T OF STATE (Feb. 1994), http://dosfan.lib.uic.edu/ERC/economics/trade_reports/1993/SouthAfrica.html.

of abject poverty.[28] Many did not and still do not have access to basic sanitation, water, infrastructure, and education.[29] The economic challenges that the developed world experienced in 2008 are a perpetual and "normal" reality for many countries in in the developing world. The solutions proposed in the Consensus were defenestrated by the developed world when it experienced the global crisis.[30] Whilst many developing countries suffer this perpetual crisis, they were called upon to embrace the framework of the Consensus.

Despite the economic reality that exceeds anything the developed world experienced in the financial crisis of 2008, South Africa, starting with the government of Nelson Mandela, embraced the Washington Consensus and expansive free trade. It entered into the GATT agreements, succeeded by the WTO, which undertook first world free trade commitments as a developed country.[31] It systematically eliminated tariffs on imported items.[32] South Africa's reduction of tariffs exceeded that of what one may consider similarly situated economies, namely the BRICS countries.[33]

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28. Greg Nicholson, *South Africa: Where 12 million Live in Extreme Poverty,* DAILY MAVERICK (Feb. 3, 2015), http://www.dailymaverick.co.za/article/2015-02-03-south-africa-where-12-million-live-in-extreme-poverty/#.VpOmARFUfww.

29. *See* Friedman, *supra* note 7, at 40 ("The Word Economic Forum ranks South Africa as 148 out of 148 countries in Math and Science in 2014."); *South Africa Anger at 'Worst Maths and Science' Ranking*, BBC (June 3, 2014), http://www.bbc.com/news/world-africa-27683189; *see also* Julian Rademeyer, *Is SA Bottom of the Class in Maths and Science? WEF Ranking is Meaningless*, AFRICA CHECK (Sept. 3, 2014), https://africacheck.org/reports/is-sa-bottom-of-the-class-in-maths-and-science-why-ranking-is-meaningless/.

30. The Consensus among the developed world dissipated in the 2008–2009 global financial crisis. ROBERT SKIDELSKY, KEYNES: THE RETURN OF THE MASTER 101, 102, 116–117 (2009). In the aftermath of the global financial crisis, we witnessed rigorous government intervention among many of the developed countries prompting Gordon Brown, the former British Prime Minister to declare, "the old Washington Consensus is over." Abhijit, *Old Washington Consensus is Over: Gordon Brown*, Pressrun.net (Apr. 3, 2009). http://www.pressrun.net/weblog/2009/04/old-washington-consensus-is-over-gordon-brown.html.

31. *See* Faizel Ismail, *South Africa's role in the Multilateral Trade System*, TULANE, http://www.tulane.edu/~dnelson/PEBricsConf/Ismail%20SA.pdf. ("Some argue that South Africa took its rightful place among the developing world.").

32. ALEX BORAINE ET AL., SOUTH AFRICA AND THE WORLD ECONOMY IN THE 1990s 174, 175 (1993).

33. Vera Thorstensen ET AL., *BRICS in the WTO: In Search of a Positive Agenda, in* BRICS IN THE WORLD TRADE ORGANIZATION: COMPARATIVE TRADE POLICIES BRAZIL, RUSSIA, INDIA, CHINA AND SOUTH AFRICA 13, 75 (2014) ("average tariffs applied by the BRICS members are quite close, ranging from 7.7% in South Africa to 13.6% in Brazil. However, there is a significant difference in the average bound tariffs. China, due to its recent accession to the WTO, has no relevant margin between applied and bound tariffs: 0.4 percentage points (pp) between the averages of said tariffs. India has a difference of 35.6 pp. between the averages of the two tariffs. Brazil is the only BRICS country with an average tariff applied to agricultural goods that is lower than

Together with the elimination and reduction of tariffs, local content rules were eliminated.[34] Even though South Africa is Africa's largest economy, the experiences for the majority of the population remains that of an underdeveloped country.[35] The uncritical embrace of free trade resulted in the decimation of sectors of the economy, such as textiles.[36] These industries were important in providing employment and keeping people out of poverty.[37]

Not only did the GATT and WTO agreements mean tariffs in the textile and other industries had to be reduced, it further meant that South Africa, like other countries that assumed similar obligations, were legally circumscribed in subsidizing their industries. For South Africa, this meant that the historically disadvantaged population (saddled with decades of discrimination and attendant disabilities) could not be subsidized or given a leg up because this would invite charges of unfair trade practices.[38] With the decimation of key sectors of the economy, hundreds of thousands of people lost their jobs. The majority who fail to secure alternate jobs receive unemployment and welfare payments from the state.[39] This drain to the economy is profound. Free trade has moved large sections of the population from employment to welfare.

Apartheid shielded inefficient industries, which were largely controlled by the white minority population.[40] At the same time, apartheid also meant that the historically disadvantaged Black majority lived and continue to live in an underdeveloped reality. Apart from grave poverty, they suffered and continue to suffer grave impediments with respect to entrepreneurship and

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that which is applied to non–agricultural goods. The other members have higher agricultural tariffs and this is particularly so in the case of India, whose applied and bound averages in the sector are 32.2% and 113.1% respectively.").

34. The Agreement on Trade–Related Investment Measures (TRIMs) agreed upon by members of the World Trade Organization in 1994 that became effective in 1995 banned local content requirements that promote the interests of domestic industries.

35. RASIGAN MAHARAJH, OVERCOMING UNDERDEVELOPMENT IN SOUTH AFRICA'S SECOND ECONOMY (2005).

36. Truett & Truett, *supra* note 10.

37. *See id.* ("Successive rounds of the GATT agreements including the Paraguay Round and the Doha agreements resulted in the elimination of tariffs for textiles. The consequence of this was the percentage of employees in the textile industry decreased dramatically.").

38. Under the WTO rules, countries can impose countervailing duties against imports aided by subsidies. *Subsidies and Countervailing Measures Overview*, WTO (2016), https://www.wto.org/english/tratop_e/scm_e/subs_e.htm.

39. Louise Ferreira, *Factsheet: Social Grants in South Africa — Separating Myths From Reality*, AFR. CHECK (Feb. 24, 2016), https://africacheck.org/factsheets/separating–myth–from–reality–a–guide–to–social–grants–in–south–africa/.

40. RUCHIR SHARA, THE LIBERATION DIVIDEND 64 (Haroon Bhorat ET AL. eds., 1993); BORAINE, *supra* note 32, at 176.

acquisition of skills, which, prevents them from competing on an equal footing.[41] Undoubtedly, a lot of unskilled production, like the clothing industry, has migrated from the developed world to the developing world.[42] The superstructure of the economies of the developing world is not monolithic. At times, what on the surface might appear to be a developed economy, like South Africa, is not really developed at least from the perspective of the majority of the population. South Africa is more akin to a semi–industrialized industry with foots in both the developed and developing world.[43] The free trade policies were neither informed, nuanced, nor reflective of South Africa's unique realities. No other country with the level of unemployment and abject poverty like South Africa has assumed free trade obligations of a developed world country. The decision makers of South Africa adopted free trade in an uncritical manner. The free trade agreements commenced under the watch of Minister Trevor Manual, democratic South Africa's first Trade and Industry Minister and later first Black Minister of Finance. Minister Manual has been hailed by big business as an insightful visionary. If the truth were told, he was likely the most unqualified Minister occupying both portfolios because he had neither an economics, law, banking background or even a university degree.

The conventional orthodoxy of trade and comparative advantage has not resulted in benefits to the South African economy. South Africa, a country with relative political and economic stability, rich resources, a sophisticated infrastructure, and a well–functioning stock market has not acquired significant foreign direct investment.[44] South Africa has one of the most advanced constitutions and sophisticated legal framework operating under the rule of law and an independent judiciary. It has a free press and one of the strongest financial systems in the world. If we are to believe the Washington Consensus, this is an optimum legal regime. Herein lies one of the stark contradictions. The South African Constitution confers rights including civil and political rights, socio–economic rights, and labor rights to its citizens.[45] The social contract that ushered in the Constitution reflects a realization that the success and legitimacy of the constitutional order is

41. Friedman, *supra* note 7.

42. Mike Morris ET AL., *Clothing and Textiles Paper: An Identification of strategic interventions at the Provincial Government level to secure the growth and development of the Western Cape Clothing and Textiles Industries* 6 (2005), https://www.westerncape.gov.za/other/2005/10/final_paper_most_updated_printing_clothing_and_textiles.pdf.

43. JAMES J. HENTZ, SOUTH AFRICA AND THE LOGIC OF REGIONAL COOPERATION 181 (2005).

44. *See* Schneiderman, *supra* note 13, at 251 (asserting that foreign direct investment has plummeted as wealth disparities has worsened)

45. *See* S. AFR. CONST. 1996 ch. 2.

dependent on the realization of fundamental human rights, which includes not only civil and political rights, but also higher material standards of living for the entire population. In this regard, the Constitution confers a right to receive education, health care, water, and extensive rights to workers.[46]

The law provides workers a host of rights including the right to fair labor practices.[47] The extensive worker protection finds inspiration from the workers struggle against apartheid.[48] These protections are an unqualified good. The workers have used their power to clamor for the right to organize and achieve a living wage.[49] The granting of higher wages raises the cost of production and doing business in South Africa. The majority of developing countries do not provide for similar kind of rights and worker protections. The courts of South Africa have interpreted the obligations on socio–economic rights and employer obligations to workers in an expansive and enlightened manner.[50] An oft–repeated slogan of business is that labor laws in South Africa are highly regimented. From the perspective of countries with weak constitutions providing little citizen rights that might be correct. The South African Constitution emerged from a particular struggle reflecting an enlightenment that is unique to its history and unique in the annals of constitution making. Given that the objective realities of the South African economy is more like that of a developing country, the worker rights impose financial challenges, which can be

46. *Id.* §§ 23, 26, 27.

47. *See id.* ch. 2 § 23 (providing the Codes of Good Practice on the Basic Condition of Employment, Employment Equity, Labour Relations, and Occupational Health and Safety, the South Africa Constitution); Manpower Training Act 56 of 1981 (S. Afr.); Occupational Health and Safety Act 85 of 1993 (S. Afr.); Compensation for Occupational Injuries and Diseases Act 130 of 1993 (S. Afr.); Labour Relations Act 66 of 1995 (S.Afr.); Basic Conditions of Employment Act 75 of 1997 (S. Afr.); Employment Equity Act 55 of 1998 (S. Afr.); Skills Development Act 97 of 1998 (S. Afr.); Skills Development Levies Act 9 of 1999 (S. Afr.); Unemployment Insurance Act 63 of 2001 (S. Afr.); Unemployment Insurance Contributions Act 4 of 2002 (S. Afr.); Employment Services Act 4 of 2014 (S. Afr.), as amended respectively, and read with the respective regulations and notices issued.

48. *See Workers' Rights*, CONST. CT. S. AFR. (last visited June 18, 2016), http://www.constitutionalcourt.org.za/text/rights/know/workers.html#key, for an overview of the historical journey of worker struggles.

49. The demand of workers has received a sympathetic hearing from the Constitutional Court. *See* Nat'l Union of Metal Workers of South Africa and Others v. Bader Bop (Pty) Ltd and Another 2003 (3) SA 513 (CC) (S. Afr.).

50. *See* South African National Defence Union v. Minister of Defence 1999 (4) SA 469 (S. Afr.) (affirming the right to collectively organize as a right entrenched in the Constitution); *see also* Nat'l Educ. Health & Allied Workers Union (NEHAWU) v. Univ. of Cape Town and Others 2003 (3) SA 1 (CC) (S. Afr.), for a discussion where the Constitutional Court protected the rights of workers to continued employment in the event of transfer of the business.

avoided by moving production to countries that do not require these enlightened and costly obligations.[51]

From a comparative standpoint, western economies developed in particular stages. First, they were liberal — establishing the capitalistic system and solidifying the industrial base.[52] Britain, France, and many developed countries embraced free trade only after they achieved a certain level of economic prosperity, which filtered down to their population.[53] Otherwise, the argument went they could not compete on an equal footing. Second, they were later democratic in terms of extending the franchise to the entire population. Finally, the distributive function emerged when western countries began to cater to the less well off sectors of society in terms of addressing their material needs.[54] The United States, the most developed western country, only embarked on the distributive function during the 1930's under President Roosevelt's New Deal era.[55] A similar pattern of development is reflected in the economic growth of the Asian Tigers namely South Korea, Taiwan, Singapore, and Malaysia.

The Constitution of South Africa requires that the second and the third requirements be fulfilled concurrently. Democratic accountability and respect for the rights of workers is central in all decision making. There are financial costs incurred from the well–deserved worker rights when compared against other developing countries such as Bangladesh, Vietnam, and India or for that matter even more advanced economies like China. Many developing countries do not exercise political and economic power in a democratic and transparent manner. It is also difficult to compete with countries that have very lax labor laws and no constitutional obligations to provide basic needs to their populations. Given these differences, the cost of doing business in South Africa is elevated particularly with respect to low skilled manufacturing.

Given the high cost of manufacturing vis–a–vis other developing countries that lack an enlightened rights culture, there is an incentive for manufacturers to move their production out of South Africa or for traders

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51. *See* RICHARD N. DEAN ET AL., DOING BUSINESS IN EMERGING MARKETS A TRANSACTIONAL COURSE 1 (2015) (explaining that the World Bank characterizes the BRICs countries as emerging markets, a characterization, which at a minimum should also be applied to South Africa).

52. ZIYAD MOTALA, CONSTITUTIONAL OPTIONS FOR A DEMOCRATIC SOUTH AFRICA A COMPARATIVE PERSPECTIVE 98 (1994).

53. Toni Pierenkemper, *The Emergence of Free Trade in Europe*, *in* FREE TRADE, (2015).

54. MOTALA, *supra* note 52.

55. Robert Higgs, *The Mythology of Roosevelt and the New Deal*, FOUND. FOR ECON. EDUC. (Sept. 1, 1998), http://fee.org/freeman/the–mythology–of–roosevelt–and–the–new–deal/.

to purchase goods cheaper abroad. Free trade facilitates this incentive. The free trade policies favor consumers that have financial resources, which in South Africa is largely a minority. In the brutal conditions of the marketplace, the majority of the population are not merely consumers. They are also workers and producers.[56] As Montesquieu wrote "in countries where the people are actuated only by the spirit of commerce, they make a traffic of all humane, all the moral virtues; the most trifling things, those which humanity would demand are there done, or there given, only for money."[57] Without jobs, ordinary people do not have the ability to purchase goods, whether foreign or domestic, regardless of how cheap or abundant the goods might be.[58]

In addition to free trade, South Africa also liberalized its currency controls and allowed major corporations to move their headquarters outside South Africa.[59] The conventional orthodoxy, disseminated by business, media, and many academics suggested it was a sound decision, which would allow these companies access to cheaper capital to be used in South Africa.[60] This was purely spinning of yarn and the latter has not materialized. The individual companies and their shareholders benefitted by moving their capital to more lucrative markets. The moving of South African companies offshore has brought no advantages to the South African economy.

Of late, the United States and other countries are facing the problem of inversion, where a company merges with a foreign entity and moves their corporate headquarters to the foreign country. In effect, this results in the transferring of the U.S. firm's tax residence to a foreign jurisdiction without any actual changes to where and how the company transacts its business.[61] The merger is primarily motivated to lower the tax burden in

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56. We witness the tension between free trade and the interests of workers in the developed world as well seen in recent political strife in the United States. *See* Lawrence Summers, *What's Behind the Revolt Against Global Integration?*, WASH. POST (Apr. 10, 2016), https://www.washingtonpost.com/opinions/whats-behind-the-revolt-against-global-integration/2016/04/10/b4c09cb6-fdbb-11e5-80e4-c381214de1a3_story.html.

57. GEOFFREY R. STONE ET AL., CONSTITUTIONAL LAW 10 (7th ed. 2013).

58. BRUCE E. CLUBB, UNITED STATES FOREIGN TRADE LAW LXII (1991).

59. Shawn Hattingh, *BHP Billiton and SAB: Outward Capital Movement and the International Expansion of South African Corporate Giants* 11, TAX JUSTICE (2007), http://www.taxjustice.net/cms/upload/pdf/Ilrig_0809_South_African_giants.pdf.

60. *Companies Going Offshore can only Benefit South Africa*, IOL (Nov. 11, 1998), http://www.iol.co.za/business/personal-finance/financial-planning/investments/39-companies-going-offshore-can-only-benefit-south-africa-39-1.992562?ot=inmsa.ArticlePrintPageLayout.ot.

61. Lori Montgomery, *Obama Hits at Companies Moving Overseas to Avoid Taxes*, WASH. POST (Sept. 22, 2014), https://www.washingtonpost.com/business/economy/2014/09/22/e5294e0a-429d-11e4-b437-1a7368204804_story.html.

the United States by shifting profits to the foreign jurisdiction, which has a lower tax base.[62] This has created a firestorm amongst the political branches and calls to punish such corporate behavior in the United States.[63] Although not identical to inversion, ultimately, the liberalization of currency controlsallowed companies that were truly South African to move their primary listing abroad, which permitted these companies to repatriate their profits to foreign destinations as if they were foreign companies, even though they were not.[64] These companies represented the crown jewels of the South African economy. Crucially, prior to the liberalization in 1995, the companies had to invest their profits in South Africa to benefit South Africans.[65] Now they are permitted to repatriate their profits to foreign jurisdictions. These decisions were indulgent to the privileged sector and largely benefitted the business elite, who could move their capital out of South Africa and also reduce their tax rates to the detriment of the general welfare.

Liberal currency controls became a reality to many developed countries, such as Britain and France, only in the late 1970's and early 1980's.[66] Other Western European Countries within the European Union abolished exchange controls in the early 1990's. Before the abolishment of exchange controls, most foreign currency transactions required approval and were to be conducted through approved intermediaries.[67] When South Africa liberalized its currency controls, it was nowhere near the level of industrialization as Britain and France. This is another example of liberalization, reflecting choices rigged in favor of a few who were permitted to move their capital out of the country to maximize profits without being mindful of the needs of the majority in South Africa.

Despite decades of isolation, South Africa has much greater foreign trade than other BRICS countries.[68] Most of it constitutes imports. Foreign

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62. Pat Regnier, *Everything You Need to Know about Companies Leaving America for Taxes*, TIME (Sept. 23, 2014), http://time.com/money/3378719/corporate-tax-inversions-leaving-america/; Alan Pyke, *Corporate Tax Rates Aren't the Reason American Companies Flee to Tax Havens*, THINK PROGRESS (Feb. 9, 2015), http://thinkprogress.org/economy/2015/02/09/3620741/inversion-mergers-not-about-tax-rate/.

63. John D. McKinnon & Damian Paletta, *Obama Administration Issues New Rules to Combat Tax Inversions*, WALL ST. J. (Sept. 22, 2014), http://www.wsj.com/articles/treasury-to-unveil-measures-to-combat-tax-inversions-1411421056.

64. Hattingh, *supra* note 59.

65. SHARA, *supra* note 40, at 64.

66. ALAN C. SWAN & JOHN F. MURPHY, CASES AND MATERIALS ON THE REGULATION OF INTERNATIONAL BUSINESS AND ECONOMIC RELATIONS 711 (2d ed. 1991).

67. *Id.*

68. When one considers the degree of openness of the countries, Brazil has the lowest share of trade in relation to its GDP of all the BRICS countries. Between 2008

direct investments have not materialized to any significant degree. The standard claim by big business as to the lack of investment in South Africa is the high cost of labour. Similarly, those that control capital argue that the trade unions are too powerful and have the ability to win pay raises above the rate of inflation and productivity.[69] Economic justice gets scant attention in the debate over wages and free trade.

Developing countries like South Africa and Brazil are plagued by extreme inequality. The response of workers is that despite working hard, they do not receive affordable wages that they can live off. The debate about wages has to take cognizance of the high cost of living, which before the large deprecation in the South African currency over the past few years exceeded the cost of living in many developing countries. Food and basic staples in South Africa are produced locally and workers earn far less than their counterparts in developed countries. There are monopoly practices, cartels, and crony capitalism, which is endemic in many developing countries and contributes to the high cost of living. There has been high profile exposure of collusion among producers of goods acting in concert to maximize their profits.[70] These examples constitute the tip of the iceberg. These are matters, which need to be resolved within the domestic laws of South Africa and other developing countries. Cartels and crony capitalism have adverse effects on the poor.[71]

South Africans are subjected to regressive laws that provide exclusive licensing rights to privileged parties, which distorts competition and leads to higher prices. Ever since the Appellate Division (as it was then known) decision in the TDK case, parties with distribution licenses can prevent parallel importation of legitimate goods under copyright protection.[72] This

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and 2010, foreign trade accounted for twenty–four percent of Brazil's GDP, in comparison with fifty–two percent for Russia, forty–eight percent for India, fifty–five percent for China and sixty–one percent for South Africa. Thorstensen, *supra* note 33, at 75.

69. SHARA, *supra* note 40, at 64.

70. The collusion has been pervasive, extending to the pharmaceutical, bread, and construction industries. *See, e.g.,* Tembinkosi Bonakele, Commissioner, Presentation to the Portfolio Committee on Economic Development on 15 Years of Competition Enforcement (Mar. 10, 2015); *In the matter between* The Competition Commission and Pioneer Foods (Pty) Ltd (2010) 15/CR/Feb07 50/CR/May08 (S. Afr); *South African Tribunal Imposes Maximum Fines in Bread Cartel Case*, MONCKTON CHAMBERS (Feb. 3 2010), http://www.monckton.com/south–african–tribunal–imposes–maximum–fines–bread–cartel–case/; DAVID LEWIS, THIEVES AT THE DINNER TABLE: ENFORCING THE COMPETITION ACT: A PERSONAL ACCOUNT (2012) (discussing the monopoly practices and abuse of dominant sectors).

71. *The Impact of Cartels on the Poor,* U.N. Conference Trade and Development (July 24, 2013), http://unctad.org/meetings/en/SessionalDocuments/ciclpd24rev1_en.pdf.

72. Frank & Hirsch (Pty) Ltd. V. A Roopanand Brothers (Pty) Ltd. 1993 (580/91)

results in the holder of the copyright being able to exclude other legitimate items and charging higher prices for the goods for which it has an exclusive copyright. The US approach, applies the "doctrine of first sale" which means a legal copy can be sold to anyone.[73] Once you have a lawfully made product, whether purchased locally or from a foreign source from a common origin, there can be no limitation on selling that product because of an exclusive license. In Japan, the exclusive right of the copyright owner does not extend to genuine or licensed goods, which have been sold to a third party outside Japan.[74] The EU through the "doctrine of exhaustion" has increased the scope of competition within member countries.[75] The South African approach to copyright protection protects the profit margins of businesses, distorts competition, and leads to higher prices for many goods that retail for much cheaper in the developed world.

Extreme inequality is inimical to liberty and counterproductive for long–term political stability.[76] The revolutionary writers including Jean Jacque Rousseau and Baron de La Brede Montesquieu, who influenced Thomas Jefferson, wrote about the challenges to democracy where there are wide disparities in wealth.[77] Democracy cannot function where beggars and millionaires live side by side. Similarly, Jefferson wrote that democracy would be undermined if one group had large amounts of property whereas others had very little.[78] South Africa has the largest Gini coefficient, which is used to measure inequality. It is astounding that many basic staples and services cost more in South Africa and other developing countries than in advanced developed countries where individual earnings are multifold more. These inequalities resulted in the wave of uprisings in North Africa during the "Arab Spring" over low wages and the high cost of living.

Over the past five years, South Africa has suffered labor unrest culminating in the tragedy at the British owned Lonmin platinum mines.[79] The basic clamor of the workers, working under the most difficult conditions, was to demand an affordable wage. South Africa has seen a

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ZASCA 90 (S. Afr.).

73. *See* Quality King Distrib. v. L'Anza Research Int'l, 523 U.S. 135 (1998); K Mart Corp. v. Cartier, 486 U.S. 281 (1988).

74. FOLSOM, *supra* note 1, at 989.

75. Case No. C–355/96, Silhouette Int'l v. Hartlauer, 1998 E.C.R. (July 16, 1998).

76. MOTALA, *supra* note 52, at 20.

77. ERNST BARKER, THE SOCIAL CONTRACT: ESSAYS BY LOCKE, HUME, AND ROUSSEAU 190 (2d ed. 1952); STONE, *supra* note 57, at 10.

78. STONE, *supra* note 57, at 9–10.

79. Maeve McClenaghan & David Smith, *South Africa: Killing of 34 Marikana Mine Strikers — The Role of British Company Lonmin,* GLOBAL RESEARCH (Nov. 24, 2013), http://www.globalresearch.ca/south–africa–killing–of–34–marikana–mine–strikers–the–role–of–british–company–lonmin/5359728.

wave of uprisings over the past few years.[80] Continued inequality compounded with a large underprivileged population politicized by activism, creates a combustible situation.

IV. A RETHINK ON UNRESTRICTED FREE TRADE

The economic development of the Asian Tigers such as Taiwan, Malaysia, Korea, and Singapore occurred as a result of investment in their own people, their education,[81] and their economy.[82] This is also what happened in Germany and Japan after World War II.[83] These examples reflect the facilitation of economic growth through investment in their own population and the government guiding the process instead of ceding this power to the private sector.[84] The example of South Korea is particularly instructive. South Korea's per capita income was about the same as Ghana in 1960 when Ghana achieved independence but below that of a number of Sub–Saharan African countries.[85] For a number of decades, it followed inward policies and achieved unprecedented growth rates. Today, South Korea is the eighth largest exporting nation.[86] It has been integrated into the WTO and is now firmly in the free trade camp. South Korea's and the other Asian Tigers' path to development provides valuable lessons to policy makers in developing countries. After almost three decades of the unchallenged mantra of free trade and monetary policy determined by the International Monetary Fund, governments in many developing countries are pushing back. For some like South Africa, it may not be possible to put the genie back in the bottle and make a hundred and eighty degree turn with respect to each and every unwise and misinformed choice. The challenge for decision makers is to make strategic adjustments to level the playing field and create better opportunities.

The starting point is to realize that free trade and foreign direct investment by multi–nationals has not delivered African countries from

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80. Michael Kaplan, *South Africa Labor Strikes Costs Economy $500M per Year as Nation Struggles with Slow Economic Growth*, IBT (Sept. 18, 2015, 9:23 AM), http://www.ibtimes.com/south–africa–labor–strikes–cost–economy–500m–year–nation–struggles–slow–economic–2103563.

81. South African government policy in education has been an abject failure. The education system, beginning with Minister Sibusisu Bhengu retiring the best of our teachers, Minister Kader Asmal's outcome based education curriculum and closing down of teacher training colleges are epic scandals.

82. *See* DEAN, *supra* note 51, at 2.

83. Volker Stanzel, *Germany and Japan: A Comeback Story*, GLOBALIST (Mar. 7, 2015), http://www.theglobalist.com/germany–and–japan–a–comeback–story/.

84. BARKER, *supra* note 77, at 189.

85. DEAN, *supra* note 51, at 2.

86. *Id.*

poverty. From Nigeria to South Africa to Uganda, decision makers are recognizing the benefits of trade protection, public development banks, and more expansionary monetary policies — all heresies under the Washington Consensus.[87] There are many examples where the developed world talks free trade, but then rigs the rules of the game by using a host of non–tariff barriers, such as supposed quality controls, which keep out goods.[88] African countries operating individually, given their market size, have not been successful in using the same tactics. China and Brazil have been more effective in using the same tools against western countries.[89] South Africa has attempted to unscramble the egg. They have tried to play hardball with the United States with respect to the African Growth Opportunity and Investment Act ("AGOA").

South Africa imposed high tariffs on the importation of American chicken. It resisted lowering the tariffs, arguing that American chicken farmers are aided by government subsidies and the poultry are afflicted with diseases like bird flu.[90] The South Africans were further concerned that chicken exports from the United States would hurt small scale emerging black farmers. The United States argues that South Africa is a rich and mature country that does not need a leg up.[91] That description is inaccurate, at least in terms of the reality of the Black majority. South Africa was placed with a dilemma — does it focus on developing its own capacity or lose the prospect of being denied exports to the United States under AGOA, which would also result in the loss of jobs? The United States President personally stepped in with an ultimatum — unless South Africa removes the restrictions on chicken exports, the United States would remove South Africa's preferential access to US markets under AGOA.[92] South Africa was unsuccessful in pushing back using non–tariff trade barriers. South Africa ultimately relented and now allows the importation of US chicken, beef, and pork.[93] The developing countries do not have the

87. Rowden, *supra* note 15.

88. Yepoka Yeebo, *EU Trade Deal Will Likely Crush Industry in West Africa*, QUARTZ (Oct. 3, 2014), http://qz.com/274597/eu–trade–deal–will–likely–crush–industry–in–west–africa/.

89. Thorstensen, *supra* note 33, at 81.

90. Witney Schneidman, *An end to the never–ending South African Poultry Dispute*, BROOKINGS (Jan. 19, 2016) http://www.brookings.edu/blogs/africa–in–focus/posts/2016/01/19–south–african–poultry–dispute–schneidman.

91. *South Africa Spurns Free Trade to Protect its Meat Market*, ECONOMIST (Nov. 17, 2015), http://www.economist.com/news/middle–east–and–africa/21678672–america–and–south–africa–are–beating–drumsticks–trade–war–playing–chicken.

92. *Id.*

93. *South Africa and US Resolve Agricultural Products Trade Dispute*, FIN. TIMES (Jan. 7, 2016), http://www.ft.com/cms/s/0/55babca6–b559–11e5–8358–9a82b43f6b2f.html#axzz45WtHNRVC.

same leverage in the war of non–tariff trade barriers. South Africa stood to lose hundreds of millions of dollars and thousands of jobs if the United States refused to allow South African exports of fruit products and wine.

Whilst they unsuccessfully resist the developed countries in the specific skirmishes, the developing world is pursuing a strategy to fight what is perceived as strong–arm tactics, if not outright bullying from the developed world. Increasingly, there is a realization that governments have an important role to play in the development of the economy, which cannot be left to the marketplace.[94] The adoption of rabid free trade stymies developing countries from resorting to government intervention or adopting policies "such as trade protection, subsidized commercial credit, tax incentives, and public support for research and development" to build up domestic industries over time.[95] In a sense, they are forced to relinquish their policy space to adopt industrial policies, which develop their economy.[96]

Former United Nations Secretary General Kofi Annan recently called on West African countries to proceed cautiously on free trade, which, in the context of the EU's deal with West Africa, he and others argued would crush what little industry West African countries have and exacerbate the massive unemployment in the region.[97] Apart from raw materials, it is not as if European countries have an overwhelming demand for goods from African countries. Ultimately, the free trade results in the stuttering of what little African businesses exist, which are replaced by imports from European countries.

V. FREE TRADE AMONG THE DEVELOPING WORLD

Together with taking back the initiative in setting their own policies to address their unique problems, including investment and development in their own people and economies, it is increasingly being recognized that developing countries can gain more through trade from regional integration within the continent or with similarly situated economies[98] than integration

94. The executive secretary of the Economic Commission for Africa, Carlos Lopes, has called on African countries to not blindly follow IMF's priority of very low inflation. He has suggested that the central banks consider more expansionary policies for higher public investment, particularly for supporting their manufacturing industry. *See* Rowden, *supra* note 15.

95. *Id.*

96. *Id.*

97. Yeebo, *supra* note 88; *see also* Rowden, *supra* note 15 (explaining that the deal was finally consummated with enormous pressure being exerted by the EU who threatened to cut of access to European markets for African goods).

98. *Annan Discusses Free Trade at U.N. Forum*, INST. FOR AGRIC. & TRADE POL'Y

with the developed world. At the WTO, African countries and the BRICS nations have a common cause to push back against further free trade negotiations with the developed world.[99]

The most ambitious initiative on the African continent is The Tripartite Free Trade Area ("TFTA") agreed to by African countries in June of 2015 in Egypt.[100] The initiative seeks to create a free trade zone across the entire African continent.[101] It envisions bringing together all three of Africa's regional trading blocs to create what would be the largest trading bloc in terms of population.[102] Africans trade more with one another in manufactured goods than they do with the developed world.[103] The full potential of the deal is dependent on the development of proper physical and institutional infrastructure in many parts of the continent.[104] As in any trade agreement, there is the potential problem of smaller economies in Africa having to compete against large economies. The converse is also true; namely that some countries have better rights protections for workers, which increases the costs of doing business. These and other problems including the technical details of the agreement are being worked out and are anticipated to be completed by 2017.

VII. RETHINK ON BITS

Now that many developing countries have realized that foreign direct investment either does not materialize or is not always what it is projected to be, they are evaluating and abrogating BITS, which undermines their regulatory authority.[105] Developing countries soured on being compelled

(June 15, 2004), http://iatp.org/news/annan-discusses-free-trade-at-un-forum.

99. Thorstensen, *supra* note 33, at 37–42.

100. *Tripartite Free Trade Area: An Opportunity Not a Threat*, COMESA, (Apr. 28, 2016), http://www.comesa.int/index.php?option=com_content&view=article&id=974:tripartite-free-trade-area-an-opportunity-not-a-threat&catid=26:other-news&Itemid=48.

101. *Africa Creates TFTA — Cape to Cairo Free-Trade Zone*, BBC NEWS (June 10, 2015), http://www.bbc.com/news/world-africa-33076917

102. David Luke & Zodwa Mabuza, *The Tripartite Free Trade Agreement: A Milestone for Africa's Regional Integration Process*, INT'L CTR. TRADE & SUSTAINABLE DEV. (June 23, 2015), http://www.ictsd.org/bridges-news/bridges-africa/news/the-tripartite-free-trade-area-agreement-a-milestone-for-africa.

103. *Sector Report Manufacturing in Africa*, KPMG (2014), https://www.kpmg.com/Africa/en/IssuesAndInsights/Articles-Publications/General-Industries-Publications/Documents/Manufacturing%20in%20Africa.pdf.

104. Soamiely Andriamanajara, *Understanding the Importance of the Tripartite Free Trade Area*, BROOKINGS (June 17, 2015), http://www.brookings.edu/blogs/africa-in-focus/posts/2015/06/17-tripartite-free-trade-area-andriamananjara.

105. Leon E. Trakman & Kunal Sharma, *Why is Indonesia Terminating its Bilateral Investment Treaties*, EAST ASIA F. (Sept. 20, 2014), *http*://www.eastasiaforum.org/2014/09/20/why-is-indonesia-terminating-its-bilateral-investment-treaties/.

to relinquish their sovereignty or compromise their national prerogatives. In this regard, they have determined that is important to have disputes adjudicated before their own courts as opposed to private international tribunals.[106] Over the past few years, South Africa like a number of developing countries, has terminated or announced its intention to terminate BITs with several European countries.[107] South Africa argues that these BITs are inimical to the country's social and economic goals of black economic empowerment. Moreover, the continued existence of many BITs prevent the government from adapting the laws to bring the obligations of foreign investors in line with the imperatives of their Constitution.[108] Apart from the constitutional obligations, it is problematic when a country cannot adopt legitimate regulatory laws to advance public interest because the corporate profits of a foreign entity would be depleted.[109] Furthermore, it is untenable that a domestic entity would be bound by the regulatory regime advanced to promote public welfare, but a foreign entity that originates from a jurisdiction with which South Africa has BITs would escape such obligations.

Since 1994, South Africa has signed forty BITs.[110] The BITs allow foreign entities to challenge regulatory frameworks to advance the public good, which undermined the social and policy objectives of the

106. South Africa, Venezuela, Bolivia, Ecuador, India and Indonesia have all announced cancelation of their BITs agreements. *See* Martin Khor, *Investor Treaties in Trouble*, IPS NEWS (May 12, 2014), http://www.ipsnews.net/2014/05/investor-treaties-trouble/; Jeffrey Kron & Matthew Clark, *South Africa Changing Approach to Investment Protection–What does it mean for Investors?*, NORTON ROSE FULBRIGHT (2015), http://www.nortonrosefulbright.com/files/south-africas-changing-approach-to-investment-protection-127893.pdf; Ben Bland & Shawn Donnan, *Indonesia to Terminate more than 60 Bilateral Investment Treaties*, FIN. TIMES (Mar. 26, 2014), http://www.ft.com/cms/s/0/3755c1b2-b4e2-11e3-af92-00144feabdc0.html#axzz3t7HFIszd.

107. Robert Hunter, *South Africa Terminates Bilateral Investment Treaties with Germany, Netherlands and Switzerland*, INT'L ARB. & INV. L., http://www.rh-arbitration.com/south-africa-terminates-bilateral-investment-treaties-with-germany-netherlands-and-switzerland/.

108. For example, the BIT's rules on compensation vary with what the Constitution requires. There are also constitutional mandates on equity embodied in legislation, which the BIT's are at variance with. Jonathan Lang & Bowman Gilfillan, *Bilateral Investment Treaties – a shield or a sword?*, BOWMAN GILFILLAN (Nov. 1, 2013), http://www.bowman.co.za/FileBrowser/ArticleDocuments/South-African-Government-Canceling-Bilateral-Investment-Treaties.pdf.

109. Friedman, *supra* note 7, at 37–38; *Still Not Loving ISDS: 10 Reasons to Oppose Investors' Super-rights in EU Trade Deals*, CORP. EUR. (Apr. 16, 2014), http://corporateeurope.org/international-trade/2014/04/still-not-loving-isds-10-reasons-oppose-investors-super-rights-eu-trade.

110. *Anglo American South Africa Limited, Submissions to the Portfolio Committee on Trade and Industry on The Promotion and Protection of Investment Bill, 2015* ANGLO AM. (Sept. 15, 2015) https://www.thedti.gov.za/parliament/2015/AASA15Sept2015.pdf.

government. From the perspective of the government, canceling of BITs would allow for a recalibrating of the rights and responsibilities of investors and the state. The BITs with Britain concluded prior to the adoption of the democratic Constitution, even though it came into effect after the Constitution was adopted.[111] The question is how does one explain the existence of the post–1994 BITs? What is highly disturbing is the lack of foresight when these BITs were entered into.[112] Starting from the very top namely Minister Manual, the first Minister of Trade and Industry after the 1994 elections, all the way to the bureaucrats that negotiated these treaties, there was a profound lack of knowledge of the legal and technical expertise of international law.[113] It is disconcerting that there are no minutes of cabinet meetings or any sort of empirical findings to show the consequences or benefits that these agreements would bring.[114] An informed analysis would have revealed that many of the provisions in the BITs were inimical to the constitutional imperatives and constituted a surrender of the state's law and policy control. Under some of the BITs, the imperative of local, particularly Black economic empowerment was circumscribed by the national treatment and other clauses.[115]

The Constitution makes a distinction between expropriation and deprivation of property.[116] In the seminal case of *Agri South Africa*, the Constitutional Court of South Africa held that that there is "no expropriation in circumstances where deprivation does not result in property being acquired by the state."[117] The court majority held that private property rights cannot be over emphasized at the expense of the state's social responsibilities to ensure that all South Africans can benefit from the mineral resources of the country.[118] Where the state takes custodianship of mineral rights and grants it to others, its actions do not constitute expropriation, which warrant compensation. It is a deprivation in furtherance of other constitutional imperatives namely affording opportunities to the historically disadvantaged.[119] The South African government felt that the constitutional mandate could not be effected in relation to foreign firms where you have an existing BIT, which does not

111. Leon, *supra* note 6, at 601.

112. *See id.* at 599–600 (explaining there was a lack of understanding of the legal and economic implications of these agreements).

113. Mossallem, *supra* note 11, at 7.

114. *Id.*

115. *Id.* at 7–8.

116. S. AFR. CONST. § 25 (1996).

117. Agri South Africa v. Afriforum, Case 2013 CCT 51/12 at ¶ 59 (S. Afr).

118. *Id.* at ¶ 62.

119. *Id.* at ¶ 68–69, 73.

distinguish between a deprivation and expropriation.[120]

The incompatibility between the existing BITs and the constitutional imperatives came to a head in the *Foresti* Case.[121] The South African legislature passed the Minerals and Petroleum Resources Development Act ("MPRDA"),[122] which came into effect in 2004. The MPRDA required companies that had private mineral rights to apply for a license from the state to continue mining for minerals. The license would be granted subject to the company meeting certain conditions of black economic empowerment.[123] This is designed to afford blacks a more meaningful participation in the economy.[124] The rights to mine under the new licenses were more restrictive than under the previous licensing system.[125] In the *Foresti* case, the Italian and Luxembourg petitioners claimed that the applicable Mineral Law that extinguished their mining rights and further required them in terms of the Mining Charter of 2004 to transfer a percentage of their shares to historically disadvantaged South Africans, which amounted to an expropriation without compensation in violation of exiting BITs with Italy and Luxembourg.[126] *Foresti* filed for arbitration with the International Center for the Settlement of Investment Disputes ("ICSID") alleging that the South African government's conduct amounted to expropriation. The parties ultimately settled the matter.[127] As discussed above, the Constitutional Court of South Africa in the *Agri South Africa* case subsequently validated the MPRD. The court recognized the context and the importance of the measure in a "progressive Constitution, high unemployment rate and a yawning gap between the rich and the poor which could be addressed partly through the optimal exploitation of its rich mineral and petroleum resources, to boost economic growth."[128] The dispute brought out in sharp focus, the conflict between obligations under

120. Klaaren, *supra* note 16.

121. *In re* Piero Foresti v. Republic of South Africa, ICSID Case No ARB(AF)/07/1 (2010).

122. *The Minerals and Petroleum Resources Development Act*, REPUBLIC OF S. AFR. (2002) http://www.dmr.gov.za/publications/summary/109–mineral–and–petroleum–resources–development–act–2002/225–mineraland–petroleum–resources–development–actmprda.html.

123. Leon, *supra* note 6, at 619.

124. Friedman, *supra* note 7, at 41. Originally, it was envisaged that companies were supposed to grant a fifty–one percent stake to Black owners. It was subsequently reduced to twetny–six percent.

125. For example under MPRDA, there was a five–year limit on licenses. Companies were permitted to reapply for additional terms.

126. Brickhill, *supra* note 14, at 155.

127. *See* Brickhill, *supra* note 14, at 163–164 (overviewing of the salient terms of the settlement,).

128. Agri South Africa v. Afriforum Case, 2013 CCT 51/12 at ¶ 2 (S. Afr).

the BITs and domestic constitutional imperatives.

An additional problem was the question of compensation. The traditional principle under the BITs requires "prompt, adequate and effective compensation" in terms of market value.[129] The Constitution of South Africa in addition to mentioning market value contain a number of additional factors, which need to be considered, including the history of acquisition and the purpose behind the expropriation to determine compensation.[130] In calibrating the various factors, the Constitution permits less than market value in determining compensation. The constrains on the government's policy making power and the perception that the BITs conflicted with key constitutional imperatives precipitated the review of South African BITs ultimately leading to the decision to terminate BITs. The BITs were perceived as one–sided favoring the investor to the detriment of public policy.[131]

VII. NEW INVESTMENT LAW

After the *Foresti* debacle, South Africa announced that it was formulating a new investment law that will protect foreign investments

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129. *See* Kevin Smith, *The Law of Compensation for Expropriated Companies and the Valuation Methods Used to Achieve that Compensation*, L. & VALUATION (2001) http://users.wfu.edu/palmitar/Law&Valuation/Papers/2001/Smith.htm (emphasizing the United States and many western countries expect compensation that is "prompt, adequate and effective."). This was the standard clause in the BIT's entered into by South Africa. *See* Leon, *supra* note 6, at 601–602.

130. S. AFR. CONST. § 25(3):

> The amount of the compensation and the time and manner of payment must be just and equitable, reflecting an equitable balance between the public interest and the interests of those affected, having regard to all relevant circumstances, including
>
> a) the current use of the property;
> b) the history of the acquisition and use of the property;
> c) the market value of the property;
> d) the extent of direct state investment and subsidy in the acquisition and beneficial capital improvement of the property; and
> e) the purpose of the expropriation.
>
> 4) For the purposes of this section
> a) the public interest includes the nation's commitment to land reform, and to reforms to bring about equitable access to all South Africa's natural resources; and
> b) property is not limited to land.

131. *See* Schneiderman, *supra* note 13, at 247 (asserting that international investment agreements by their very nature are meant to constrain policy options on the part of governments).

subject to the mandates under its Constitution and its right to set policy goals.[132] The bill went through various revisions culminating in the adoption of the Protection of Investment Act.[133] The Act in the first provision in the preamble affirms the country's obligation "to protect and promote the rights enshrined in the Constitution." In other parts of the preamble, it specifies the government's right to regulate in the public interest. This obligation includes "measures to protect or advance persons, or categories of person, historically disadvantaged in the Republic due to discrimination . . . ." The obligation to advance the purposes of the Constitution is affirmed in section 3 and section 4 of the Investment Act.[134] Existing BITs will continue to be respected as per the period stipulated in the treaties.[135] It is unclear how the provisions in existing BITS, which are incompatible with the government's obligations under the Constitution, will be handled.

With respect to dispute resolution, after the government's experience in *Foresti*, there was no appetite to compel arbitration.[136] The Act envisages disputes should be addressed in the first instance through mediation that is appointed through agreement between the government and the foreign investor.[137] An investor is not precluded from seeking recourse to a binding decision. The Investment Act requires that disputes must be resolved before the courts of the country or any other tribunal or statutory body created for this purpose.[138] There is no longer any binding

132. Jonathan Klaaren & Fola Adeleke, *SA on the Right Path with New Foreign Investment Law* (Sept. 25, 2015), http://www.bdlive.co.za/opinion/2015/09/25/sa-on-the-right-path-with-new-foreign-investment-law; *see also* Trade and Industry on The Promotion and Protection of Investment Bill, *supra* note 110; *see id.* at 4–5 (praising the bill for bringing South Africa's investment laws in line with the Constitution). *Cf The Banking Association South Africa*, MEDIA RELEASE (July 28, 2015), http://www.banking.org.za/docs/default-source/press-releases/the-banking-association-south-african-balanced-expropriation-bill-media-release-final.pdf?sfvrsn=2 (arguing that the bill will have a negative impact on foreign investment because it offers investors less protection than under the BITS.).

133. Protection of Investment Act, 22 of 2015 (S. Afr.) [hereinafter Investment Act].

134. The Act is to be interpreted in a manner consistent with the Bill of Rights. Investment Act § 3(b)(i). It also requires a calibration of the public interest and the rights and obligations of the investor. *Id.* at § 4(a). Section 4(b) affirms the country has the right to regulate investment in the public interest. *Id.* at § 4(b). The Bill of Rights and all other laws are applicable to foreign investors. *Id.* at § 4(c).

135. *Id.* at § 15(1). *See* Report of the Portfolio Committee on Trade and Industry on the Promotion and Protection of Investment Bill [B18–2015] 5426, (Nov. 4, 2015) [hereinafter Investment Bill], https://pmg.org.za/tabled-committee-report/2597/.

136. The dispute resolution is regulated in Article 13 of the Investment Act.

137. Investment Act. § 13(1)–13(2).

138. *Id.* at § 13(4); Jackwell Feris & Cliffe Dekker Hofmayr, *South Africa's New Investment Bill: What are the Implications for Foreign Investors* AFRICAN LAW &

arbitration. In an address to Parliament, the Minister of Trade and Industry, Rob Davies suggested that arbitration decisions apart from favoring narrow commercial interests and undermining important government policies also produce inconsistent and unpredictable outcomes inimical to the rule of law.[139] However, the government can consent to arbitration if it so wishes.[140]

The issue of expropriation, compensation, public interest and national treatment[141] is aligned with the Constitution.[142] The Investment Act will be complemented by legislation on expropriation.[143] Foreign investors and their investors cannot be treated less favorably than South African investors in "like circumstances".[144] The word "like circumstances" appears to be a flexible and contextual standard.[145] Foreign investors do not enjoy any benefits with respect to government procurement.[146] In the drafting process, it was clear that the policy makers moved away from the position that all foreign investment is good towards a model of "investment for sustainable development model" which stipulates that investment must positively contribute to the country's sustainable development objectives.[147] The Act provides that there is no "right for a foreign investor

BUSINESS (Aug. 19, 2015), http://www.africanlawbusiness.com/news/5765–south–africa–new–investment–bill.

139. Minister Rob Davies, Minister of Trade & Indus., Debate on the Protection of Investment Bill (Nov. 17, 2015).

140. Investment Act § 13(5).

141. National treatment stands for the proposition that foreigners must be treated the same way as national of the country. This impedes the opportunity to promote the advancement of historically disadvantaged sectors of the population through Black Economic advancement ("BEE"). National treatment is a key component of the WTO, GATT and TRIPS agreements. *See Understanding the WTO – Principles of the Trading System* WTO (2016), https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm.

142. *See* Investment Act § 7 (dealing with national treatment); *id.* § 10 (making property rights subject to the provisions of the Constitution); *id.* § 4 (affirming the government's right to regulate and make policy choices).

143. *See* Report of the Portfolio Committee on Trade and Industry on the Promotion and Protection of Investment Bill [B18–2015] 5426, (Nov. 4, 2015), available at https://pmg.org.za/tabled–committee–report/2597/. In May of 2016, Parliament passed an Expropriation Bill, Bill 4B–2015. The Bill awaits the assent of the President in which case it will become binding and be referred to as the Expropriation Act, 2016, as per section 32 of the Bill.

144. Investment Act § 8(1).

145. *See* Investment Act § 8(2)(a)–(g) (assessing a host of factors, including (a) the effect of the investment; (b) the sector of the foreign investment, aim of any measure relating to foreign investment; (d) factors relating to the foreign investor or the foreign investment in relation to the measure concerned; (e) effect on third persons and the local community; (f) effect on employment; and (g) effect on the environment).

146. Investment Act § 8(4)(b).

147. Mossallem *supra* note 11, at 4.

or prospective foreign investor to establish an investment in the Republic."[148] These developments signify a rejection of the framework for investment put forth by the developed countries.[149] They also mark a realization that there are no automatic benefits, which accrue from free trade and foreign direct investment.[150] BITs often lead to constraints, which limit the ability of developing countries to adopt policies that advance the well being of its citizens.

CONCLUSION

Despite tensions between labor and business, policy makers in the developed world still sing the praise of free trade. They decry the repudiation of BITs by developing countries. South Africa's embrace of free trade, liberal monetary policies, and constraining BITs was done in an uninformed manner without thinking through the implications. It was also adopted in a historical manner. The executive secretary of the Economic Commission for Africa, Carlos Lopes, recently stated, "[i]t's not a matter of choosing between state and market as if these were two opposites. That discussion is over. Everybody agrees now that there is a role for the state and there is a role for the market. There are regulations that are necessary. The U.S., Europe, and Japan have done it. The moment they get in crisis, what do they do? They intervene in the banks and so on."[151] The developing world, particularly African countries have finally caught on to this indispensable reality. They have a right to develop just as the developed countries have. Rabid free trade with the developed world is not always free and often comes with adverse consequences for development. The BITs have proved inimical to developing countries ability to fashion their domestic policy choices and advancing broad public policy. Trade policies and economic choices need critical repositioning otherwise South Africa, like many developing countries will face an existential crisis. South

148. Investment Act § 7(2).

149. From the perspective of the developed countries, the canceling of BITS will deter foreign direct investment. However, South Africa has received foreign direct investment from countries with whom it has not had BITS and little foreign direct investment from some countries with which, it has a BITS in place. *See* Davies, *supra* note 139.

150. *Cf.* EU Chamber of Commerce and Industry in Southern Africa, *The Promotion and Protection of Investment Bill 2013: Submission by the EU Chamber of Commerce and Industry in Southern Africa* (Aug. 2015), http://suedafrika.ahk.de/fileadmin/ahk_suedafrika/Dokumente/Chamber_Press_Releases/EU_Chamber_of_Comerce_Parliamentary_Submission_Investment_Bill_Aug2015_Falsepdf. The Chamber argues that the canceling of BITS with EU member states sent a negative message to the business community by lessening the protection of investors. *Id.* at 2–5. The Chamber voiced it concern about less than full market value compensation. *Id.* at 9.

151. Rowden, *supra* note 15.

Africa's new Investment Act is a significant effort to recalibrate its investment regime.

GOING GREEN: LEGAL CONSIDERATIONS FOR MARIJUANA INVESTORS AND ENTREPRENEURS

FRANK ROBISON*

This article discusses legal considerations for the private equity industry interested in investing in businesses that directly handle marijuana. This article will include two parts. Part I, discusses the legal and regulatory considerations connected to deploying private equity to the marijuana industry. It focuses on private equity funds and private placements.

The total, legal and illegal, U.S. marijuana market is estimated to be fourteen billion to sixty billion dollars. The legal U.S. marijuana market is estimated to be $1.5 to $2.5 billion. Colorado alone estimates that its marijuana businesses will legally sell 100 metric tons in 2014. That is a lot of green!

In this space, business dealings and crime have been intertwined since the possession of marijuana was criminalized in the 1930s and this will likely continue to be so as long as marijuana remains illegal under federal law. Notwithstanding decriminalization and legalization trends at the state level, cultivating, distributing, or possessing marijuana is unlawful under the Controlled Substances Act. Federal money laundering statutes and the Bank Secrecy Act remain in effect with respect to marijuana related financial transactions. Aiding and abetting, accessory after the fact, and conspiracy are also federal crimes. Yet capital is being deployed in the marijuana industry.

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* Frank Robison serves as a Senior Associate at Vicente Sederberg LLC, a law firm dedicated to the responsible regulation of cannabis. When Mr. Robison wrote this article, in 2015, he served as Assistant University Counsel at the University of Colorado, Boulder Office of University Counsel. Mr. Robison has seventeen years of experience at various high-tech companies as a business manager and entrepreneur. Mr. Robison holds a B.A. from Colby College, an M.A. from the University of California San Diego, a J.D. from Vermont Law School, an LL.M. in Constitutional Law from the University of Seville, Spain and an LL.M. in Entrepreneurial Law from the University of Colorado Boulder. Mr. Robison is also a licensed U.S. Customs Broker. Mr. Robison is currently pursuing an LL.M. in Taxation at Georgetown University Law Center. He also finds time to be a dad and husband, enjoying family friendly Colorful Colorado.

In spite of the inherent risk, as long as returns are high, people will exploit these markets. Prior to putting capital in play, individuals and businesses seeking investments and investors should understand the inherent risks.

Part II, which is under development, will discuss two issues: first, developments in state laws, as examples, the residency requirements for investors and proposed retail marijuana legislation in various states as well as address other salient legal developments on the state and federal levels to deploying capital to the marijuana industry; and, second, the trend of "rolling up marijuana" businesses and the respective legal implications. A roll up is a technique used to increase the value of small companies in the same market by acquiring and merging them. In many states, regulations require marijuana businesses to reserve large amounts of cash before even applying for a license; like in many industries, this favors businesspeople with cash and other capital. In addition, economies of scale significantly affect cost per unit output and margins allowing efficiently managed large operations to dominate. These issues have caused roll ups to be a popular strategy in Colorado and other marijuana states where marijuana businesses may desire to consolidate vertical and horizontal operations in order to promote growth and improve the internal rate of return. Whether this will lead to "Big Marijuana," analogous to "Big Pharma" or the tobacco industry, is a question on industry participants' minds as well as those individuals sitting on the sideline waiting on further legal developments prior to risking capital.

Part I: Touch and Grow — Deploying Private Equity to Businesses that Handle Marijuana —

INTRODUCTION

The marijuana industry is awash in green. While marijuana remains classified as a Schedule I controlled substance under the Controlled Substances Act ("CSA") — marijuana along with ecstasy, heroin, LSD, and hallucinogenic mushrooms, but curiously not pure cocaine or crystal meth, is a Schedule I controlled substance, the most restrictive status under federal law — paradoxically, it also drives entrepreneurial activities and generates deals, revenues, and jobs in the states that have legalized it.[1] This intersection of the legal, under state law, with the illegal, under federal law, has created interesting business, financial, legal, and regulatory issues. The issues range from preemption to privacy, to drug use in the workplace, to conducting research with marijuana as well as the use of the federal banking system. Controversies and uncertainties appear limitless; the appetite for legislation as well as litigation is far from satiated.

This article is a legal–issue playbook for deploying private equity[2] in the marijuana industry.[3] It addresses whether a private equity fund may legally raise money, invest these funds in businesses that actually touch marijuana and, subsequently, distribute proceeds to investors. It also addresses whether marijuana businesses may legally solicit investors through private placements or intrastate offerings. Given marijuana's status under the

1. 21 U.S.C. §§ 812(b)(1), (c)(10) (2016). The CSA classifies marijuana as a Schedule I controlled substance because of the determination that marijuana has a high potential for abuse and has no accepted medical utility. The CSA also prohibits the cultivation, sale, distribution, and use of marijuana.

2. In this article, private equity refers to the financing of high risk, potentially high reward projects.

3. While the marijuana industry includes retail stores, growing operations, and infused–products manufacturers as well as ancillary businesses like growing equipment, enterprise software, and child resistant containers In this paper the marijuana industry means the former group, the businesses that actually touch and directly handle marijuana.

CSA, the legality of working directly with these businesses is uncertain. In all jurisdictions, providing legal assistance about conduct, criminal or civil, that happened in the past is compliant with ethical rules. However, in certain jurisdictions, a lawyer may not assist a client in conduct that is criminal under federal law, structuring marijuana business deals creeps into this gray area. [4] In spite of the challenges, investors are seeking to deploy capital in this industry.[5]

The state–federal interplay of four issues — banking, finance, taxation, and securities — directly impacts an investor's ability to deploy capital in and conduct business with the marijuana industry. This article analyzes these issues and other barriers created by federal law as well as discusses whether it is legally possible to construct solutions to these challenges.[6]

Under the federal law, cultivating, manufacturing, distributing or

4. *Compare* Colo. Bar Ass'n Ethics Comm., Op. 125 (2013) [hereinafter Colo. Ethics Op. 125] (providing advice on past conduct acceptable but structuring deals, e.g. a lease, is unlawful) *and* Me. Prof'l Ethics Comm'n., Op. 199 (2010) (representing or advising clients would "involv[e] a significant degree of risk which needs to be carefully evaluated" requiring Maine attorneys to determine "whether the particular legal service being requested rises to the level of assistance in violating federal law") *and* Conn. Bar Ass'n Prof'l Ethics Comm., Informal Op. 2013–02 (2013) (indicating that individual lawyers must draw the line between permissible advice to clients on the requirements of the Connecticut Palliative Use of Marijuana Act and impermissible assistance to clients in conduct that violates federal law but "[w]hether or not the CSA is enforced, violation of it is still criminal in nature. . . . Lawyers may not assist clients in conduct that is in violation of federal criminal law.") *with* Ariz. Ethics Op. 11-01 (2011) (advising that to forbid attorney assistance regarding conduct prohibited by federal law yet compliant with state law would "depriv[e] clients of the very legal advice and assistance that is needed to engage in the conduct that the state law expressly permits"). *See also* Internal Revenue Advisory Council, 2014 *Pub. Rep* 25 (Nov. 19, 2014) ("Tax assistance to marijuana businesses . . . Marijuana businesses that are now legal in some states but still illegal under federal law need ethical and competent professional tax advice. Tax professionals who give that advice need assurance that they will not be adversely affected by the fact that the business is illegal under federal law.").

5. *See, e.g.* Jess Remington, *Marijuana Market One of the Country's Fastest Growing, Hindered by Federal Raids*, REASON.COM (Nov. 8, 2013, 4:50 PM), http://reason.com/blog/2013/11/08/report-marijuana-market-one-of-the-count; Mark Fidelman, *Why Legalizing Medical Marijuana Will Make Investors Extremely Wealthy*, FORBES (Nov. 04, 2014, 12:43 AM), http://www.forbes.com/sites/markfidelman/2014/11/04/why-legalizing-medical-marijuana-will-make-investors-extremely-wealthy/; John Kester, *The Pot Industry Puts on a Tie, As Marijuana Becomes Legal, Businesses Look for Managers Who Know the Ropes*, WALL ST. J. (July 15, 2014, 12:17 PM), http://blogs.wsj.com/cfo/2014/07/15/pot-industry-puts-on-a-tie/.

6. This article is an intellectual exercise designed to explore salient legal issues connected to investing in marijuana businesses. It outlines the legal landscape and highlights risks associated with deploying capital into the marijuana industry. The article is not intended to provide any particular person legal advice. If a person or entity requires legal advice on these matters, this person should retain his, her, or its own lawyer.

possessing marijuana is illegal. Depending on whether the quantity is substantial, the offense is punishable with a mandatory minimum sentence of ten years in prison.[7] In addition, federal money laundering statutes[8] and the Bank Secrecy Act ("BSA")[9] remain in effect with respect to marijuana related activities.[10] Aiding and abetting,[11] accessory after the fact,[12] and conspiracy[13] are all federal crimes. The risk of forfeiture is also

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7. 21 U.S.C. § 841(a)(1) (2014) (Punishment for 1,000 kilograms or 1,000 plants includes "a term of imprisonment which may not be less than 10 years . . . or a fine not to exceed the greater of . . . $10,000,000 if the defendant is an individual or $50,000,000 if the defendant is other than an individual, or both"); § 856(a)(1)–(2) (2016) (providing that it shall be unlawful to:

> (1) knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance;
> (2) manage or control any place, whether permanently or temporarily, either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use, with or without compensation, the place for the purpose of unlawfully manufacturing, storing, distributing, or using a controlled substance).

8. *See generally* 18 U.S.C. §§ 1956, 1957 (1986) (providing federal anti–money laundering statutes); *see also* § 1956(b) (stating that a person who conducts a financial transaction "knowing that the property involved . . . represents the proceeds of some form of unlawful activity," may be imprisoned and fined the greater of $500,000 or twice the value of the property involved).

9. The Bank Secrecy Act ("BSA") is the common name for the statutes and regulations dealing with money laundering and counter terrorism. The BSA is intended to protect the integrity of the U.S. financial system. The BSA is central to all transactions connected to any subject matter that is or may be illegal. Accordingly, a basic understanding is fundamental to investors in the marijuana industry. *See* 31 U.S.C. § 310; Pub. L. No. 91–508, 84 Stat. 1114 (1970); *See also FAQ: Marijuana and Banking*, AM. BANK. ASS'N (Feb. 2014), https://www.aba.com/Tools/Comm-Tools/Documents/ABAMarijuanaAndBankingFAQFeb2014.pdf:

> All banks are subject to federal law, whether the bank is a national bank or state–chartered bank. At a minimum, all banks maintain federal deposit insurance which requires adherence to federal law. Violation of federal law could subject a bank to loss of its charter . . . . All banks are subject to the requirements of the BSA. Under the BSA, banks must report to the federal government any suspected illegal activity which would include any transaction associated with a marijuana business.

10. DEP'T. OF TREASURY, FINANCIAL CRIMES ENFORCEMENT NETWORK, BSA EXPECTATIONS REGARDING MARIJUANA–RELATED BUSINESSES, FIN–2014–G001, Feb. 14, 2014 [hereinafter FinCEN Guidance].

11. *See* 18 U.S.C. § 2 (2016) (providing that a person who "aids, abets, counsels, commands, induces or procures" any federal crime "is punishable as a principal" giving rise to the same consequences as the underlying crime).

12. *See* 18 U.S.C. § 3 (2016) (establishing that a person who knows "that an offense against the United States has been committed, receives, relieves, comforts or assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact.").

13. 18 U.S.C. § 371 (2016) ("If two or more persons conspire either to commit any offense against the United States . . . and one or more of such persons do any act to

omnipresent.[14] Do not forget Al Capone and the possibility of income tax evasion.[15] These civil and criminal issues give rise to personal liability and business risks for anyone or any entity operating in this space.

While federal legal issues are central to the analysis, this article draws on the Colorado and Washington experiences to illustrate how private equity fund managers could manage a fund and how marijuana businesses could solicit investors through private placements, therefore reducing exposure to federal penalties and punishment. From scientists driven to treat and cure medical issues, to growers and plan breeders looking to develop new strains, and to dispensaries looking simply to turn a profit, these businesses seek capital and desire to obtain credit to develop their ideas. Most marijuana businesses are not eligible for Small Business Administration loans and do not have access to simple bank loans or revolving lines of credit; much less, have access to capital raised through a public offering.[16]

Freeing up capital on which innovation feeds presents unique challenges in the marijuana industry. Private equity is available, but informed investors should structure deals that take into account the risks created by conflicting state and federal laws. For example, banking regulations make basic banking and financing challenging; federal and state tax laws foster an environment of mistrust and evasion; federal and state securities laws provide protection to the investor, but also places limitations on the ability

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effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.").

14. *See* 21 U.S.C. § 881(a)(2) (2016) (providing that there are no property rights and the following are subject to forfeiture: property, products, and equipment used or intended to be used in violation of the CSA or other federal crimes); § 881(a)(6) (conveying that nobody has a property right to proceeds of illegal activities used in connection to a violation of the CSA or other federal crimes); § 881(a)(7) (stating that all real property, including leases, which is used, or intended to be used, to commit, or to facilitate the commission of a felony is subject to forfeiture).

15. 26 U.S.C. § 7201 (2016) ("any willful attempts to evade any tax is guilty of a felony and, upon conviction, "shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution").

16. *E.g.*, Gene Marks, *If You're a Small Business Dealing in Marijuana, You're Still Breaking the Law*, WASH. POST (Aug. 12), https://www.washingtonpost.com/news/on-small-business/wp/2016/08/12/gene-marks-if-youre-a-small-business-dealing-in-marijuana-youre-still-breaking-the-law/ (describing one marijuana business owner that had a "tough time" even keeping a bank account for his business; his company's account was with a credit union that only allowed him to conduct basic services such as direct deposits); *see* 34 CFR § 84 (2016) (requiring compliance with the Drug Free Workplace Act as a condition of receiving federal funds); *see also* Pub. L. No. 100–690 § 513 (1988); 34 CFR § 84 (2106); 20 USC § 1145g; 34 CFR § 86.1 (2016) (mandating that certain recipients of federal funds put into place "standards of conduct that clearly prohibit, at a minimum, the unlawful possession, use, or distribution of illicit drugs and alcohol by students and employees on its property or as part of its activities").

to raise funds.

To a certain extent, the innovation requirement falls on the business planners. This is not to say that the marijuana entrepreneur lacks innovative drive. From nutraceuticals and pharmaceuticals to cultivating strains rich in certain chemical compounds, the marijuana industry will innovate, but sophisticated business service providers are critical.

Both entrepreneurs and business managers play critical roles in a businesses' internal rate of return. Likewise, both are exposed to similar legal risks; being cognizant of the challenges and minimizing legal exposure is critical to anyone seeking or deploying capital. Because the marijuana industry does not have access to traditional capital markets, the industry has to be creative in order to obtain the capital funding required to develop and grow.

II. BACKGROUND

Prior to discussing legal considerations and deploying capital, an analysis of the market dynamics and, significantly, the Department of Justice's ("DOJ's") position on the state, legal, and regulatory regimes provides context to assess the risks connected to deploying capital. Sections II(A) and (B) provide a brief analysis of the U.S. marijuana market. Section II (C) discusses critical information about the DOJ's approach to dealing with state conduct while understanding federal enforcement priorities are critical for anyone participating in this industry.

A. Market Potential

There are reports and stories about sacks of cash that abound in the retail marijuana states.[17] While estimates vary greatly between marketing groups, economists, and state and federal agencies, the legal marijuana market is reported to be over one billion dollars.[18] Harvard economist, Jeffrey Miron, estimates the total market, legal and illegal markets, to be

17. In this article, the terms "retail" and "recreational" are used interchangeably; the terms indicate a state with a regulatory scheme to control, license, and tax the cultivation, distribution, and use of marijuana for personal non–medical purposes.

18. Tom Huddleston, Jr., *Legal Marijuana Sales Could Hit $6.7 Billion in 2016*, FORTUNE (Feb. 1, 2016, 6:00 AM), http://fortune.com/2016/02/01/marijuana-sales-legal/ (estimating that the current United States' legalized cannabis market was valued at $2.7 billion in 2014 and poised to grow to $10.8 billion in 2018); B. Kilmer ET. AL., *What America's Users Spend on Illegal Drugs: 2000–2010* RAND CORP. (Feb. 2014), http://www.whitehouse.gov/sites/default/files/ondcp/policy-and-research/wausid_results_report.pdf (estimating the recreational, legal and illegal, marijuana market to be $30 to $60 billion); Bruce Barcott, *How to Invest in Dope*, N.Y. TIMES (June 25, 2013), http://www.nytimes.com/2013/06/30/magazine/how-to-succeed-in-the-legal-pot-business.html?pagewanted=all&_r=0 ("Medical marijuana is now a $1.5 billion industry.").

currently fourteen billion dollars.[19] The U.S. Government recognizes that the total may be as large as sixty billion dollars.[20] Others assert the market could eventually rival the NFL's market value.[21] It also draws natural comparisons to other vice markets, such as tobacco and alcohol.[22]

Because of their statuses as recreational marijuana states with operating regulatory frameworks, this paper draws upon the Colorado and Washington experiences to illustrate the challenges in legally deploying capital in legal under state law markets.[23] Colorado and Washington charge sales and excise taxes to collect tax revenue.[24]

Colorado and to a limited extent Washington are the only states with

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19. Divya Raghavan, *Cannabis Cash: How Much Money Could Your State Make From Marijuana Legalization?*, NERDWALLET (Sept. 22, 2014), www.nerdwallet.com/blog/cities/economics/how-much-money-states-make-marijuana-legalization/.

20. Kilmer, *supra* note 18.

21. Christopher Ingraham, *The Marijuana Industry Could be Bigger than the NFL by 2020*, WASH. POST (Oct. 24, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/10/24/the-marijuana-industry-could-be-bigger-than-the-nfl-by-2020/.

22. *See generally* Ariel Nelson, *How Big Is The Marijuana Market?*, CNBC (Apr. 2010, 12:04 AM), http://www.cnbc.com/id/36179677 (noting that the combined revenue of tobacco and alcohol was $263 billion in 2008).

23. *See* Colo. Const. Art. XVIII, § 16 (Effective December 10, 2012, by passing Amendment 64, Colorado amended its constitution to permit and regulate the personal use of marijuana in the same way that alcohol is permitted and regulated); WASH. REV. CODE § 69.51A.040 (2014) (medical); WASH. REV. CODE § 69.50–401 (3) (2014) (recreational); *see also* WASH. INITIATIVE MEASURE No. 502, (July 8, 2011), http://sos.wa.gov/_assets/elections/initiatives/i502.pdf.

24. COLO. REV. STAT. §12–43.4 (2016); COLO. CODE REGS. 201–18 (2016); COLO. CONST. Art. XVIII, § 16 (1)(a); *see, e.g.*, *Marijuana Taxes, Licenses, and Fees Transfers and Distribution Aug. 2014 Sales Reported in Sept.*, COLO. DEP'T OF REVENUE,(Oct. 2014) https://www.colorado.gov/pacific/sites/default/files/0814%20Marijuana%20Tax%2C%20License%2C%20and%20Fees%20Report.pdf (indicating that Colorado has a 2.9% sales tax, a 10% marijuana sales tax and 15% excise tax on the average market rate of retail marijuana, totaling 27.9% and as of August 2014, the Marijuana Enforcement Division collected $21,670,703 in tax revenues); *see also* Jack Healy, *After 5 Months of Sales, Colorado Sees the Downside of a Legal High*, N.Y. TIMES (May 31, 2014), http://www.nytimes.com/2014/06/01/us/after-5-months-of-sales-colorado-sees-the-downside-of-a-legal-high.html?_r=0; WASH. ADMIN. CODE 314-55-020 (2014) (addressing excise tax payment requirements); Niraj Chokshi, *Moody's: Washington Might Not See the Marijuana Tax Windfall Previously Projected,* WASH. POST (July 22, 2014), http://www.washingtonpost.com/blogs/govbeat/wp/2014/07/22/moodys-washington-might-not-see-the-marijuana-tax-windfall-previously-projected/ (explaining that Washington State imposes a twenty–five percent excise tax on producer sales to processors, another twenty–five percent excise tax on processor sales to retailers, and a further twenty–five percent excise tax on retailer sales to customers, plus the state Business & Occupation gross receipts tax, plus the state sales tax of 6.5%, plus local sales taxes). During the first month of legal sales, sales generated $3.8 million in revenues and about $1 million in tax revenue. In total, Moody calculated the total effective tax rate to be about 44 percent; Joseph Henchman, *Taxing Marijuana: The Washington and Colorado Experience*, TAX FOUNDATION (Aug. 25, 2014), http://taxfoundation.org/article/taxing-marijuana-washington-and-colorado-experience#_ftn14.

meaningful revenue numbers. While marijuana sales tax revenues fell short of the sixty million dollar estimate in 2013, the state collected $33.5 million.[25] Of course, the total sales tax does not account for income subject to state income taxes as these are two completely distinct tax concepts. In Washington, the Washington State Liquor Control Board oversees the marijuana program. It aggressively estimates two–year marijuana tax revenue for the 2015–17 biennium to be $120 million and for the 2017–19 biennium will be $336 million.[26]

Through most lenses, these markets are large and, unless federal priorities change or the Supreme Court deems state based regulation schemes unconstitutional, the recreational and medical markets will continue to grow.[27] While many investors will avoid investments tainted with even the hint of illegality altogether; other investors and entrepreneurs believe the risk is worth the potential return.

B. Novel Social and Economic Experiments

Entrepreneurial drive and spirit are ingrained in the United States' social and political structure. In the United States, "a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[28] Foreseeably, enthusiasts invoke Thomas Jefferson, offering partial quotations in the process.[29] The Bill of Rights provides the foundation for federalist thinking — "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[30] This linchpin of federalism sets the backdrop for a fluid and growing marijuana legalization and decriminalization movement.

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25. Colo. Dep't of Revenue, *2013 Annual Report*, https://www.colorado.gov/pacific/sites/default/files/2013%20Annual%20Report_0.pdf.

26. *See generally Publications Archives*, WASH. STATE. ECON & REV. FORECAST COUNCIL, http://www.erfc.wa.gov/publications/publications_archives.html.

27. *See, e.g.*, James A. Baker III, *The Cannabis Industry: Growing Pains for Now, But Success Will Come*, CHRON.COM, (Nov. 3, 2014, 6:28 AM), http://blog.chron.com/bakerblog/2014/11/the-cannabis-industry-growing-pains-for-now-but-success-will-come/.

28. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

29. THOMAS JEFFERSON, THE WRITING OF THOMAS JEFFERSON: VOL. II 164 (H.A. Washington Ed., 1861) ("It is vastly desirable to be getting underway with our domestic cultivation and manufacture of hemp, flax, cotton, and wool."); Thomas Jefferson, THE THOMAS JEFFERSON PAPERS SERIES 1: GENERAL CORRESPONDENCE 1651–1827, MEMORANDUM OF SERVICES (1800), http://hdl.loc.gov/loc.mss/mtj.mtjbib009438 ("The greatest service that can be rendered to any country is to add a useful plant to its culture.").

30. U.S. CONST. AMEND. X.

Twenty–seven states, the District of Colombia, and various territories, have passed laws that allow marijuana use for therapeutic or medicinal purposes.[31] Over 1.5 million Americans have received recommendations from medical doctors to use marijuana.[32] In 2014, Colorado became the first U.S. state to legalize and regulate recreational use and sale of marijuana, followed closely by Washington and later by Alaska, and Oregon.[33] Not surprisingly, marijuana is cocktail party fodder as being the next big thing; in turn, inspiring comments that an investment bubble is already forming.[34]

The states are indeed experimenting; no approach is alike. Some states have merely eliminated punishment and penalties relating to certain marijuana–related activities.[35] Others have implemented comprehensive regulatory and licensing regimes to control the cultivation, distribution, and sale of marijuana.[36]

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31. ALASKA STAT. § 17.37.030 (2014); ALA. CODE ANN. § 13A–12–214.2 (2014); ARIZ. REV. STAT. ANN. § 36–2811 (2014); CAL. HEALTH & SAFETY CODE § 11362.5 (2014); COLO. CONST. art. XVIII , § 14; CONN. GEN STAT. § 21a–408a (2014); Del. Code Tit. 16, § 4903a (2014); D.C. Code § 7–1671.02 (2014); Fla. Stat. § 381.986; HAW. REV. STAT. § 329–125 (2014); 410 ILL. COMP. STAT. 130/25 (2014); IOWA CODE § 124d (2014); KY. REV. STAT. ANN. § 218a.010(21)(6) (2014); ME. REV. STAT. tit. 22, § 2423–A (2014); MISS. CODE ANN. § 41–29–136(4) (2014); MD. CODE ANN. § 13–3313 (2014); MASS. GEN. LAWS CH. 94c App., § 1–3 (2014); MICH. COMP. LAWS § 333.26424 (2014); MINN. STAT. § 152.32 (2014); MO. REV. STAT. § 195.207 (2014); MONT. CODE ANN. § 50–46–319 (2014); NEV. REV. STAT. § 45.A.200 (2014); N.H. REV. STAT. ANN. § 126–X:2 (2014); N.J. STAT ANN. § 24:6i–6 (2014); N.M. STAT. ANN. § 26–2b–4 (2014); N.Y. PUB. HEALTH LAW § 3362 (Mckinney 2014); OR. REV. STAT. § 475.319 (2014); R.I GEN. LAWS § 21–28.6–4 (2014); TENN. CODE ANN. § 39–17–402(16)(A)–(B) (2014); UTAH CODE ANN. § 58–37–4.3 (West 2014); VT. STAT. ANN. tit. 18, § 4474b (2014); WASH. REV. CODE § 69.51a.040 (2014); WIS. STAT. § 961.14(4)(T) (2014).

32. Russ Belville, *America's One Million Legalized Marijuana Users*, NORML (May 31, 2011), http://blog.norml.org/2011/05/31/americas-one-million-legalized-marijuana-users/; *Medical Marijuana, Pros and Cons. Number of Legal Medical Marijuana Patients*, PROCON.ORG (Oct. 27, 2014), http://medicalmarijuana.procon.org/view.resource.php?resourceID=005889.

33. Lawrence Downes, *The Great Colorado Weed Experiment*, N.Y. TIMES (Aug. 2, 2014), http://www.nytimes.com/2014/08/03/opinion/sunday/high-time-the-great-colorado-weed-experiment.html.

34. Ellen Chang, *Is Marijuana the Next Bubble?* MAINSTREET (Feb. 26, 2014, 12:09 PM), http://www.mainstreet.com/article/marijuana-next-bubble/page/2; *see* Editorial, *Repeal Prohibition, Again*, N.Y. TIMES (last visited Sept. 8, 2016), http://www.nytimes.com/interactive/2014/07/27/opinion/sunday/high-time-marijuana-legalization.html?_r=0.

35. Todd Garvey & Brian Yeh, *State Legalization of Recreational Marijuana: Selected Legal Issues*, CONG. RES. SERV. (2014), http://www.fas.org/sgp/crs/misc/R43034.pdf; *see generally State Medical Marijuana Laws,* NCSL (Nov. 13, 2014), http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx.

36. *A Comparison of the World's First Three Jurisdictions to Legally Regulate Marijuana: Colorado, Washington and Uruguay*, DRUG POL'Y ALLIANCE (May 15,

In spite of continued state decriminalization and legalization coupled with regulatory control and licensing, under the CSA, the cultivation, distribution, and possession of marijuana is illegal under federal law,[37] except for a limited federally approved carve–out for research.[38]

A change in executive branch administration could change federal attitudes towards the burgeoning state marijuana industry, particularly in the recreational space. Further, unless the federal government de–schedules or reschedules marijuana, courts may find state laws permitting the licensing and taxation of a Schedule I controlled substance to be unconstitutional.

On December 18, 2014, Nebraska and Oklahoma petitioned the Supreme Court to declare Colorado's recreational marijuana laws to be in violation of the U.S. Constitution's Supremacy Clause, claiming that such laws constitute "a patchwork of state and local pro–drug policies and licensed distribution schemes throughout the country which conflict with federal laws."[39] These states argue that a "positive conflict" exists between the CSA and other federal laws and international treaties and Colorado's recreational marijuana laws to the extent that the conflicting schemes "cannot consistently coexist."[40] On March 21, in a six–two decision, the Supreme Court denied Oklahoma and Nebraska's motion for leave to file a bill of complaint.[41] Nevertheless, while less and less likely, future challenges could ultimately render state–based marijuana licensing and tax regulatory schemes unconstitutional, but the Supreme Court does not have the power to force Colorado and other legal marijuana states to

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2014), http://www.drugpolicy.org/resource/comparison-worlds-first-three-jurisdictions-legally-regulate-marijuana-colorado-washington-.

37. *See* United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483, 495, 499 (2001) (holding that Congress has the right to regulate marijuana and may criminalize the production and use of cannabis even where states approve its use for medicinal purposes); Gonzales v. Raich, 545 U.S. 1, 32 (2005) (holding that the commerce clause gave Congress authority to prohibit the local cultivation and use of marijuana, despite state law to the contrary, and that local use affects supply and demand in the national marijuana market); *see also* Wicker v. Filburn, 317 U.S. 111, 129 (1942) (affirming Congress's broad power to regulate commercial activities if the activities in the aggregate affect interstate commerce).

38. *Oakland Cannabis Buyers' Coop.*, 532 U.S. at 490 (holding that under the federal law using, possessing or manufacturing "marijuana (and other drugs that have been classified as 'Schedule I' controlled substances), [is illegal and] there is but one express exception, and it is available only for Government–approved research projects, § 823(f)"); *see generally* Frank Robison & Elvira Strehle–Henson, *Cannabis Laws and Research at Colorado Institutions of Higher Education*, Colo. Law. (Oct. 2015).

39. Br. for the Pet., Nebraska v. Colorado, 136 S. Ct. 1034 (2016) [hereinafter Nebraska and Oklahoma Brief];

40. *Id.*; *see also* 21 U.S.C. § 903 (2012).

41. Nebraska v. Colorado, 136 S. Ct. 1034 (2016), *cert. denied.*

recriminalize the cultivation, manufacture, distribution, and possession of marijuana.

In spite of the threats to state based regulatory regimes, certain entrepreneurs feel insulated from any future federal interference and disruptions, arguing that the genie is out of the bottle.[42] Other entrepreneurs understand the stark risks. One industry professional stated, "[t]he next administration could be the difference between taking back flips off a boat in the Gulf of Mexico for the rest of my life after Phillip Morris buys me out versus finding something else to do."[43]

C. Federal Evolution: From Reefer Madness to Enforcement Priorities

The origin of the federal controlled substance regime relates back to the Marijuana Tax Act and the Uniform State Narcotic Act.[44] Driven by the Federal Bureau of Narcotics', led by the now infamous in the marijuana industry, Harry Jacob Anslinger, propaganda and anti–marijuana sentiments, exemplified by the documentary "Reefer Madness," led to the passage of the CSA in 1970 and several international treaties.[45] This paradigm is in place today and set the backdrop for the forty–five year long war on drugs, including enforcement at the local, state, and federal levels.

Despite the federal specters, where there is innovation and market growth, investors tend to find a way to deploy capital. In addition to the massive amounts of cash, which inherently tends to spark interest, the current federal overtures have a net effect of precipitating entrepreneurial and investor interest in this market.

Over the past seven years, the federal government has overtly adjusted

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42. DOUG FINE, TOO HIGH TO FAIL 288–99 (2012).

43. Interview with anonymous source Denver, Colorado (2014).

44. *See infra* Appendix I; *see also* Brent Staples, *The Federal Marijuana Ban Is Rooted in Myth and Xenophobia*, N.Y. TIMES (July 29, 2014) http://www.nytimes.com/2014/07/30/opinion/high-time-federal-marijuana-ban-is-rooted-in-myth.html?_r=0.

45. *E.g.*, Economic and Social Council Res. 1196 (XLII), Single Convention on Narcotic Drugs of 1961 (May 16, 1967) (restricting legal marijuana uses to medical and scientific purposes, and requiring international cooperation and enforcement).

its enforcement priorities three times. First, in 2009, the DOJ issued guidance (Ogden Memo) stating that medical marijuana operations in medical marijuana states are not a prosecutorial priority.[46] The Ogden Memo makes clear that retail marijuana operations remain an enforcement priority and it outlines other activities that would trigger federal action.[47] The Ogden Memo triggered the first major wave of capital deployment in this market because entrepreneurs liberally interpreted the guidance to mean that large–scale marijuana operations, designed to furnish the medical marijuana industry, did not concern the federal government.[48]

Second, in 2012, DOJ responded releasing another memorandum (Cole Memo I) establishing that large scale commercial grow operations are an enforcement priority even if the marijuana is purportedly for state medical marijuana users.[49]

> [S]everal jurisdictions have considered or enacted legislation to authorize multiple large–scale, privately operated industrial marijuana cultivation centers. Some of these planned facilities have revenue projections of millions of dollars based on the planned cultivation of tens of thousands of cannabis plants.
>
> The Ogden Memorandum was never intended to shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. *Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law.*[50]

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46. Memorandum from David W. Ogden, Deputy Att'y Gen., U.S. Dep't of Justice, for Selected U.S. Atty's, Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana (Oct. 19, 2009) [hereinafter Ogden Memo] ("[P]riorities should not focus federal resources in your States on individuals whose actions are in clear and unambiguous compliance with existing state laws providing for the medical use of marijuana. For example, prosecution of individuals with cancer or other serious illnesses who use marijuana as part of a recommended treatment regimen consistent with applicable state law, or those caregivers in clear and unambiguous compliance with existing state law who provide such individuals with marijuana, is unlikely to be an efficient use of limited federal resources.").

47. *Id.* ("[U]nlawful possession or unlawful use of firearms; violence; sales to minors; financial crimes and marketing activities inconsistent with state marijuana medical laws; amounts of marijuana inconsistent with compliance with state law; illegal possession or sale of other controlled substances; or ties to other criminal enterprises.")

48. FINE, *supra* note 42, at 111, 112.; Ryan J. Reilly, *Obama's Drug War: After Medical Marijuana Mess, Feds Face Big Decision on Pot*, HUFFINGTON POST, (Jan 26, 2013 11:18 AM), http://www.huffingtonpost.com/2013/01/26/obamas-drug-war-medical-marijuana_n_2546178.html; TRISH REGAN, JOINT VENTURES 7 (2011).

49. Memorandum from James M. Cole, Deputy Att'y Gen., U.S. Dep't of Justice, for all U.S. Atty's, Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (June 29, 2011) [hereinafter Cole Memo I].

50. *Id.*

At this juncture, capital deployment to this market may have slowed but in no event did it dry up.[51] Investors should not overlook the importance of the Cole Memo I. The DOJ corrected any misunderstandings it perceived by directing the Drug Enforcement Administration ("DEA") to shut marijuana businesses down and initiating prosecution under the CSA, tagging on aiding and abetting and money laundering charges as well as initiating forfeiture proceedings.[52]

It also warns individuals doing business with marijuana that the industry is still illegal and the DOJ maintains prosecutorial discretion.

> [L]egal state activities, medical and recreational, do not shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. *Persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law.* Consistent with resource

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51. *See generally* Adam Nagourney, *In California, It's U.S. vs. State Over Marijuana*, N.Y. TIMES (Jan. 13, 2013), http://www.nytimes.com/2013/01/14/us/14pot.html?pagewanted=all&_r=1&; Tony Dokoupil, *Will Pot Barons Cash In on Legalization?*, NEWSWEEK (Oct. 22. 2012, 1:00 AM), http://www.newsweek.com/will-pot-barons-cash-legalization-65259; Jose Pagliery, *Don't Expect a Marijuana Boom, Even Where it's Legal*, CNN MONEY (Nov. 8, 2012, 8:15 AM), http://money.cnn.com/2012/11/08/smallbusiness/marijuana/; *see also* MASS. GEN. LAWS § Pt. I, tit. XV (2014) (showing that in 2012, Massachusetts voters passed the Massachusetts Medical Marijuana Initiative, becoming the18th state to legalize medical marijuana use).

52. *See* United States v. Bartkowicz, No. 1:10–cr–00118–PAB 2010 WL 3733552, at *1 (D. Colo. May 5, 2010) (holding that Colorado state law related to marijuana afforded the defendant, Mr. Bartkowicz, no defense whatsoever to federal crimes and sentencing defendant to five years in federal prison); John Ingold, *Owner Who Bragged of Large Medial–Pot Operation Jailed in DEA Raid*, DENVER POST (Feb. 13, 2010), http://www.denverpost.com/ci_14393797; Lisa Leff, *California Pot Dispensaries Told by Feds to Shut Down: U.S. Prosecutors Send Letters Even Though State Law Allows*, MSNBC (Oct. 6, 2011, 7:56 PM), http://www.nbcnews.com/id/44806723/ns/us_news-crime_and_courts/t/calif-pot-dispensaries-told-feds-shut-down/; *Medical Marijuana: Deadline Reached for Colorado Dispensaries Near Schools to Move or Shut Down*, HUFFINGTON POST (Feb. 27, 2012, 10:39 AM), http://www.huffingtonpost.com/2012/02/27/medical-marijuana-deadlin_n_1303712.html; Bob Young, *DEA: Warning Letters to 11 Pot Dispensaries Don't Signal War on State Law*, SEATTLE TIMES (May 1, 2013, 8:30 PM), http://seattletimes.com/html/localnews/2020902577_potdispensariesxml.html; Jeremy Meyer ET. AL., *Feds Raid Denver–Area Marijuana Dispensaries, Grow Operations, 2 Homes*, DENVER POST (Nov. 21, 2013, 10:00 AM), http://www.denverpost.com/breakingnews/ci_24570937/feds-involved-raid-at-denver-area-marijuana; Eric Gorski ET. AL., *DEA Raids Four Denver Marijuana Sites Related To VIP Cannabis*, DENVER POST (April 30, 2014, 7:58 AM), http://www.denverpost.com/news/ci_25666066/dea-raids-vip-cannabis-cuts-open-safes; Jacob Sullum, *Feds Prosecute Medical Marijuana Patients While Tolerating Commercial Cannabis — All In The Same City*, FORBES (May 15, 2014, 3:06 PM), http://www.forbes.com/sites/jacobsullum/2014/05/15/feds-prosecute-medical-marijuana-patients-while-tolerating-commercial-cannabisall-in-the-same-city/; Matt Ferner, *DEA Raids 2 Los Angeles Medical Marijuana Dispensaries*, HUFFINGTON POST (Oct. 24, 2014, 1:29 PM), http://www.huffingtonpost.com/2014/10/24/dea-raid-medical-marijuana-los-angeles_n_6038926.html.

> constraints and the discretion you may exercise in your district, *such persons are subject to federal enforcement action*, including potential prosecution. State laws or local ordinances are not a defense to civil or criminal enforcement of federal law with respect to such conduct, including enforcement of the CSA.[53]

Third, in 2013, as medical marijuana legalization expanded and Colorado and Washington passed retail laws, the DOJ updated the guidance establishing the current federal enforcement priorities connected to marijuana — distribution to minors, sales involving gangs, diversion, violence, drugged driving, and use or possession on federal land or property.[54]

In spite of the Cole Memo I and Cole Memo II's warnings, DOJ simultaneously indicates that states such as Colorado and Washington that have decriminalized and legalized marijuana "and that have also implemented strong regulatory and enforcement systems . . . are unlikely to threaten the federal priorities."[55] This has allowed the avalanche of growth and interest in this space to continue.[56] Even though Cole Memo II directly contributes to the massive growth in marijuana industry, the conduct is merely not an enforcement priority — even though it remains illegal at the federal level.

In February 2014, the Department of Treasury ("Treasury"), through its Financial Crimes Enforcement Network ("FinCEN") and DOJ, realized a panoply of risks associated with this business — robbery, unreported income, questionable accounting practices among others and issued guidance to enable banks to have commercial relationships with marijuana businesses, even recreational marijuana businesses.[57] The guidance addresses specific issues related to the BSA where marijuana has been legalized within the state.

To close out 2014, Congress's federal spending law contains a provision that prohibits the DEA and DOJ from preventing implementation of state medical marijuana laws, signaling yet another shift in enforcement policy

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53. Cole Memo I, *supra* note 49.

54. Memorandum from James M. Cole, Deputy Att'y Gen., U.S. Dep't of Justice, for all U.S. Atty's, Guidance Regarding Marijuana Enforcement (Aug. 29, 2013) [hereinafter Cole Memo II].

55. *Id.*

56. *See generally* Divya Raghavan, *Cannabis Cash: How Much Money Could Your State Make From Marijuana Legalization*, NERDWALLET (Sept. 22, 2014), http://www.nerdwallet.com/blog/cities/economics/how-much-money-states-make-marijuana-legalization/ (estimating market size and tax revenue of the 2014 marijuana market); *see also* Matt Ferner, *Marijuana Tax Revenue May Top $3 Billion A Year With Legalization*, HUFFINGTON POST (Sept. 22, 2014, 7:40 PM), http://www.huffingtonpost.com/2014/09/22/legal-marijuana-taxes_n_5863860.html.

57. FinCEN Guidance, *supra* note 10.

to businesses and investors.[58]

These developments are important for investors because it sets a backdrop that while not ceding any ground on marijuana's legality under federal law, the federal government presumptively is uninterested in the commercial activities of these businesses as long as the Cole Memo II enforcement priorities are not implicated. In certain respects, this government action is accentuating the meaning of *caveat emptor*. On one hand, the guidance establishes that marijuana businesses operating in states with robust regulatory regimes are unlikely to implicate the federal enforcement priorities.[59] On the other hand, the FinCEN Guidance has discouraged banks from offering banking services.[60]

Even though the banking industry's willingness to implement the nuanced compliance requirements may be evolving, as discussed below, the marijuana industry remains under–banked and cash–based because banks generally do not offer general banking services, checking accounts, loans, credit, or credit cards to any entity that directly works with marijuana. Unless marijuana is rescheduled and is uniquely scheduled so that state laws do not conflict with the CSA or is de–scheduled altogether, any capital deployed to the marijuana industry puts individuals involved at risk of criminal prosecution and subjects their assets and proceeds to potential forfeiture. How to reconcile conflicting federal and state laws regarding the cultivation, manufacture, distribution, or possession of marijuana remains a challenge. Individuals operating in this space should ask two questions: foremost, are the risks worth it? Second, assuming they are, how do you reduce them?

III. LEGAL CONSIDERATIONS FOR PRIVATE EQUITY DEPLOYMENT

From landlord–tenant matters to employment law, marijuana businesses face a broad range of legal issues. Section III provides an overview of key

58. Pub. L. No. 113–235. § 538, 128 Stat. 2129, 2217 (2014) ("None of the funds made available in this Act to the Department of Justice may be used, with respect to the States of Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Washington, and Wisconsin, to prevent such States from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.").

59. Cole Memo II, *supra* note 54.

60. FinCEN Guidance, *supra* note 10 ("Because federal law prohibits the distribution and sale of marijuana, financial transactions involving a marijuana related business would generally involve funds derived from illegal activity.").

legal considerations for anyone seeking or providing financing to this industry.

An understanding of banking and finance, taxation, and securities is fundamental for any person or business seeking to deploy capital in these markets. Underlining these four issues is legal enforceability of basic contracts connected to a transaction where the underlying subject matter violates federal law. Even though these four issues coupled with contractual enforceability uncertainty are certainly not an exhaustive list of issues that impact the marijuana industry, they illustrate the challenges marijuana businesses face in obtaining and effectively deploying capital.

A bedrock principle of contract law is that contracts in contravention of public policy are void and unenforceable.[61] Colorado and Arizona court cases have affirmed this principle holding that the subject matter of a contract involving a marijuana business is illegal and therefore, unenforceable.[62] The CSA does not contain an exception covering state laws; therefore, state laws provide no protection from the federal laws. Thus, contracts for the sale of marijuana are void because they are against public policy.[63]

These cases inject uncertainty as to whether an investment contract with a nexus to a marijuana business that manufactures, distributes, or dispenses marijuana in violation of the federal controlled substances legal regime is enforceable as a matter of law. This question raises significant business and legal issues for any investor, fund, or wealthy individual regarding structuring a deal and, ultimately, the deal's legitimacy. To be sure, investors should only invest what they can afford to lose because any marijuana business deal that involves a CSA violation cannot be completely legal.

Since contracts play a critical role in most investments, stakeholders should structure them so that criminal and civil legal exposure is minimized. This section further discusses major risks and respective strategies to minimize exposure through diversification of investments, limited liability business structures, tax planning, and adhering to the principles of Cole Memo II. Furthermore, certain issues relating to federal and state security laws are considered.

A critical legal barrier to obtaining financing is certain marijuana states' residency requirements for license holders and equity investors. To

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61. *See generally* 5 WILLISTON ON CONTRACTS § 12:1 (4th ed.).

62. Haeberle v. Lowden, No. 2011CV709 (Colo. Dist. Ct. 2012) ("Contracts for the sale of marijuana are void as they are against public policy . . . . Accordingly, the contract here is void and unenforceable."); Hammer v. Today's Health Care II, CV2011–051310 (Ariz. Sup. Ct. 2012).

63. *Id.*

participate in equity financing deals with marijuana businesses in Colorado and Washington, the regulations require that an individual or entity with an ownership interest must be a state resident.[64] This means that, in these states, out–of–state investors interested in investing in marijuana businesses are limited to loaning money. Convertible loans may be an investment option for out of state investors as long as the loans are convertible conditional on certain changes in state and federal law.[65] Colorado has a legal mechanism to allow persons who are residents of the United States, but not Colorado, to have an interest in the Colorado marijuana business — dubbed a "permitted economic interest."[66] The conversion or transfer of such interest is contingent on the holder of the interest as qualifying as an owner, by meeting Colorado's two–year residency requirement or a change in applicable law.[67] In fact, with the passage of Senate Bill 040, the Colorado residency requirements are set to change January 1, 2017, facilitating out of state investment and, theoretically, precipitating an influx

64. *Compare* COLO. REV. STAT. § 12–43.3–307 (2016) ("An owner, as defined by rule of the state licensing authority, who has not been a resident of Colorado for *at least two years* prior to the date of the owner's application.") *and* WASH. REV. CODE ANN. § 69.50.331 (2014) ("(i) A person doing business as a sole proprietor who has not lawfully resided in the state for *at least three months* prior to applying to receive a license; (ii) A partnership, employee cooperative, association, nonprofit corporation, or corporation unless formed under the laws of this state, and unless all of the members thereof are qualified to obtain a license.") *with* Oregon Legalized Marijuana Initiative, Measure 91 (2014) (allowing "possession, manufacture, sale of marijuana by/to adults, subject to state licensing, regulation, taxation.") *and* California's Compassionate Use Act of 1996 collective or cooperative based regime. *See also Frequently Asked Questions*, OREGON.GOV (last visited Sept. 8, 2016), https://www.oregon.gov/olcc/marijuana/Pages/Frequently-Asked-Questions.aspx (Commission stating that Measure 91 "does not specifically address [the residency] question"); CAL. HEALTH AND SAFETY CODE 11362.775 (2016) (California's regulatory scheme has a not–for–profit foundation, providing that medical marijuana patients and primary caregivers may "associate within the State of California in order collectively or cooperatively to cultivate marijuana for medical purposes").

65. Colo. Rev. Stat. § 12–43.3–104 (12.4)(2016) ("Permitted economic interest" means any unsecured convertible debt instrument, option agreement, warrant, or any other right to obtain an ownership interest when the holder of such interest is a natural person who is a lawful United States resident and whose right to convert into an ownership interest is contingent on the holder qualifying and obtaining a license as an owner under this article; or such other agreements as may be permitted by rule of the state licensing authority"); Marijuana Enforcement Division, Form, DR 8555, https://www.colorado.gov/pacific/sites/default/files/DR%208555e%20PEI%202016_2.pdf.

66. *See* 1 Colo. Code Regs. § 212–1:1.204 (outlining factors that Colorado's Marijuana Enforcement Division uses to evaluate whether a person has an ownership interest in a licensed retail marijuana business); 1 Colo. Code Regs. § 212–2.204 (outlining factors that Colorado's Marijuana Enforcement Division uses to evaluate whether a person has an ownership interest in a licensed medical marijuana business).

67. Colo. Rev. Stat. § 12–43.3–104 (12.4)(2016); 1 Colo. Code Regs. § 212–2.202.5; Marijuana Enforcement Division, Form, DR 8555.

of capital.[68] This change in Colorado law will be addressed in the Part II of this Article.

Irrespective of the residency requirements, structuring wholly intrastate deals reduces risks of triggering Cole Memo II enforcement priorities — not diverting marijuana proceeds from marijuana states to non–marijuana states — and simplifies inherently complex securities law compliance matters.

A. Banking

The elephant in the private equity room is the well–documented difficulty that marijuana businesses have in obtaining basic banking services and, in turn, capital. This subsection first synthesizes banking challenges related to financing businesses that directly handle marijuana. Second, it explores salient financing issues and offers suggestions for approaches to reduce risks connected to the problematic areas.

Under the BSA, if the financial institution knows that the property constitutes proceeds from an unlawful activity, accepting a marijuana business customer is a criminal act.[69] Under the BSA, for a financial institution or bank to accept a marijuana business customer is a crime, if the financial institution is aware that the customer directly handles marijuana. If the bank conducts transactions "knowing that the property involved . . . represents the proceeds of some form of unlawful activity," with the intent to promote the unlawful activity, the bank officials can be imprisoned and fined the greater of $500,000 or twice the value of the property involved.[70]

In an attempt to explain how banks can serve legal marijuana businesses while remaining compliant with the BSA, FinCEN issued the FinCEN Guidance in an attempt to assist the banking and marijuana industries with compliance.[71] Banks serving marijuana businesses must comply with ambiguously defined guidance, including the performance of due diligence requirements, which amount to a fusion of customer policing and novel banking institution compliance requirements. The FinCEN Guidance requires the banks to assess the risks of providing services to a marijuana related business through customer due diligence. This diligence includes: verifying that the business is licensed and registered; reviewing the license application (and related documentation); requesting information about the business and related parties from the state; developing an understanding of

68. Colo. Senate Bill 040 (2016).

69. 18 U.S.C. § 1956(a)(1) (2012).

70. 18 U.S.C. § 1956(a).

71. FinCEN Guidance, *supra* note 10.

normal business activities; ongoing monitoring of information about the business and related parties and any respective suspicious activity; and re–performing this due diligence on a periodic basis.[72] The compliance requirements are ambiguously defined and foreign to banking operations. As an example, banks, and likely bank regulators, for that matter, do not understand what normal business activities and monitoring information as well as activities means.

In order to offer bank accounts to the marijuana businesses, the federal government, in effect, requires banks to police their customers' businesses. Compounding the risks of being client cops, DOJ maintains that "[t]he provisions of the money laundering statutes, the unlicensed money remitter statute, and the . . . BSA remain in effect with respect to marijuana–related conduct" and can form the basis for prosecution under those statutes.[73] In light of the risks, banks are not willing to implement compliance programs that adhere to the FinCEN guidance because the framework is unclear and the risk of liability is pervasive.

In addition, banks must file one of three specialized categories of suspicious–activity reports ("SARs"). The "marijuana–limited" SAR is used to notify FinCEN that the financial institution's customer operates in compliance with state laws and no additional suspicious illegal activity is suspected.[74] The other SARs notify FinCEN of additional illegal activities.

Seemingly simple workarounds, like forming management companies or

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72. *Id.* ("In assessing the risk of providing services to a marijuana related business, a financial institution should conduct customer due diligence that includes: (i) verifying with the appropriate state authorities whether the business is duly licensed and registered; (ii) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana related business; (iii) requesting from state licensing and enforcement authorities available information about the business and related parties; (iv) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers); (v) ongoing monitoring of publicly available sources for adverse information about the business and related parties; (vi) ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and (vii) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.").

73. Memorandum from James M. Cole, U.S. Dep't of Justice, for All U.S. Atty's, Guidance Regarding Marijuana Related Financial Crimes (2014) [hereinafter Financial Crimes Memo],

74. *See* FinCEN Guidance, *supra* note 10 (indicating that the: SAR should be limited to the following information: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana–related business; and (iv) the fact that no additional suspicious activity has been identified. Financial institutions should use the term "MARIJUANA LIMITED" in the narrative section).

a holding company that conduct marijuana and non–marijuana business, would likely give rise to illegal conduct. A third party doing the banking on behalf of an entity, fund, or marijuana business, likely would be tantamount to money laundering and aiding and abetting among other federal crimes subjecting the entity to criminal prosecution and asset forfeiture.

The net result of federal guidance, cynically a prosecutorial hedge, and the possibility of penalties that flow from the failure to comply with the due diligence requirements is that banks are unwilling to assume the risks of conducting business with the marijuana industry.[75] Bank regulators permit banking, but regulators are forcing banks to manage ongoing compliance in a way that is foreign to a bank's standard operations. In addition to the civil and criminal risks and consequences, bankers logically would like to avoid costs connected to additional regulatory scrutiny. In sum, the environment translates to banks not offering banking services to the marijuana industry, in spite of the FinCEN guidance.[76] Colorado Bankers Association stated the following about the guidance, "[a]t best, this amounts to 'serve these customers at your own risk' and it emphasizes all of the risks. This light is red."[77]

By contrast, FinCEN is publically expressing optimism. FinCEN's Director, Jennifer Calvary insisted that,

> [T]he guidance is having the intended effect. It is facilitating access to financial services, while ensuring that this activity is transparent and the funds are going into regulated financial institutions responsible for implementing appropriate AML [anti–money laundering] safeguards.[78]

Taken together, the DOJ and FinCEN Guidance indicate that these agencies are unlikely to sanction or otherwise take action against the banks or their

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75. *See* Sam Kamin, *The Limits of Marijuana Legalization in the States*, 99 IOWA L. REV. BULL. 39, 47 (2014) (discussing regulatory issues confronted by banks and businesses in the marijuana industry); *see, e.g.*, Julie Hill, *Banks, Marijuana, and Federalism*, 65 CASE W. RES. L. REV. 597 (2015); *see also* John B. Stephens, *Pot Shops Shunned by Banks Haul in the Cash*, USA TODAY (Aug 31, 2014, 7:30AM), http://www.usatoday.com/story/money/business/2014/08/31/pot-marijuana-industry/13628491/ (commenting on the banking challenges for marijuana businesses).

76. *See, e.g.*, Jacob Sullum, *Marijuana Money Is Still a Pot of Trouble for Banks*, FORBES (Sept. 18, 2014, 5:42 PM), http://www.forbes.com/sites/jacobsullum/2014/09/18/local-banks-terrified-by-friendly-neighborhood-marijuana-merchants/ (following the FinCen guidance does not make marijuana banking legal, but rather the federal government does not view it as an enforcement priority as long as the banking participants, bank and client, follow the guidance).

77. COLO. BANKING ASS'N, CBA STATEMENT REGARDING DOJ AND TREASURY GUIDANCE ON MARIJUANA AND BANKING (2014), http://cloudfront-assets.reason.com/assets/db/13926500993160.pdf.

78. Jennifer Calvery, FinCEN, Remarks at the 2014 Mid–Atlantic AML Conference Washington, DC (Aug. 12, 2014).

customers for conducting banking operations pursuant to the guidance. Further, the Cole Memo II, coupled with the FinCEN guidance, is indicative that the federal government is unlikely to target individuals who invest in businesses that are legal at the state level as long as the Cole Memo II's priorities are not implicated.

Regardless of whether banks readily offer services to businesses that handle marijuana, investors and banks must have a high–risk tolerance to do business in this space. The FinCEN Guidance reinforces that DOJ may prosecute banks serving marijuana businesses. The DOJ, Treasury, and banking regulators reserve the right to penalize and prosecute as well as simultaneously impose amorphously defined risk management and compliance requirements on banks. FinCEN has authority to impose civil penalties on businesses and banks that violate the BSA.[79] Against this backdrop, investors and banks must have a high–risk tolerance to manage capital in this field.

The attitudes of bank regulatory agencies may be changing, despite the regulatory uncertainty. While examples are difficult to identify, a number of banks anecdotally appear to have decided to work with the marijuana industry.[80] For example, the First Security Bank of Nevada has stated its intention to provide banking services to medical marijuana businesses.[81] Colorado marijuana businesses report that at least one Colorado bank is adhering to the FinCEN guidelines allowing the businesses that actually touch marijuana to bank. Washington banks, Salal Credit Union, and Numerica Credit Union, appear to be servicing the Washington marijuana

79. *See* 31 U.S.C. § 5321 (2016) (granting significant authority to Treasury to initiate civil actions and impose civil fines for failing to comply with the BSA); 31 C.F.R § 1010.810 (2016) (delegating enforcement and compliance authority to FinCEN).

80. As an aside, Colorado enacted a law that authorizes the formation of a credit union, Fourth Corner Credit Union, to service the marijuana industry. Keith Coffman, *Colorado Governor Signs Law Creating State–Run Marijuana Banking Co-ops*, REUTERS (June 6, 2014, 7:43 p.m.), http://www.reuters.com/article/us-usa-colorado-marijuana-idUSKBN0EH2HH20140606; *see also* Sophie Quinton, *Why Marijuana Businesses Still Can't Get Bank Accounts*, STATELINE (Mar. 22, 2016), http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/22/why-marijuana-businesses-still-cant-get-bank-accounts ("About 40 percent of Colorado cannabis businesses lack bank accounts altogether, according to the office of U.S. Rep. Ed Perlmutter, a Democrat who has pushed to improve banking for the cannabis industry. State officials would not comment on that number."). It still requires approval and insurance from the National Credit Union Administration. Additionally, the credit union still must obtain a master account from the Federal Reserve System as well as share deposit approval and insurance from the National Credit Union Administration.

81. Interview by Chris Sieroty with John Sullivan, *First Security Bank of Nevada to Handle Pot Businesses* (May 19, 2014), http://www.knpr.org/son/archive/detail2.cfm?SegmentID=11210.

industry.[82] In total, according to FinCEN, based on marijuana limited SAR reporting, there are currently 105 individual financial institutions from states in more than one third of the country engaged in banking relationships with marijuana related businesses.[83]

Yet, given the compliance requirements, doing business with the marijuana industry arguably lacks economic significance for banks. The industry is currently a $1.5 to $2.5 billion industry.[84] Assuming *arguendo* that every legal marijuana business is following the FinCEN guidance, on average, each of the 105 financial institutions willing to do business is doing approximately nineteen million dollars annually with the industry (that is, two billion/105). Unquestionably, a significant portion of the legal market is not being processed as required by FinCEN. This implies that the industry's primary problem may be lack of economic significance to the banks.

If these banks are successful, expect others to follow the lead.

B. Finance

A successful marijuana startup, like many startups, is characterized by two attributes: high growth potential and innovation. As long as there is growth and innovation, there will be funding. As long as there are above average returns, information asymmetries, and business and market uncertainties there are dynamic capital markets. Overlaying the federal laws and regulations on states regulatory regimes calls this traditional financial paradigm into question.

While cash rich, marijuana businesses lack access to traditional sources of capital. Without normal banking operations, any semblance of traditional financing is challenging, at best. The limited ability to bank translates to difficulties in accessing capital markets. Further, as indicated, marijuana businesses operate on a cash–only basis, which raises direct and indirect costs, increases the risk of crime, and impedes a state's ability to account for the revenues.

Startup costs and the cost of capital in the marijuana industries are high.[85] Costs, including indoor gardening capital equipment, security, and state required tracking systems are relatively high for a stereotypical marijuana entrepreneur. Since obtaining funds remains difficult, willing

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82. *See e.g.*, Sala Credit Union Services, https://www.salalcu.org/business/ (last visited Sept. 14, 2016).

83. Calvery, *supra* note 78.

84. *See* Huddleston, *supra* note 18.

85. Eleazar David Melendez, *Marijuana Dispensaries Becoming Exclusive Domain of The 1 Percent*, HUFFINGTON POST (June 25 2013), www.huffingtonpost.com /2013/06/25/marijuana-dispensaries_n_3496588.html.

investors expect a rate of return proportionate with the risk.[86]

While deploying capital inherently requires a bank, creative business planners are finding ways to distribute and access capital, perhaps in violation of the bevy of applicable federal laws. Studying available sources of the funds is challenging, as business owners tend to maintain scarce sources of capital as privately as possible. Presumably, bootstrapping as well as friends and family are the largest source of funds but certainly not the only source. Other sources include private equity, including niche firms (i.e. VCs, micro–VC) and wealthy individuals.

Although, the marijuana industry's best, perhaps only, hope to achieve commercial parity with other industries is for the federal government to eliminate marijuana as a Schedule I controlled substance. This, however, will alter the legal and commercial landscape altogether; it will decrease or eliminate the criminal risks with doing business in this industry, paving the way for tobacco and alcohol, among other industries that have access to capital and are familiar with highly regulated businesses.

In the meantime, other options for changing the legal landscape may prove easier to accomplish. First, the marijuana industry should focus on those banks that are willing to engage with the industry. This will demonstrate to other banks that they will lose potentially profitable and valuable banking customers if they shun marijuana businesses. Second, marijuana businesses should assist the banking industry by assisting to compile the information required to complete the FinCEN due diligence and information reporting requirements, thereby reducing a substantial practice impediment to the banks. Third, the marijuana industry should continue various lobbying efforts; including, (1) encouraging state banking associations to lobby on their behalf; (2) requesting that federal officials include guidance assurances that the federal government will not prosecute banking officers or banks; (3) promoting that federal officials reduce reporting requirements including further simplifying the SAR mechanisms;

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86. *E.g.*, Tom Huddleston, *Investors Buzz for Marijuana–Related Businesses,* FORTUNE (Nov. 11, 2014), http://fortune.com/2014/11/11/medmen-private-equity-funding-marijuana/ (discussing the scarcity of venture capital); Full Circle Capital Corp., Annual Report (Form N–2/A), 55 (Dec. 16, 2014) (explaining that Full Circle Capital

> [I]nvested $500,000 in a warrant as part of a $30 million senior secured convertible note purchase agreement with Advanced Cannabis Solutions, Inc. (ACS), a non–residential property owner. The agreement to purchase convertible notes is contingent upon ACS' satisfaction of certain requirements. The convertible notes will bear interest at a fixed rate of 12.00% per annum and have a final maturity of January 21, 2020.

ACS Leases lease growing space and related facilities, commercial real estate, and equipment, to licensed marijuana business operators for their production needs, arguably not an ancillary marijuana business but rather a business that directly handles marijuana).

(4) enlisting in state banking association to lobby; and (5) empowering Congress to pass laws exempting banks from certain compliance and policing issues.

C. Taxation

Whether entrepreneurs or investors are using financial institutions or dealing with sacks of cash, so long as they are complying with the federal tax laws, taxation issues directly affect the internal rate of return on invested capital. Three major tax issues affect a marijuana business and attracting investors: first, Internal Revenue Code ("IRC"[87]) § 280E deduction limitation, which in effect forces marijuana businesses to pay tax on gross revenues, minus cost of goods sold; second, the issue of self–incrimination based on filing a tax return on a business that is engaged in illegal federal activity; and, third, tax penalties imposed on taxpayers paying taxes in cash. These issues play a direct role in determining the optimal organizational structure of the operating entity, that is the marijuana business, as well as any entity that may invest in an operating entity.

First, federal income taxes are based on "gains or profits and income derived from any source whatsoever," unless the source is specifically exempted.[88] Since there is no IRC exemption for illegal income, the IRS requires taxpayers to report and pay taxes on illegal income.

While marijuana income is subject to federal taxation, a business' ability to deduct expenses and capitalize depreciable assets is limited. IRC § 263A states that any cost that is prohibited from being be taken into account in computing taxable income for any taxable year may not be capitalized and expensed.[89] Section 280E prohibits tax deductions or credits for marijuana business expenses.[90] Together these IRC sections prohibit marijuana businesses from deducting indirect costs and capitalizing depreciable or amortizable assets. In sum, even if marijuana is legal at the state level, the IRC limits the taxpayer's ability to account for direct and indirect costs as well as capitalized property, such as plants and

87. IRC means the Internal Revenue Code of 1986, 26 U.S.C, as amended.

88. Commissioner v. Glenshaw Glass, 348 U.S. 426, 429 (1955).

89. 26 U.S.C. § 263A9(a)(2)(B) (2012) ("Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.").

90. 26 U.S.C. § 280E (2012) ("No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) *consists of trafficking in controlled substances* (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.") (emphasis added).

equipment. Indeed, the IRS has used § 280E to collect additional tax revenues in connection to marijuana businesses that report income.[91]

The IRS regulations provide examples of where capitalization of the deduction is prohibited.[92] Although the examples do not address IRC § 280E, they specifically state that any item not allowed to be deducted under another section of the IRC is not eligible for capitalization.[93] Therefore, a business is likely prohibited from using the benefits of IRC § 263A because of IRC § 280E.

Certain tax professionals argue that the capitalization rules should apply to certain expenses excluded by IRC § 280E asserting that businesses may use the absorption and capitalization rules established by IRC § 263A to limit the IRC § 280E effect.[94] As indicated, IRC § 263A allows businesses to capitalize certain direct and indirect expenses. These professionals supposedly advise the marijuana industry to reduce gross revenues by *increasing* cost of goods sold using the absorption and uniform capitalization rules to capitalize and deduct certain direct costs and indirect expenses. Again, such expenses would, if deducted currently rather than capitalized, be prohibited.

Other tax professionals take the questionable position that expenses in producing marijuana are deductible and expenses connected to selling are not.[95] Perhaps these professionals place emphasis on the "trafficking in controlled substances" language of IRC § 280E. Surely, production is a component of trafficking and, even if it is not, production likely is aiding and abetting trafficking. If a tax professional takes a questionable position, he or she must report these practices and positions to IRS. In reviewing these approaches, the IRS ultimately may not allow the taxpayer to use the expense and capitalization rules in this manner.[96]

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91. *See, e.g.*, Lisa Leff, *Harborside Health Center, Oakland Pot Shop, Hit with $2.4 Million Tax Bill*, YAHOO NEWS (Oct. 4, 2011, 8:19 PM), https://www.yahoo.com/news/irs-hits-oakland-pot-shop-2-4m-tax-212354119.html.

92. 26 U.S.C.A. §§ 263A(c), (d) (2015).

93. 26 U.S.C. § 263A.

94. Eric D. Budreau, *CPA Perspective on Marijuana Business in Colorado*, CLE Presentation at Colorado Bar Association, Nov. 19, 2014 (stating that he does not endorse this approach but certain tax professional may be advising clients using this rationale).

95. Todd Arkley, *Financial Pages: Account Management for Tax Purposes*, MARIJUANA VENTURES (Sept. 2014) ("If it is a cost related to acquiring/creating your product, then it will likely be an allowable deduction on your federal tax return. If it is a cost related to selling your product, it will likely not be allowed on your federal tax return.").

96. APB Opinion No. 28; FASB Statement 109, Accounting for Income Taxes; ASC 740–10; FIN 48 (requiring businesses to analyze and disclose income tax risks); *see generally* FINANCIAL ACCOUNTING STANDARDS BOARD, FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES AN INTERPRETATION OF

Returns on invested capital and taxation are intertwined. The overlap between the financing efficacy and tax planning is fundamental to making good investment decisions. Of course, relaxing § 280E would reduce yet another barrier to obtaining capital in this industry. Furthermore, the disallowance of expenses provides an incentive to those engaged in marijuana businesses in states permitting such businesses to understate the reported income.

Two Tax Court cases illustrate the challenges faced by marijuana businesses in taking advantage of fundamental tax practices. A 2007 Tax Court case provided many marijuana businesses hope that by engaging in health care activities they could deduct their expenses as a health care business.[97] In 2012, the Tax Court substantially narrowed this position by limiting what constitutes health care to more traditional health care activities that do not include dispensing marijuana or other caregiving services.[98] As a result, tax planning by deducting businesses expenses with a nexus to marijuana appears to have been eliminated; however, an ancillary business, with actual and distinct revenues, as an example a business that sells marijuana paraphernalia (if such goods are not marketed as or intended to be controlled substance paraphernalia), may be permitted to deduct some expenses against the operations of the ancillary business. As a second example, a parent or holding company could provide services, such as those provided by an intellectual property holding company.

Second, businesses operating legally under state law assert that filing a federal tax return connected to an illegal activity under federal law constitutes self–incrimination (that is paying tax on the illegal business is a confession of a crime).[99] Courts have held that engaging in illegal

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FASB STATEMENT NO. 109 (June 2006), http://www.fasb.org/resources/ccurl/86/12/aop_fin48.pdf.

97. Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner, 128 T.C. 173 (2007).

98. Olive v. Commissioner, 139 T.C. No. 2 (2012).

99. *See* Int. Rev. Code of 1954, § 4744 (stating that the Fifth Amendment protects individuals from such compulsory, incriminating disclosures and provides a complete defense to prosecution.); *see also* Leary v. United States, 395 U.S. 6, 28–29 (1969); People v. Duleff, 515 P.2d 1239, 1240 (Colo. 1973) ("[T]he Fifth Amendment prohibits licensing requirements from being used as a means of discovering past or present criminal activity which is subject to prosecution by calling attention to the licensee and his activities . . .There is no doubt that the information which Duleff would have been required to disclose would have been useful to the investigation of his activities, would have substantially increased the risk of prosecution, and may well have been a direct admission of guilt under federal law."). *See generally Leary*, 395 U.S. 6; Haynes v. United States, 390 U.S. 85 (1968); Grosso v. United States, 390 U.S. 62 (1968); Marchetti v. United States, 390 U.S. 39 (1968). John Ingold, *Marijuana Activists Lose Initial Challenge to Colorado Marijuana Taxes,* DENVER POST (Aug. 22, 2014, 1:14 PM), http://www.denverpost.com/news/ci_26387324/marijuana-activists-argue-pot-taxes-violate-self-incrimination.

activities is not an excuse or justification for the failure to file a federal income tax return.[100]

To be sure, when a marijuana business files a federal tax return and pays federal income taxes, the taxpayer is documenting violations of federal crimes included in the CSA. Marijuana businesses that are legal under state law must file state tax returns in order to maintain their status as legal entities.[101] While filing a state return in those states in which marijuana businesses are legal would not result in self–incrimination for state law purposes, how the federal government will use the tax returns is uncertain.[102] Indeed, under the Federal/State Tax Information Exchange Program, the IRS, and the relevant state department of revenue have the right to view the others' tax returns and audit information.[103]

Investors should evaluate the consequences of reporting income or failing to report income from marijuana business investments. States permitting legal marijuana businesses would likely lose substantial revenue if the federal government began to use tax returns as a method of enforcing the federal criminal law against marijuana businesses.

Third, many marijuana businesses, which are legal under state law, strive to operate legitimately. Because of the lack of available banking services, many businesses find it necessary to pay quarterly federal and state withholding taxes in cash. The IRS imposes a ten percent penalty tax on businesses, which pay such amounts in cash, creating yet another impediment to a favorable internal rate of return.[104]

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100. United States v. Sullivan, 274 U.S. 259, 264 (1927).

101. *See, e.g.*, COLO. REV. STAT. § 39–28.8–304(1)–(2) (requiring Colorado marijuana businesses to pay taxes); COLO. REV. STAT. § 39–28.8–306 (providing penalties for marijuana tax evasion).

102. Sarah Ferris, *Colorado Judge Will Not Strike Down 'Self–incriminating' Marijuana Taxes*, WASH. POST (Aug. 25, 2014), http://www.washingtonpost.com/blogs/govbeat/wp/2014/08/25/colorado-judge-will-not-strike-down-self-incriminating-marijuana-taxes/ (rejecting claims that paying federal income taxes are a violation of the a person's right against self–incrimination); *see also* Ariel Shearer, *IRS Targets Medical Marijuana Businesses In Government's Ongoing War On Pot*, HUFFINGTON POST (May 29, 2013), http://www.huffingtonpost.com/2013/05/29/irs-medical-marijuana_n_3346801.html.

103. 26 U.S.C. § 6103(d) (2016).

104. *See* 26 U.S.C. § 6302(h) (2016) (requiring Treasury to implement regulations for the electronic funds transfer system); 26 C.F.R. § 31.6302–1 (2016) (a taxpayer that is required to withhold payroll taxes under 26 C.F.R. § 31.6302–3 (2016), Treas. Reg. § 31.6302–3 must use the electronic funds transfer system to make all deposits of those taxes); 26 U.S.C. § 6656(b)(2) (2016) (imposing penalties for failing to use electronic funds transfer system); Rev. Rul. 95–68, 1995–2 C.B. 272 (1995) (requiring use of electronic funds transfer system and affirming penalties for failing to use electronic funds transfer system); *see also* David Migoya, *IRS Fines Unbanked Pot Shops for Paying Federal Payroll Tax in Cash*, DENVER POST (July 2, 2014), http://www.denverpost.com/business/ci_26075425/undefined?source=infinite; Trevor Hughes, *Pots of*

The seemingly obvious solution of using a payroll company may implicate the federal crimes of aiding and abetting and money laundering.[105] Many payroll companies and, likewise, many banks are avoiding relationships with such businesses.

Tax planning drives many private equity investment decisions. In this industry, incentives are high to underreport income, particularly when deductions are not allowed. Investors seeking to deploy capital should consult with a certified tax professional or attorney who specializes in tax matters and carefully choose businesses in which they invest. Each issue affects the organizational structure of both the investing fund and the business, requiring careful evaluation.

The federal government has a financial incentive to equalize the tax consequences for marijuana businesses with other businesses such as alcohol and tobacco in order to facilitate industry growth and, in turn, increase tax revenues. As in the financing area, the tax arena provides many areas in which lobbying may have the consequence of reducing the risks associated with deploying capital in this market; as examples: (1) lobbying Congress to eliminate the IRC § 280E expense rule in states where certain marijuana businesses have been legalized; (2) lobbying federal officials to agree not to use the state or federal tax return in order to impose criminal liability on those engaged in the space and not violating state law and in the case of Washington and Colorado, state regulated businesses; and, (3) lobbying the Treasury to issue a ruling that the capitalization rules do not exclude business which can not avail themselves of IRC § 280E.

D. Securities and Registration Exemptions

Many investments in marijuana businesses involve the sale and purchase of securities. The primary purpose of securities laws is to inform and

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Marijuana Cash Cause Security Concerns, USA TODAY, (July 13, 2014, 12:50 PM), http://www.usatoday.com/story/news/nation/2014/07/13/marijuana-cash-flow-colorado/12271369/.

105. 18 U.S.C. § 1956(a)(1)(B); *see also* U.S. v. Fishman, 645 F.3d 1175, 1187 (10th Cir. 2011) (explaining that the crime of money laundering requires the following elements: (1) knowingly conducting a financial transaction; (2) the funds are proceeds of a specific unlawful activity; (3) the defendant knows the funds involved are proceeds of that unlawful activity; and (4) the transaction is designed to conceal the nature, location, source, ownership, or control of the proceeds.); U.S. v. Sherman, 262 F.3d 784, 794 (8th Cir. 2001) (explaining that a person or organization "who aids and abets money laundering is criminally liable as a principal, and the government's burden to show aiding and abetting requires that the defendants 'associated themselves with the venture, participated in it as in something they wished to bring about, and sought by their actions to make it succeed.'") (quoting U.S. v. Alvarez, 987 F.2d 77, 83 (1st Cir. 1993)).

protect investors from information asymmetries.

Against the backdrop of the green rush, the Securities and Exchange Commission ("SEC") warned investors about risks connected to marijuana related investments.[106] Illicit marijuana–related investments have been sold in registered and unregistered offerings alike taking many forms.[107] The examples provided by the SEC indicate that fraudsters, scam artists, and general crooks are trying to take advantage of the buzz, pun intended, surrounding this marijuana industry.

In spite of this development, many business people in this industry are seeking to structure legitimate business deals. The structure of private equity investment contracts varies greatly. As previously mentioned, private equity means the financing of potentially high risk and high reward projects.[108] When a person invests in a common enterprise expecting profits predominately from the efforts of others the underlying "investment contract" is a security.[109]

Securities laws apply broadly. While there are two basic types of securities — debt securities and equity securities — a security is a term used for many kinds of investment contracts including stocks, bonds, and mutual funds, among many others.

Marijuana companies and managers of other peoples' wealth must consider securities laws. The civil and criminal consequences of not doing so are severe.[110] The Securities Act requires issuers of securities to issue a prospectus, comply with gun jumping rules,[111] and to face heightened liability under §§ 11 and 12.[112] Issuers include a marijuana business, raising money through a private placement, or venture capital firms, where

106. NASAA, *New Products in Classic Schemes Identified as Top Investor Threats* (Nov. 12, 2014); SEC, *Investor Alert: Marijuana Related Investment*, (May 15, 2014); FINRA, *Marijuana Stock Scams* (May 29, 2014).

107. SEC. ADMIN. ASSOC., *New Products in Classic Schemes Identified as Top Investor Threats* (Nov. 12, 2014); SEC, *Investor Alert: Marijuana Related Investments* (May 15, 2014); FINRA, *Marijuana Stock Scams* (May 29, 2014).

108. *Supra* note 2 and accompanying text.

109. 15 U.S.C. § 77b (1) (2012) (defining security); SEC v. W.J. Howey Co., 328 U.S. 293, 294–97 (1946).

110. The Securities Act of 1933 § 11, 15 U.S.C. § 77k (2016) (material misrepresentation or omission of fact in the registration statement); § 12(a)(1) (contract rescission for sale or offer of unregistered securities or gun jumping violation); § 12(a)(2) (contract rescission for a prospectus or oral communication containing materially false and misleading statement); § 24, 15 U.S.C. § 77x (criminalizing willful false or misleading statements in registration statements); 15 U.S.C. § 78ff(a) (criminalizing willful false or misleading statements in 18 U.S.C. § 1348 (fraud)).

111. *See* Securities Exchange Act of 1933 § 5 (explaining that gun jumping is the concept of stimulating interest in a security prior to the filing of a registration statement).

112. The Securities Act of 1933 §§ 10(b), 11, 12, 15 U.S.C. §§ 77j–77l (2016).

the firms invest in portfolios of private companies.

Issuers or sellers of securities must file a registration statement or find and rely upon an available exemption.[113] Structuring marijuana industry investment vehicles so that they are exempt from the registration requirements and public disclosure requirements of the federal securities laws will reduce costs, decrease regulatory scrutiny in an already highly scrutinized industry and, under certain exemptions, conveniently facilitates compliance requirements with the instate residency requirements, like in Colorado and Washington.

Residency requirements complicate the deployment of capital and providing financing to these businesses.[114] For example, in Colorado, investors have two–year residence requirements (which are set to change in 2017) because Colorado Marijuana Enforcement Division considers the source of funds and financial review as principle compliance areas, subjecting applicants to thorough background checks.[115] In Washington, the residency requirement is three–months.[116] In both states, equity owners of businesses that touch marijuana must be residents of the state in question.

Two types of transaction exemptions are important in the marijuana space: intrastate offerings and private placements. Anyone seeking to rely upon these exemptions should seek the advice of a lawyer, keeping in mind a lawyer may be confronted with ethical challenges related to providing legal advice connected to structuring deals in this space.[117]

The sale of registration exempt securities will differ from state to state according to any given state's marijuana and blue–sky laws.[118] Of course,

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113. The Securities Act of 1933 § 5(a), 15 U.S.C. § 77e (2016) (providing that "[u]nless a registration statement is in effect as to a security, it shall be unlawful for any person," to use any means of interstate commerce in connection to security).

114. Mike Riggs, *The Actual Reason Why Denver Won't Become the Silicon Valley of Marijuana, A Pesky Regulation will Keep Outside Investors from Blowing up Colorado's Pot Market*, CITYLAB (Sep 24, 2013), http://www.citylab.com/politics/2013/09/why-denver-wont-become-silicon-valley-marijuana/7007/; Nick Summers, *For Marijuana Entrepreneurs, Sticky Red Tape Remains in Colorado*, BLOOMBERG BUSINESSWEEK, (Sept. 25, 2013), http://www.businessweek.com/articles/2013-09-25/for-marijuana-entrepreneurs-sticky-red-tape-remains-in-colorado.

115. COLO. CODE REGS. §§ 212–1:1.232 & 212–1:1.202 (2016).

116. COLO. CODE REGS. § 212–2.202 (2016) (retail licensing process); § 212–1:1.232 (factors considered when determining residency); WASH. REV. CODE 69.50.331 (1)(b)(2014); WASH. ADMIN. CODE 314–55020 (2014) (detailing marijuana license qualifications and application process including background check and residency requirement for applicants and financiers).

117. *Supra* note 5 and accompanying text.

118. *See, e.g.*, CAL. CORP. CODE § 25102 (f), (n) (2014) (California intrastate exemptions); COLO. REV. STAT. § 11–51–308 (2016) (private placement exemptions including Section 4(2) under the Securities and Exchange Act of 1933 as well as offers

the issuer or seller of the investment interests should contact the state regulators to confirm that the offering has been cleared for sale in the state.[119]

Useful exemptions are highlighted below. Section 3(a)(11) including Rule 147 is used in connection with intrastate exemptions. Many intrastate investment contracts do not need to be registered under the Securities Act of 1933 or any state securities law.[120] Section 4(a)(2) including Regulation D is used in connection with private placements. Relying on exemptions has advantages and disadvantages.

1.Interstate Offerings

Section 3(a)(11) [121] exempts securities offered and sold only to persons resident in a single state by an issuer incorporated in and doing business in that state. While less relied upon than other federal exemptions, Section 3(a)(11) provides the basis for an intrastate fund.

> The legislative history . . . suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment. Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the section 3(a)(11) exemption.[122]

The specific advantage of the Section 3(a)(11) exemption includes a requirement to restrict eligible investors to a single marijuana friendly state. A Cole Memo II priority is preventing diversion of marijuana. While the guidance is limited to diversion of marijuana, likewise the distribution or diversion of proceeds that have a nexus to marijuana business securities may trigger increased federal scrutiny.[123] Relying on this exemption,

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to no more than twenty persons in Colorado and ten purchasers); WASH. REV. CODE § 21.20.320 (2014).

119. *State Securities Regulators*, SEC (Jan. 11, 2005), http://www.sec.gov/answers/statesecreg.htm (last visited Dec. 26, 2014).

120. *See generally,* COLO. DEP'T REG. AGENCIES, *Exempt Private Placements*, http://cdn.colorado.gov/cs/Satellite/DORA-SD/CBON/DORA/1251627030613; *see also,* CAL. CORP. CODE 25102 (n) (2014) (California "qualified purchaser" exemption).

121. The Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c (2012) ("Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.").

122. 17 C.F.R. § 230.147 (2016) ("Part of an issue", "person resident", and "doing business within" for purposes of section 3(a)(11)).

123. STATE OF COLORADO, *Task Force Report on the Implementation of Amendment 64* 33 (Mar. 13, 2013), http://www.colorado.gov/cms/forms/dor-tax/A64TaskForceFinalReport.pdf ("The residency requirements will also position the new regulatory framework to better withstand federal scrutiny, given that they discourage out–of–state

informs federal authorities that investors are not directly diverting proceeds to other states; in fact, the explicit message is that capital is being deployed and proceeds are being distributed within the marijuana friendly state. The disadvantages include the burden being on the issuer to establish that conditions of exemption have been met.

In the marijuana space, restrictive contractual covenants are important. Colorado and Washington marijuana businesses could take advantage of Section 3 (a)(11) and Rule 147 as long as investment contracts contain covenants requiring ownership transfers to comply with state regulations including restricting investors from reselling to out of state residents. Likewise, fund managers could form intrastate funds relying upon these exemptions as long as the investors and portfolio companies are intrastate.

Rule 147 is a safe harbor to Section 3(a)(11).[124] Rule 147 typically applies to small business entities that would like to raise limited amounts of money, without incurring the expensive fees associated with registering with the SEC. Rule 147 requires that all purchasers must be residents of the state, eighty percent of the business's gross revenues, assets, and use of offering proceeds must be within the state, and resales are limited to state residents.[125] Rule 147 also has practical limitations, including a strict advertisement compliance requirement. Even though this exemption presents challenges for marijuana businesses with multistate operations, it provides additional flexibility for businesses with limited out of state assets and operations.

2. Private Placements

Regulation D is relied upon heavily for private placements. A private placement is the sale of interests in a business (securities) to a limited number of qualified private investors, typically taking the form of a private placement memorandum ("PPM") for one of the following: a subscription agreement for preferred stock, limited partner interest in a limited partnership, or membership interest in a limited liability company ("LLC"). In fact, ownership interests in limited liability organizations are broadly considered securities under state and federal securities laws. The contractual vehicle between venture capital fund managers and portfolio companies typically takes the form of a stock purchase agreement, also, for preferred stock.

Rule 506 of Regulation D is considered a "safe harbor" for the private

residents from moving to Colorado expressly to establish an adult-use marijuana business.").

124. 17 C.F.R. § 230.147 (1974).

125. *Id.*

offering exemption of Section 4(a)(2) of the Securities Act.[126] It allows an unlimited amount of money to be raised, an unlimited number of accredited investors, up to thirty–five non–accredited investors, and is subject certain restrictions on public advertising.[127]

Even though Regulation D exemptions are relied upon in unregistered security transactions, they may not be ideal in the marijuana industry context because the distribution of proceeds from the sale of marijuana across state lines is, on many levels, analogous to the actual diversion of marijuana. Consequently, the Cole Memo II's diversion–control prevention enforcement priority may be triggered. Further, recall in 2005, the U.S. Supreme Court held that Congress had the power to and did prohibit purely intrastate cultivation and possession of marijuana.[128] To avoid the diversion inference, investors should be limited to the same state or marijuana states with similar regulations (that is, only investors from retail marijuana states or only investors from medical marijuana states).

The advantage of the Regulation D Rule 506 lies in the requirement for investors to be sophisticated or accredited.[129] Due to the high–risk nature of the marijuana industry, entities seeking investments should only deal with persons that have sufficient knowledge and finance experience so that they can evaluate the risk as well as afford the risks. Therefore, Rule 506 requires what good businesses sense dictates — sophistication and accreditation. As an aside, if an issuer (again a business seeking capital or fund) relies on any of the Regulation D exemptions, it is required to file notice with SEC after the first sale.[130]

To summarize, on the one hand, the use of unregistered securities reduces costs and decreases regulatory scrutiny in an already highly scrutinized industry. In addition, under certain exemptions, in state residency requirements are aligned with the federal government's diversion control concerns. On the other, unregistered securities tend to be less liquid. While illiquidity based on the unregistered status of the security is a risk, prudent investors will put significant weight on the DOJ's diversion–control enforcement priority when evaluating investment opportunities.

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126. *Id.* § 230.506 (exemption for limited offers and sales without offering limitation).

127. *Id.*

128. Gonzales v. Raich, 545 U.S. 1, 1–3 (2005).

129. The Securities Act of 1933 § 4, 15 U.S.C, § 77d (2012); 17 C.F.R. § 230.501 (2016) (defining accredited investor); 17 C.F.R. § 230.506(b)(2)(ii) (2016) (sophistication means the knowledge and experience in financial and business matters such that he is capable of evaluating merits and risks of prospective investment).

130. 17 C.F.R. § 239.500, Rule 503(a) (Form D).

IV. PLAYBOOK FOR PRIVATE EQUITY DEPLOYMENT

The private equity business is enormously complex.[131] Typically, private equity firms invest money from pension funds, institutions, and high net worth individuals with an exit strategy of either an initial public offering or sale to another company. Private equity takes many forms like hedge funds, leveraged buyouts, and venture capital, but typically, venture funds invest in portfolio companies in exchange for preferred equity stock or debt, which is convertible into equity upon a subsequent event or milestone. Pending the investment vehicle, investments can be locked up for years, a decade, or longer. Other investment vehicles are debt focused with an option to convert to equity based on certain events, as an example, rescheduling of marijuana under federal law.

A nuanced private equity industry is emerging to serve marijuana businesses.[132] Noted wealthy individuals support the marijuana industry. George Soros, John Sperling, and Peter Lewis have spent millions supporting the cannabis industry.[133] In spite of this support, large,

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131. From the need to understand business management to the highly technical products and services that characterize specific markets, understanding private equity is challenging. Many private equity funds are structured as limited partnerships ("LPs") and, accordingly, limited partnership agreements govern the terms of the agreements. Others are limited liability companies or corporations. In any case, the organization would be one in the state that permits marijuana cultivation, distribution and use for medical or recreational purposes.

In the LP rubric, general partners ("GPs") raise capital, make investment decisions and, at least the good ones, provide valuable management services. LPs include pension plans, university foundations, endowments, and high net worth individuals; they make the investments. LPs lack expertise in management and markets. GPs (fund managers) pool portfolio companies in order to mitigate risk. *See generally* JOSH LERNER ET. AL. VENTURE CAPITAL & PRIVATE EQUITY, (5th ed., 2012); JOSH LERNER ET. AL., VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP (2012).

132. *See, e.g.*, Bill Meagher, *Private Equity Firing up Medical Marijuana Sector*, DEAL.COM, (June 16, 2014, 2:03 PM), http://www.thedeal.com/content/private-equity/private-equity-firing-up-medical-marijuana-sector.php (discussing the activities of various private equity firms including Privateer Holdings, Duchess Capital Management, PharmaCan Capital, KindBanking and the ArcView Group); EMERALD OCEAN CAPITAL, http://www.emeraldocean.com/ (last visited Jan. 25, 2015) (marketing itself as a technology and life science sector expert with a focus on the marijuana industry). *See also* Eleazar David Melendez, *Marijuana Venture Capital Fund Launches as Ganjapreneurs Go Mainstream*, HUFFINGTON POST, (June 06, 2013, 8:34 AM), http://www.huffingtonpost.com/2013/06/06/marijuana-venture-capital_n_3393061.html; Jonathan Kaminsky, *Ex–Microsoft Man Jamen Shively Plans to Unveil Mystery Marijuana Brand*, REUTERS, (May 30, 2013, 3:14 PM), http://www.reuters.com/article/2013/05/30/usa-marijuana-idUSL2N0EB0YA20130530 (discussing an ex–Microsoft employee's suspect idea to import marijuana from Mexico; Shively, the ex–Microsoft employee, states, "[w]e've created the first risk–mitigated vehicles for investing directly in this business opportunity.").

133. *See* Chloe Sorvino, *An Inside Look At The Biggest Drug Reformer In The Country: George Soros*, FORBES, (Oct. 2, 2014, 9:00 AM), http://www.forbes.com/site

institutional funds and investors are unlikely to invest in companies that actually touch marijuana until these businesses are able to do public offerings, and, in turn, list and sell shares publicly; which requires the federal government to de–schedule marijuana altogether. Recently, Pay Pal co–Founder Peter Thiel's venture fund, Founders Fund, invested in Privateer Holdings, a venture firm that invests marijuana businesses. In spite of this development, investments in companies that actually touch marijuana remain largely reserved for friends, families, and wealthy individuals. All investors are confronted with similar legal risks.

This section of the article addresses two facets of this industry: private equity funds and private placements. In both cases, the surrounding illegalities make linking incentives of all the parties, the entrepreneur as well as the general and limited partners, challenging. Obviously, businesses and investors want to make money, not a stint in the federal penitentiary. Investors face a range of risks from inherent reputational considerations to underlying investment risks caused by short–term cash flow issues resulting from the portfolio company's inability to secure a loan or obtain credit cards. Many investors, regardless of residency, will hesitate to put money into an industry that is illegal on the federal level. Similar to other industries that rely on private equity, linking incentives is critical to the success of the fund for the underlying portfolio companies or anyone else to be willing to invest directly into a marijuana business.

In the marijuana industry, investors are limited. Investors fall into four generalized categories. First, family and friends appear to be one of the largest sources of funds.[134] Second, a common dominator for many investors is that they think marijuana should be legal. The rationale for legalizing marijuna ranges from patients having access to medicine, reducing violence in Latin America, and states' rights.[135] Third, other investors are enticed by the high returns associated with the next big thing; stories abound of people wanting to throw money at marijuana.[136] Fourth,

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s/chloesorvino/2014/10/02/an-inside-look-at-the-biggest-drug-reformer-in-the-country-george-soros/ (detailing marijuana legalization efforts of numerous wealthy individuals); Richard Pérez–Peña, *John G. Sperling, For–Profit College Pioneer, Dies at 93*, N.Y. TIMES (Aug. 25, 2014), http://www.nytimes.com/2014/08/26/us/john-g-sperling-for-profit-college-pioneer-dies-at-93.html?_r=0.

134. *Money Show Wrap–Up: Financial Lessons for Cannabusinesses,* MARIJUANA BUS. DAILY (Apr. 11, 2014), http://mmjbusinessdaily.com/money-show-wrap-up-financial-lessons-for-cannabusinesses/.

135. *See* Kelly Riddell, *George Soros' Real Crusade: Legalizing Marijuana in the U.S.*, WASH. TIMES (Apr. 2, 2014), http://www.washingtontimes.com/news/2014/apr/2/billionaire-george-soros-turns-cash-into-legalized/?page=all (describing Soros's eighty million dollars in donations towards marijuana legalization).

136. *See, e.g.*, *Mentor Captial Reaches Out to Bhang to Clarify Their Intentions*, MENTORCAPITAL (June 25, 2014), http://mentorcapital.com/bha'ng-info/ (MentorCapital's strategy is to be first with public money, roll up the best cannabis participants in a

others want highly diversified portfolios.

Funds are poised to invest and angels are investing because of the anticipation that the internal rate of return will be high.[137] Of course, if the banking and tax issues are not addressed, the bottom line rate of return will be reduced significantly.

A. Investment Agreements

A key component to private equity is the incentive alignment driven structure of the markets; the core, perhaps the entire purpose, of this structure is to align incentives of the stakeholders (investors, fund managers and entrepreneurs). Inherent in financing businesses are problems of uncertainty, information asymmetries, and agency costs. In the marijuana industry, as discussed above, these issues are magnified because of the uncertainties connected to the federal law including taxation, money laundering, securities, and dealing in controlled substances. Individuals that work with private equity (funds and private placements) must understand, manage, and disclose these complications.

In the venture capital context, general characteristics of limited partners include a readiness to trade anticipated above–market gains in exchange for illiquid investments. An entrepreneur has limited access to capital and a requirement for management expertise. Private equity managers are investment professionals and bridge these worlds by identifying businesses with latent value, investing capital, and providing the business with valuable management services. While seasoned private equity managers think they understand the marijuana market, perhaps with the exception of cannabis based pharmaceuticals, understanding the capital deployment challenges is generally distinct from understanding the business of cultivation, distribution, and sale of marijuana and its compounds.

While managers are not typically involved in day–to–day operations, an understanding of the market sector is critical. To illustrate, entrepreneurs and industry insiders possess significant amounts of information on a wide range of issues, ranging from strains with recreational, scientific, or medicinal merit to knowledge of the business's prospects compared to peers. Invariably one party has more information than the other. Further, the surrounding federal illegality gives rise to unique uncertainties. These

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public vehicle and bring business professionalism to the sector. Mentor attempted to execute this strategy with a business, Bhang Chocolates, which actually handles marijuana.); *see also* Robert Sanchez, *The Money Tree*, 5280 THE DENVER MAG. (Nov. 2014) (reporting the interactions between Colorado Harvest Company and a potential investor.).

137. The author does not have enough information to evaluate internal rates of return, pre–post money valuations, and other basic financial metrics.

challenges make modeling outcomes and drafting respective contractual contingencies based on any events that may occur (as an example, unable to meet milestones because changes in state or federal law) challenging.[138]

Terms of the investment contract revolve around aligning financial interests. Typically, the fund agreements (limited partnership and subscription) provide the representations, warranties, covenants, and other contractual provisions of investors and managers to address issues inherent to private equity financing.[139] Funds agreements often require investments in or restrict investments from certain markets. Funds include cross fund investment restrictions, that is when a fund manager may not invest money from a later fund into a company the firm invested in an earlier fund; restrictive covenants involving debt and raising new funds are common. Further, subscription agreements are typically and expressly by contract subject to anti–money laundering regulations compounding risks the managers may breach. In this space, as others, agreements should maintain "key–person" clauses. In the marijuana industry, a key–person clause is critical as many purport to have business acumen, but few actually do.

Similarly, the portfolio company contracts should focus on staged financing and control to align incentives. For these reasons, marijuana businesses may not capitalize via traditional methods and institutional investors may not participate in this market for the time being.

In the private placement context, concerns are distinct. Unlike the venture capital model, while an investor may gain a certain level of control over the issuer's business, the private offering typically does not involve complex maneuvering to balance interests. The core issues are ensuring that securities exemptions are properly relied upon as well as requesting and securing sufficient financing. Going back to the well for money in exchange for preferred, much less common stock, becomes progressively more challenging.

Compounding the challenges related to financial contracts, certain state lawyers may not be able to comply with their rules of professional conduct and simultaneously draft or negotiate contracts, including leases.[140] If a

138. PAUL GOMPERS ET. AL., THE VENTURE CAPITAL CYCLE, 161–63 (2006).

139. Numerous formulaic documents are required including IRS Form SS–4, U–2, and SEC Form D, application for EDGAR Codes, among others.

140. *See* Colorado Ethics Option 125 ("A lawyer cannot comply with Colo. RPC 1.2(d) and, for example, draft or negotiate . . . leases for properties or facilities, or contracts for resources or supplies, that clients intend to use to cultivate, manufacture, distribute, or sell marijuana, even though such transactions comply with Colorado law, and even though the law or the transaction may be so complex that a lawyer's assistance would be useful, because the lawyer would be assisting the client in conduct that the lawyer knows is criminal under federal law."); *see also* Colo. Rules of Professional Conduct 1.2(d) ("a lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal. . . ."); ABA Model Rules or Prof'l

lawyer cannot assist a client with a lease, structuring an interstate PPM for a marijuana business could be a violation of the CSA as well as aiding and abetting the cultivation, distribution, and possession of marijuana among other federal crimes. To address this ethical quandary, the Colorado Supreme Court adopted a comment so Colorado attorneys may counsel and advise on Colorado's marijuana laws.[141]

B. Business Structures

Both the business operating entity and the investment fund–focused entities (whether a fund, an angel, or a group of angel investors) have an interest in setting up the appropriate business organizations. Because of the conflict between federal and state law and the banking, tax, and contractual issues, an entity organization is particularly important in achieving business planning goals, minimizing legal risk, and maximizing returns. Appendix III is an overview of various business structures. Appendix III is not intended to provide guidance, but it merely presents a summary of the alternative vehicles in which marijuana businesses and the investor relation may be formed. Undeniably, the services of lawyers and other business–planning professionals are required to effectively make these decisions to address the present ethical challenges discussed above.

Using these entities is driven by a desire to reduce personal liability as well as facilitate investment and business development. Investment entities and as with all operating businesses, marijuana businesses should consider the following factors: (1) limited liability; (2) centralized management and control; (3) liquidity of ownership interest; (4) distribution of proceeds; (5) pass–through taxation; and, (6) continuity of business life.

Reducing this section to the salient points is a challenge. In respect to funds, at least two organizational entities merit consideration: (1) the actual fund and (2) the entity the private equity professionals form to manage the fund.

Typically, the fund is structured as a limited partnership. The limited partners are investors and the general partners are the managers. In turn, the general partner forms a management services entity, typically structured as an LLC for tax and flexibility purposes.

Notwithstanding the traditional structure, private equity professionals

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Conduct 1.2(d).

141. Colo. RPC 1.2(d) cmt. 14 ("A lawyer may counsel a client regarding the validity, scope, and meaning of Colorado constitution article XVIII, §§ 14 & 16, and may assist a client in conduct that the lawyer reasonably believes is permitted by these constitutional provisions and the statutes, regulations, orders, and other state or local provisions implementing them. In these circumstances, the lawyer shall also advise the client regarding related federal law and policy.").

should consider forming C–Corporations ("C Corp") in the marijuana space. First, with or without tax losses, the tax information would not be included on the investor's federal income tax return since the C Corp is not a pass–thru entity. Second, since the investor generally holds a preferred class of stock, the investor's rights could be structured so that voting rights are prohibited in all matters relating to handling marijuana with the only rights being the organizational structure and additional investment matters. Third, it is generally easier to transfer stock interests to a subsequent or replacement investor. Fourth, the investors and manager–investors (who may receive salaries and commissions as compensation) would not show the source of income on their returns except as a dividend or salary from such company. Although the dividend and compensation would be taxed at the investor or employee level, the business income and deductions would be reported only at the corporate level, potentially providing some insulation from self–incrimination as well as civil and criminal liability.[142]

Since IRC Section 280E prevents investors from deducting expenses from federal income tax obligations, a pass–thru business structure may not be the optimal vehicle for the management service entity.[143] An LLC, electing to be taxed as a corporation, is a practical option.

If the management services entity is formed as an LLC, as is typical, it is governed by an operating agreement. The managers may structure the operating agreement to provide flexibility to adapt to changing needs and circumstances that are subject to the terms of the subscription agreement.

Electing to be taxed as a C Corp is not typical. An LLC may elect to be taxed as a partnership (that is, a pass–thru entity) or as a corporation merely by checking the appropriate box on the federal income tax forms. In either case, whether taxed as C Corp or partnership the LLC maintains significant operating flexibility. However, if pass–thru is *not* elected the managing member would show the source of income as a return or dividend allowing the members more discretion. By contrast, if pass–thru is elected, the managing member would likely be required to show income, expenses, and deductions from the marijuana business.[144]

Turning from funds to the operating business, while the six factors above

142. *See generally* Section 10(b) of the Securities Act of 1933, 15 U.S.C. § 77j(b); Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988).

143. *See* 26 U.S.C. § 280E (2016) (prohibiting tax deductions or credits for any trade or business consisting of trafficking controlled substances).

144. 26 U.S.C. § 706(b)(4)(B) ("A partnership as such shall not be subject to income tax imposed by this chapter. Persons carrying on business as partnership shall be liable for income tax only in the separate and individual capacities."); §702(a)(1)–(7) (elaborating that each partner must accounting separated for his or her share of capital gains, losses as well as bottom line income and losses); *see also* IRS Form K1, http://www.irs.gov/pub/irs-pdf/f1041sk1.pdf.

should be evaluated, marijuana businesses should consider LLCs as the primary option because of the contractual flexibility for determining the rights of the members and structure of the organization. Certainly, limited liability is important, but flexibility in structuring the ownership interests and distribution of proceeds are equally necessary. Again, an LLC electing to be taxed as a corporation provides this flexibility. As a secondary option, since business deductions for a marijuana business are unlikely to be allowed because of IRC Section 280E, C Corps which offer all six of the characteristics above should be considered for the operating business.

Because ownership interests are treated as securities under state and federal securities laws and many states regulations have license assignment restrictions, investors should not be able to resell their interest without approval. To be sure, reselling the interests to the public may not only be prohibited under state law but also it may destroy the applicable exemption. Improper reliance on securities law exemptions may result in the applicability of heightened fraud provisions as well as give rise to the possibility of administrative and civil liability.[145]

C. Raising Money, Deploying Capital and Distributing Proceeds

A core purpose of this article is to discuss whether and how managers of private capital may invest in businesses that actually touch marijuana and, subsequently, how proceeds may be distributed back to the investors. Perhaps nothing, besides federal rescheduling or descheduling of marijuana, will make investing in this industry ostensibly legal because a direct investment in a business that handles marijuana likely is a direct violation of the CSA. Likewise, the activities amount to aiding and abetting to or conspiring with someone to cultivate, distribute, and possess marijuana, even though the federal government has indicated that it does not intend to enforce federal laws in this area.[146]

Despite the challenges in finding investors, businesses that exhibit growth attributes seek and find capital.[147] Institutional and other investors have explored ancillary markets and, recently, direct investments in the retail marijuana industry. Generally, investors are intrigued by this market because of the perceived dynamic growth. Structuring an investment so that it does not implicate the Cole Memo II's enforcement priorities, adheres to DOJ requirements, and abides by the Treasury's financial

145. *See* Section 10(b) of the Securities Act of 1933, 15 U.S.C. § 77j(b); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988).

146. 18 U.S.C. § 2 (aiding and abetting); § 371 (conspiracy); §§ 1961–68 (racketeering).

147. *See, e.g.*, April Rudin, *5 Things High Net Worth Individuals Need To Know About Medical Marijuana*, HUFFINGTON POST (Dec. 3, 2014, 11:11 AM), http://www.huffingtonpost.com/april-rudin/5-thing-high-net-worthin_b_6214050.html.

guidance is feasible.

Assuming that investments do not implicate the Cole Memo II's enforcement priorities and the investors follow the FinCEN Guidance, even though federal authorities could enforce federal laws, federal authorities (such as the DOJ and the DEA) should not do so in the retail and medical marijuana states with robust regulatory frameworks. If marijuana businesses that directly handle marijuana and the respective investors adhere to the principles that follow, they will reduce the inherent risks associated with deploying capital in this industry.

Foremost, the marijuana businesses and investment entities alike must be professionally operated, comply with business and accounting standards, and, of course, understand and adhere to the federal guidance.

Second, prior to issuing or selling securities, interested parties should attempt to resolve the banking conundrum by collaborating with a bank that is willing to implement a robust compliance program. Banking relationships will facilitate the deployment of capital. Fund managers and marijuana business leaders need to work with the bank's risk managers as well as the federal regulators to establish mutually beneficial compliance programs. In turn, the bank must maintain an active compliance program, including a risk management component that actively conducts and works with clients to accomplish the required due diligence.

A fundamental component of this collaborative compliance is filing a Marijuana Limited SAR for every transaction. Using the marijuana limited SAR mechanism for every transaction is the foundation for a working business relationship between a bank and a business that directly handles marijuana. In short, the marijuana businesses and the banks should collaborate to comply with FinCEN guidance.

Third, using a PPM or other prospectus, individuals soliciting the investment should disclose all available information to the investors — the fund should be above board and *over–disclose*. The purpose of the investment should be outlined in the PPM and defined in the fund agreement highlighting the high degree of risk and illiquidity. Many investors are aware of the surreal dichotomies (illegal but won't prosecute; conduct commerce without access to banks). In spite of the general understanding, in the context of soliciting other people's money, the issuer or solicitor should be above board. The solicitor, in the interest of full disclosure and mitigating the risks associated with securities regulatory compliance, should inform all investors, including friends and family, angels, and other entities with wealth, of the criminal and civil risks, particularly forfeiture.

Fourth, continuing with critical legal compliance matters, all investors should understand and comply with state regulatory requirements (e.g. in

state residency, background checks, over 21 years old). In Colorado, for example, the prospectus should address the Colorado residency and the good moral character requirements.[148] All investors should be accredited and sophisticated; likewise, issuers should take active steps to verify that investors meet these criteria.

Fifth, specifically evaluate securities laws and regulations. Creating a wholly intrastate fund has advantages. The issuer (that is, the angel, fund managers or business) of an investment contract must be aware of the Blue Sky laws. In Colorado, the issuer should contact the Division of Securities regarding his or her intent to sell unregistered securities.[149] Likewise, in Washington, the issuer or seller should communicate with the Washington State Department of Financial Institutions.[150]

Sixth, the prospectus should provide an overview of the CSA, the BSA, the tax code, and the respective DOJ and FinCEN Guidance. The investment solicitor should (1) disclose the difficulties and risks associated with distributing proceeds and (2) acknowledge that the FinCEN Guidance affirms that, unless the FinCEN guidance is followed, doing business with marijuana businesses could be construed as money laundering and other violations of the BSA.

Seventh, as in most circumstances, business owners and fund managers should incorporate or form limited liability business organizations. Forming the entity in a limited liability structure does not assure insulation from liability, but certainly provides for less exposure. Because certain underlying activities are illegal under federal law, individuals may not be protected from federal actions by a state business organization, even if formed in a state permitting the activity. The potential to reach assets exists as well as federal enforcement, particularly if the climate in Washington, D.C. changes.

Finally distributing proceeds has risks. In addition, to the omnipresent threat of money laundering statutes and the BSA, investing proceeds from a business that directly handles marijuana is a federal crime.[151]

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148. *See* Colo. Sess. Laws § 12–43.4–306 (persons prohibited as licensees); COLO. CODE REGS. § 212–2.204 (2016) (factors considered when evaluating ownership of a license for retail marijuana establishments); COLO. CODE REGS. § 212–2.201 (2016) (complete applications requirement); COLO. CODE REGS. § 212–1:1.232 (2016) (factors considered when determining residency).

149. *See* COLORADO DEPARTMENT OF REGULATORY AGENCIES, DIVISION OF SECURITIES, EXEMPT PRIVATE PLACEMENTS, http://cdn.colorado.gov/cs/Satellite/DORA-SD/CBON/DORA/1251627030613 (last visited Sept. 8, 2016).

150. *Securities Exemption Table*, WASH. STATE DEP'T OF FIN. INSTS. (last visited Sept. 8, 2016), http://www.dfi.wa.gov/sd/exemptiontable.htm.

151. 21 U.S.C. § 854(a) (2016) ("It shall be unlawful for any person who has received any income derived, directly or indirectly, from a violation of [the CSA] punishable by imprisonment for more than one year in which such person has

Whether adhering to these guidelines provides investors sufficient comfort to risk exposure to activities that are illegal on the federal level is another question altogether, but some investors may find these risks acceptable.

V. CURRENT PRIVATE EQUITY EFFORTS

For some investors the rewards outweigh the risks. Unusual complexity and risk coupled with upside characterizes the cannabis market.[152] Many businesses are thinly capitalized, highly speculative, and merely trying to benefit from the market buzz.

Aligning the incentives of the investors is an important concern in most private equity transactions for both the private equity managers and entrepreneurs. Typically, fund managers begin the process of aligning incentives by focusing on certain markets or market segments. Funds and investments directed to businesses that actually touch marijuana, regardless of recreational or medicinal use, inherently give rise to the risks discussed in this article. Of course, the fund must find a bank willing to conduct business with it in the first place.

Although these risks are great, there are now more than seventy–five public cannabis companies in the U.S., up from thirteen at the end of 2012.[153] Investors have deployed $100 million into the general marijuana industry in the last two years.[154] In 2014, investments in the general industry grew 941.5%.[155] Niche investors are active.[156]

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participated as a principal . . . to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this section if the securities of the issuer held by the purchaser . . . do not amount in the aggregate to 1 per centum of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.") (b) (punishable by $50,000 fine or 10 years in prison or both).

152. Carol Tice, *Meet The 8 Hottest Publicly Traded Marijuana Companies*, FORBES (Nov. 14. 2014, 8:35 AM), http://www.forbes.com/sites/caroltice/2014/11/14/meet-the-8-hottest-publicly-traded-marijuana-companies/2/.

153. Viridian Capital & Research, Capital, M&A, Research and Investor Relations for Cannabis Companies (2014).

154 CB INSIGHTS, INDUSTRY, CANNABIS, https://www.cbinsights.com/industry?public_list&setup=6&subindustry=42521&topsearch_doc_type=company-lists&topsearch_id=42521&topsearch_q=cannabis#activity-pane (last visited Jan. 24, 2015).

155. *Id.*

156. *Id.* According to CB insights the listed investors (ArcView Group, PharmaCan Capital, Broadband Capital, Adam Wiggins, Delavaco Group, Broadband Capital, Dutchess Capital Management, Delavaco Group, FastFunds Financial Corporation, Dutchess Capital Management, Founders Fund, FastFunds Financial Corporation,

Investment managers seeking niche specialties may target five market segments. First, funds could target their investments in legal ancillary businesses that support the marijuana industry. Many businesses are integral to the marijuana industry, such as childproof bags to indoor growing industry products, which are potentially ripe for investment consideration. Generally, these licensing, real estate, compliance, and technology businesses are limited to over–the–counter markets.

Ancillary business segments include biotechnology, consulting services, consumption devices, cultivation, hemp based products and extracts, investment and M&A, physical security, real estate, and software. A number of examples of firms that services these sub–segments exist. Perhaps most well–known is Privateer Holdings; a private equity firm that invests, incubates, and acquires companies in the marijuana and the medical industry.[157] Until recently, Privateer had disavowed investing in companies that actually handle marijuana in U.S. markets.[158] Departing from this stance, in November 2014, it announced the creation of Marley Natural, a marijuana brand. Purportedly, the Marley Natural will have a suite of products that include heirloom Jamaican cannabis strains said to be similar to the ones Bob Marley consumed.[159] This is a radical change in stance; it appears Privateer has researched the speculative conclusion that the U.S. market has reached a tipping point.

Similarly, Fresh VC claims to have deployed capital in the medical marijuana–mobile app space.[160] While certain ancillary businesses are performing well, others have difficulties raising money and obtaining capital because they still have reputational considerations without the perceived economic upsides connected to businesses that actually manage marijuana cultivation, distribution, or sales.

Second, a fund could structure itself around the pharmaceutical or nutriceutical markets. While the underlying compliance matters should be evaluated, pharmaceuticals businesses may conduct business legally as long as the business has its licenses and approvals in place from the DEA

Medican Enterprises Therapix Biosciences, Nhale, York Plains Investment Group, North West Fund for Biomedical, North West Fund for Biomedical, Therapix Biosciences, Therapix Biosciences) have deployed capital in the ancillary as well as retail and medical markets that directly handle marijuana.

157. Interview by Kyle Jensen with Brendan Kennedy, CEO, Privateer Holdings, Interview (Oct. 14, 2014).

158. *Id.*

159. *See* Matt Ferner, *Official Bob Marley Weed Will Be for Sale Next Year*, HUFFINGTON POST (Jan. 18, 2014, 8:39 AM), http://www.huffingtonpost.com/2014/11/18/bob-marley-natural-marijuana_n_6174450.html.

160. *See* Timothy Hay, *Uber for Pot' Eaze Raises $1.5 Million to Deliver Medical Marijuana*, WALL ST. J. (Nov. 5, 2014), http://blogs.wsj.com/venturecapital/2014/11/05/uber-for-pot-eaze-raises-1-5-million-to-deliver-medical-marijuana/.

and the Food and Drug Administration ("FDA").

Nuvilex, is developing cancer treatments based upon chemical constituents of marijuana, cannabinoids. Nuvilex Inc.'s subsidiary, Medical Marijuana Sciences, Inc. is conducting research involving pancreatic and brain cancer focusing "on ways to exploit the benefits of the live cell encapsulation technology in optimizing the anti–cancer effectiveness of constituents of cannabis, known as cannabinoids, against cancers while minimizing or outright eliminating the debilitating side effects usually associated with cancer treatments."[161]

GW Pharma grows cannabis in the UK and legally imports compounds into the United States.[162] It has a cannabis focused IP portfolio; Sativex has FDA Fast Track status and is currently collaborating with major global pharmaceuticals to commercialize the drug. Novartis, a global pharmaceutical giant, acquired five percent stake in the company with an option to acquire an additional five percent.

As others do, these businesses operate legally at the federal and state levels; individuals interested in investing in this industry should evaluate this segment to better understand how to legally work with cannabis at the federal level. In any event, in the long term, pharmaceuticals may be one of the more profitable segments because of its market potential.

Third, internationally focused funds may not be hindered by the same barriers to entry, in particular banking and tax, as in the U.S. market. The international markets also present the opportunity for high rewards albeit coupled with high risk. Uruguay, Israel, Spain, and Holland have cannabis markets meritorious of consideration.

Fourth, a number of highly publicized enigmatic funds that work in a grey area exist — they appear to work with businesses that actually directly manage marijuana, but tend to promote their relationships with the ancillary ones. In this vein, the High Times Growth Fund and the Arc View fund merit mention. Arc View is California based and claims to manage a fund and various portfolio companies. Based on Arc View's website, it actively solicits "accredited investors" from apparently any state.[163] It also advertises that it has funded twenty–eight businesses with fourteen million dollars invested. By contrast, the High Times Fund has a meager web presence and, at some point in 2016, the web presence

161. NUVILEX, SEC FORM 10–K (2014), http://www.sec.gov/Archives/edgar/data/1157075/000101968714003893/nuvilex_10ka.htm.

162. *See* GW PHARM., FAQ, http://www.gwpharm.com/FAQ.aspx (last visited Jan. 11, 2015).

163. *See* THE ARCVIEW GRP., http://arcviewgroup.com/companies/ (last visited Jan. 1, 2015).

vanished.[164]

Finally, companies that actually touch cannabis: certain funds are supposedly deploying capital to companies that directly handle marijuana.[165] Remarkably, a handful of over the counter companies are dealing directly with marijuana.[166]

The game is changing rapidly on many levels. Notably, tobacco and alcohol companies as well as private equity firms that focus on tobacco, alcohol, and drug markets are evaluating the marijuana industry.[167] These companies and firms have a keen understanding of regulated vice markets. Whether individuals that manage this money will embrace risks of working with businesses that actually handle marijuana, while it remains illegal on the federal level, remains unknown. If, or perhaps when, they enter, the private equity industry will certainly look different than it does today; for one, marijuana may become commoditized where branding and marketing are critical.

VI. CONCLUSION

The green rush is on. Yet again, Colorado, along with other states, are redefining what Wild West means. Entrepreneurs, once again, are lured to marijuana states, particularly, Colorado, Nevada, Arizona, Oregon, Washington and California, with thoughts of easy money.

Notwithstanding state decisions to exempt the cultivation, sale, distribution, or use of marijuana for medical and recreational purposes, this

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164. *See* Aldo Svaldi, *High Times Launches Private Equity Fund for Marijuana Investment*, DENVER POST (Jan. 4, 2014, 12:01), http://www.denverpost.com/business/ci_24844193/high-times-launches-fund-cannabis-investment; *see also* Jill Krasny, *The Lowdown on High Times' New Weed Fund*, INC.COM (Jun 25, 2014), http://www.inc.com/jill-krasny/the-lowdown-on-the-high-times-growth-equity-fund.html; *see also* Dune Lawrence, *High Times on Wall Street*, BLOOMBERG BUSINESSWEEK (June 19, 2014), http://www.businessweek.com/articles/2014-06-19/high-times-starts-marijuana-industry-investment-fund.

165. *See, e.g.*, MENTORCAPITAL, http://mentorcapital.com/homepage/legal-marijuana-market-opportunity/ (last visited Jan. 11, 2015).

166. *See, e.g.*, Next Generation Energy Corp., Quarterly Report (Form–10–Q) (NGMC, a publicly traded company, "signed a lease for a new medical marijuana dispensary in" California); Next Generation Energy Corp., Form 10 K/A (2012); Form 10-Q (2014) (Board approved a plan to redirect resources and to focus our core business on the medical marijuana industry); Terratech http://www.terratechcorp.com/about (click "investors") (becoming a publicly traded company that directly touches marijuana); *see also* Investor Hub ticker "TRTC," http://investorshub.advfn.com/Terra-Tech-Corp-TRTC-23761/; *see generally*, Borchardt, D., *Investors Can Now Buy Shares Of A Marijuana Dispensary*, FORBES (Jan 12, 2016, 9:30 AM), http://www.forbes.com/sites/debraborchardt/2016/01/12/terratech-becomes-the-first-publicly-traded-marijuana-dispensary/#1801aee5d955.

167. Interview with anonymous Colorado marijuana businessperson (indicating Phillip Morris expressed interest in his business) (2014).

conduct continues to be a violation of federal criminal law and may be prosecuted by federal authorities. The limits of state legalization and regulation of the sale of marijuana are evident in the private equity industry. Structuring and participating in deals that violate federal laws could give rise to harsh penalties and punishments. Convincing investors to invest into a business that may implicate the investors in a criminal activity or enterprise or, more likely, that could have its assets seized by the federal government is challenging. Logically, business owners turn to family and friends, because who better to share fortune or misfortunate than someone you know or love?

While overcoming the CSA altogether, that is making the transaction legal under federal law is challenging to say the least, an investors can take steps to mitigate risk exposure. On many levels, the definition of a successful exit is limited. Of course, not going to jail is a condition precedent for a successful exit. After avoiding criminal punishment, not having assets seized is also a threshold matter. Taxation on gross revenues and limited ability to bank are massive hurdles. After getting by these obvious risks, as many entrepreneurs appear to have done, the market is growing and dynamic; entrepreneurs who take risks may reap impressive returns.

Unlike any other industry, because of the inherent risks presented by the specter of the federal laws and regulations these businesses do not have access to traditional capital markets. Private placements are a potential option for marijuana companies that need to generate capital.

Particularly concerning to the private equity industry is the inability to conduct normal banking operations. Providing a solution to the banking issue is fundamental to effectively deploying private equity. Banks and the FDIC–insured local lenders typically will not work with marijuana businesses. Providing banking services to marijuana businesses could be construed as money laundering, conspiracy to violate the CSA, or racketeering. To be sure, these are atypical and significant risks for any investor. Although certain federal overtures provide assurances that individuals who adhere to the state statutes and regulations will not be prosecuted under federal laws, the assurances are not law.

With a change in federal priorities, the enforcement paradigm may change as well. The value of a business could vary significantly with a change in political parties in Washington D.C., a Supreme Court decision or a minor modification to Congress's appropriations acts.[168] Until the

168. Consolidated and Further Continuing Appropriations Act, 2015, Sec. 538; Consolidated Appropriations Act, 2016, Sec. 763 (while these legislative acts pertains to industrial hemp and medical marijuana it demonstrates how Congress may adjust enforcement priorities in the cannabis space from year to year).

federal government embraces the open and regulated market, investors should take steps to reduce inherent risks.

Against this backdrop, the money tree is blooming.[169] While some dreams have been and will continue to be fulfilled, those who understand capital considerations and risks will fare better. Until the federal government, de–schedules marijuana there will be no legal certainty in this space. Uncertainty gives rise to high risks. High risk gives rise to high returns. How much risk is an investor willing to carry? Under the "it's legal," but it's really not dichotomy–paradigm entrepreneurs and investors should do their due diligence and they should conduct it on a regular basis because the times are changing quickly.

169. *See, e.g.*, John Maxfield, *The Business of Legal Marijuana: People Are Getting Rich. Should You Get In?*, MOTLEY FOOL (Jan. 12, 2014), http://www.fool.com /investing/general/2014/01/12/the-economics-of-marijuana.aspx (discussing that costs per pound are $800 and retail sale price are $3,000 per pound).

APPENDIX I: A BRIEF HISTORY OF MARIJUANA

The history of marijuana and the respective laws are complex, well–cited accounts often conflict. A basic understanding is necessary to understanding conflicting interests driving issues effecting marijuana businesses today.

In ancient China, people used it as a general analgesic and for migraines and nervous system disorders.[170] The Babylonians used it for textiles. The Egyptians and Greeks used it for recreation, textile and medicine. Sorting through the fact and fiction is difficult but marijuana was an important crop with many uses, industrial and medical, for thousands of years.

Fast–forwarding a few thousand years, King James required early American colonists to plant a minimum of 100 hemp plants for rope manufacturing.[171] In 1839, William O'Shaughnessy introduced marijuana to Western medicine.[172] Eventually, marijuana was readily available in the 1850s.[173] From 1854–1941 U.S. Pharmacopeia listed marijuana as a medical drug and, accordingly, it was available in U.S. pharmacies. Through the 1920s, physicians prescribed marijuana for many medical issues (analgesic, cramping, and nervous systems disorders among others).[174]

Beginning in the early 1920s, certain states began to categorize marijuana as a poison.[175] The early regulation of the growing of "hemp" culminated in the enactment of the Marijuana Tax Act of 1937, which imposed an excise tax on all sales of marijuana including marijuana and industrial hemp.[176] The American Medical Association opposed the Marijuana Tax because it taxed physicians and pharmacists.

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170. *See generally*, *History of Medical Uses of Cannibas*, THOMAS C. SLATER COMPASSION CENTER, (last visited Sept. 8, 2016), http://slatercenter.com/about-the-history/; Michael R. Aldrich, *The Remarkable W. B. O' Shaughnessy* (2006), http://antiquecannabisbook.com/chap1/Shaughnessy.htm.

171. *See* Eric Schlosser, *Reefer Madness*, THE ATLANTIC (Aug. 1 1994, 12:00 PM), http://www.theatlantic.com/magazine/archive/1994/08/reefer-madness/303476/.

172. *See* W.B. O'Shaughnessy, *On the Preparation of the Indian Hemp, or Gunjah*, (Oct. 1839), http://www.lycaeum.org/~sputnik/Ludlow/Texts/gunjah.html.

173. *See* ROBERT DEITCH, HEMP, AMERICAN HISTORY REVISITED: THE PLANT WITH A DIVIDED HISTORY 16 (2003).

174. *See generally* RICHARD J. BONNIE & CHARLES H. WHITEBREAD, THE MARIHUANA CONVICTION; A HISTORY OF MARIHUANA PROHIBITION IN THE UNITED STATES (1974).

175. California Poison Act, 1880 Cal. Stat. 102 ("extracts, tinctures, or other narcotic preparations of hemp, or loco–weed, their preparations or compounds").

176. *See generally*, Richard Bonnie & Charles Whitebread, *The Forbidden Fruit and The Tree Of Knowledge: An Inquiry Into The Legal History Of American Marijuana Prohibition*, 56 VA. L. REV. 971, 1062 (1970).

By the 1930s, marijuana was a controlled drug in every state.[177] While theories connected to the origins of the anti–cannabis/marijuana movement abound, ranging from Hearst's racial prejudices to DuPont's monopolistic chemical–market driven incentives, there is ample evidence that marijuana was used for centuries to treat medical issues and its industrial utility is unquestioned.

177. *See generally* Uniform State Narcotic Act (1932); Marijuana Tax Act, 553 STAT. 551 (1937); Food, Drug, and Cosmetic Act of 1938, 21 U.S.C.A. § 301 (2015); Boggs Act, 65 STAT. 767 (1951); Narcotics Control Act, 70 STAT. 567 (1956); Controlled Substance Act, 21 U.S.C.A. § 801 (1970).

APPENDIX II: EXAMPLES OF PUBLICLY TRADED CANNABIS COMPANIES IN 2015

Ancillary Cultivation & Retail			
	Aerogrow International	OTCQB:AERO)	http:// www.aerogrow.com/
	American Green, Inc.	OTCPink:ERBB)	http:// americangreen.com/
	AVT, Inc.	OTCPink:AVTC	http:// www.autoretail.com
	GreenGro Technologies	OTCPink:GRNH	http:// greengrotech.com/
	Growlife Inc.	OTCQB:PHOT	http:// growlifeinc.com/
	IMD Companies	OTCPink:ICBU	http:// imdcompanies.com/
	Neutra Corp	OTCQB:NTRR	http:// www.neutracorp.com/
	Quasar Aerospace Industries	OTCPink:QASP	http:// www.quasaraero.com/
	The MaryJane Group, Inc.	OTCQB:MJMJ	http:// themaryjanegrp.com/
	Two Rivers Water & Farming Company	OTCQB:TURV	http:// www.2riverswater.com/
	Verde Science, Inc.	OTCQB:VRCI	http:// verdescienceinc.com/
	Nhale, Inc.	OTCQB:NHLE	http:// www.nhaleinc.com/
Biotechnology			
	Abattis Bioceuticals Corp.	OTCQX:ATTBF	http:// www.abattis.com/s/home.asp
	Cannabics Pharmaceuticals, Inc.	OTCQB:CNBX	http:// www.cannabics.com/
	Cannabis Science, Inc.	OTCQB:CBIS	http:// www.cannabisscienc

			e.com/
	Creative Edge Nutrition	OTCPink:FITX	http:// cenergynutrition.com/
	Easton Pharmaceuticals	OTCPink:EAPH	http:// www.eastonpharma.com/
	Growblox Sciences	OTCQB:GBLX	http:// gbsciences.com/
	GW Pharmaceuticals	NasdaqGM:GWPH	http:// www.gwpharm.com/
	Medican Enterprises	OTCQB:MDCN	http:// www.medicaninc.com/
	Medical Marijuana, Inc.	OTCPink: MMI	http:// medicalmarijuanainc.com/
	Nuvilex, Inc.	OTCQB:NVLX	http:// www.nuvilex.com/
Consulting Services			
	Advanced Cannabis Solutions	OTCQB:CANN	http:// advcannabis.com/
	American Cannabis Company	OTCQB:BIMI	http:// www.americancannabisconsulting.com/
	CannLabs, Inc.	OTCQB:CANL	http:// www.cannlabs.com/
	Chuma Holdings, Inc.	OTCQB:CHUM	http://chuma.us/
	Medbox, Inc.	OTCQB:MDBX	http:// www.thedispensingsolution.com/
	Novus Acquisition & Dev.	OTCPink:NDEV	http:// www.ndev.biz/
	United Cannabis Corp.*	OTCQB:CNAB	http:// www.unitedcannabis.us/

Consumption Devices			
	mCig, Inc.	OTCQB:MCIG	http://www.mcig.org/
	ML Capital Group, Inc.	OTCQB:MLCG	http://www.mlcapitalgroupinc.com/index.php?q=home
	RapidFire Marketing	OTCPink:RFMK	http://rapid-fire-marketing.com/
	Vape Holdings, Inc.	OTCQB:VAPE	http://vapeholdings.com/
	Vapor Group, Inc.	OTCQB:VPOR	vaporgroup.com
	Vaporin, Inc.	OTCQB:VAPOD	http://www.vaporin.com/
	VaporBrand International	OTCPink:VAPR	http://vaporbrands.com/
Cultivation & Retail			
	Affinor Growers, Inc.	OTCQB:RSSFF	http://www.affinorgrowers.com/en
	Alternative Fuels Americas*	OTCQB:AFAI	http://www.afai-mjai.com/
	Cannabis Kinetics	OTCQB:CANK	http://www.cannabiskinetics.com/
	Enertopia Corp.	OTCQB:ENRT	http://www.enertopia.com/
	Force Fuels Inc.	OTCPink:FOFU	
	Med-Cannabis Pharma, Inc.	OTCQB:MCPI	http://www.med-cannabispharma.com/
	Next Gen Management Corp.*	OTCQB:NGMC	http://www.nextgenmanagementcorp.com/
	Primco Management	OTCPink:PMCM	http://www.primcousa.com/

	Terra Tech Corp.	OTCQB:TRTC	http:// terratechcorp.com/
Cannabis–based Products & Extracts			
	Alternaturals	OTCPink:ANAS	http:// alternaturals.com/
	Cannabis Sativa, Inc.*	OTCQB:CBDS	http:// www.cannabissativainc.com/
	CannaVEST Corp.*	OTCQB:CANV	http:// cannavest.com/
	Global Hemp Group	OTCQB:GBHPF	http:// globalhempgroup.com/
	Green Cures & Botanical	OTCPink:GRCU	http://gcbdinc.com/
	Latteno Food Corp.	OTCPink:LATF	http:// www.latteno.com/
	MediJane Holdings, Inc.	OTCQB:MJMD	http://medijane.co/
Hemp			
	Hemp Inc.	OTCPink: Hemp	http:// www.hempinc.com/
Investment and M&A			
	FastFunds Financial Corp	OTCPink:FFFC	http:// www.fastfundsfinancial.com/
	Full Circle Capital	NasdaqGM:FULL	http:// www.fccapital.com/index.aspx
	FutureWorld Corp	OTCPink:FWDG	http:// www.futureworldcorp.com/
	Hemp, Inc.	OTCPink:HEMP	http:// www.hempinc.com/
	Medical Marijuana, Inc.	OTCPink:MJNA	http:// medicalmarijuanainc.com/
	Mentor Capital	OTCPink:MNTR	http:// mentorcapital.com/
	Surna Inc.	OTCQB:SRNA	http://surna.com/
	TumbleWeed	OTCQB:DC	http://

	Holdings	DC	www.tumbleweedhldgs.com/
Physical Security			
	Blue Line Protection	OTCQB:BLPG	http://www.bluelineprotectiongroup.com/
	DirectView Holdings, Inc.	OTCPink:DIRV	http://directview.com/
Real Estate			
	Agritek Holdings, Inc.	OTCQB:AGTK	http://agritekholdings.com/
	CannabisRX	OTCQB:CANA	http://www.cannabis-rx.co/
	The CannaBusiness Group*	OTCQB:CBGI	http://www.cashinbis.com/
	Mountain High Acquisition	OTCQB:MYHI	http://www.mountainhighac.com/
Software			
	AnythingIT	OTCQB:ANYI	http://www.anythingit.com/
	BreedIT Corp.	OTCQB:BRDT	http://ibreedit.com/
	ENDEXX Corp.	OTCPink:EDXC	http://www.endexx.com/
	Medical Cannabis Payment Solutions	OTCPink:REFG	http://medicalcannabispaymentsolutions.com/
	Singlepoint, Inc.	OTCPink:SING	http://www.singlepointinc.com/
Dispensary			
	Terra Tech Corp.*	TRTC	www.terratechcorp.com
Notes * indicates a business that appears to directly handle marijuana			

APPENDIX III: BUSINESS STRUCTURES

There are three primary business structures (not including a sole proprietorship) and several variations.

Partnership: There are three types of partnerships:

1. General Partnership: In a general partnership, the percentage of ownership may vary but each partner is responsible for reporting and paying his or her percentage share of tax on the income or losses of the partnership and has an unlimited share in the debt and obligations of the partnership. The partnership must still file a tax return but it does not pay the tax liability. Due to the risks involved, individuals generally should not willing to invest in a marijuana business as a general partner.
2. Limited Partnership: In a limited partnership, the investors are generally limited partners and the manager/operator of the business is the general partner. For tax purposes, the income and losses flow through to the partners according to their interest. Limited partners' rights are generally set out in the Limited Partnership agreement and must comply with state law and federal tax rules. Limited partners are not liable for the debts and obligations of the limited partnership and do not participate in making managerial decisions for the business. The general partner is liable and makes all managerial decisions.
3. Limited Liability Partnership: Limited Liability Partnerships insulate the other partners from debts and obligations incurred by another partner. In many states, these are limited to professional organizations such as doctors, lawyers and architects and like the sole proprietorship are not a viable investment vehicle.

Corporations: Corporations are incorporated under state law by filing incorporation documents with the Secretary of State. The primary advantage of the corporate structure is to limit liability of both investors and manager/owners. Personal assets are protected from lawsuits and other business issues that can arise. For tax purposes, the corporation may be either a C corporation or an S corporation. It is generally easier to sell or merge a corporation than another type of entity because it is a simple matter of changing shareholders rather than establishing a new entity.

1. C Corporation: Unless a corporation makes an S election, it will be taxed as a separate entity from its investors (shareholders). This runs a risk of double taxation and does not provide the shareholders with any tax losses.
2. S Corporation: The S corporation is not a separate legal business

form. To become an S corporation and receive a tax pass through of income and losses, the corporation must make an S election. There are a number of requirements to be eligible for an S election including the number and type of shareholders. Because of these restrictions, it is generally not a good vehicle for investment except for some small and medium sized closely owned and domestic businesses. Like any other form of pass–thru entity, (LLC, Limited Partnership, and LLP) more income may be allocated to the investor/shareholder on which taxes are owed individually, without cash going to the investor/shareholder.

Limited Liability Companies: The LLC has attributes of both the corporate and partnership structures. Except for provisions required under state law, the LLC is primarily governed by the Operating Agreement agreed upon with the members.[178] As such, it is a contract amongst the members. Flexibility in terms of operation is generally much simpler than in a corporation. There are no limitations on the number or type of investors as in a corporation electing S treatment. For tax purposes, the LLC may elect to be treated as a corporation with a tax at the corporate and member level or as a pass–thru entity like a partnership.

178. Limited Liability Company Act, COLO. REV. STAT § 7–80–108 (2016); WASH. REV. CODE ANN. § 25.15.018 (2016).

COMMENT

THE PRICE OF FREE MOBILE APPS UNDER THE VIDEO PRIVACY PROTECTION ACT

SUZANNE L. RIOPEL*

After the Washington City Paper published Judge Bork's rental history of 146 videos during the Supreme Court nomination hearings in 1988, Congress enacted the Video Privacy Protection Act ("VPPA"). The statute mostly adapted to changing video platforms, but the extent of its protections for smartphone users is questionable. This Comment will argue that the VPPA does not adequately safeguard consumers when app developers or providers allow users to download mobile apps for free. This Comment will discuss the statutory definitions of videotape service provider, consumer, and personally identifiable information ("PII"). It will explain how and why mobile apps collect personal data and what countermeasures the Federal Trade Commission ("FTC") has taken to regulate mobile businesses. The Comment will analyze the legislative history of the VPPA, the issues with the definitions of consumer and PII, and the societal response to privacy intrusions. This Comment will recommend that the FTC issue business guidance, promote consumer awareness, and bring enforcement actions against businesses that fail to protect consumers. This Comment will conclude that while the VPPA serves as the minimum standard to prevent unauthorized disclosures by mobile app providers and developers, new judicial standards and reliance on the FTC are better measures of regulating mobile commerce in this context.

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* J.D. Candidate 2017, American University, Washington College of Law.

INTRODUCTION

The advent of the smartphone and its mobile applications ("apps") brought technology closer to the most private areas of one's life: users can manage their financial affairs, medical conditions, and dating prospects all in one place. Beyond convenience and efficiency, the smartphone created a new form of entertainment by allowing its users to watch videos clips, television episodes, and movies in the palms of their hands. Since 68% of Americans own smartphones, and 94.5% of all mobile apps downloaded are predicted to be free, consumer privacy concerns attached to these free apps are highly relevant.[1]

In *Riley v. California*,[2] Chief Justice John Roberts emphasized the privacy of a smartphone by describing it as "a digital record of nearly every aspect of [a person's] life from the mundane to the intimate."[3] Subsequently, the U.S. Supreme Court significantly increased the protection of mobile phones by requiring police to obtain a warrant before viewing information stored on an arrestee's cellphone.[4] The extent of permissible government intrusion into personal information is always a hotly contested issue, but businesses in the mobile community deserve more scrutiny because their actions are equally as intrusive and more evasive towards consumers' personal information.

One legislative protection is the Video Privacy Protection Act ("VPPA"), which prohibits a videotape service provider from knowingly disclosing personally identifiable information ("PII") of its consumers to

1. Monica Anderson, *Technology Device Ownership: 2015*, PEW (Oct. 29, 2015), http://www.pewinternet.org/2015/10/29/technology-device-ownership-2015; Connie Guglielmo, *Mobile Apps Won't Lead to Riches for Most Developers*, FORBES (Jan. 13, 2014, 6:32 PM), http://www.forbes.com/sites/connieguglielmo/2014/01/13/mobile-apps-may-not-pave-the-way-to-developer-riches-sales-average-less-than-1250-a-day/#36b332b735d1 (Gartner, Inc. predicts that 94.5% of all mobile apps downloaded will be free apps).

2. 134 S. Ct. 2473 (2014).

3. *Id.* at 2490.

4. *Id.* at 2494–95.

third parties without consent.[5] Some courts view the VPPA as an antiquated law from the "videotape–era" whereas other courts broadly interpret the VPPA as including video platforms, such as online streaming websites and mobile apps.[6] As video technology becomes more advanced, the definitions of videotape service provider, consumer, and PII become more uncertain. In a society where privacy is rapidly eroding, the VPPA stands as one of the last remaining defenses in guarding our private viewing habits.[7]

This Comment argues that the VPPA does not adequately safeguard information linking a consumer's identity to his or her private viewing history when app developers allow users to download mobile apps for free. This Comment discusses the statutory definitions of videotape provider, consumer, and PII. Next, it explains how a mobile app collects data, such as a consumer's personal information and why businesses are encouraged to share that personal information with third parties regardless of whether the consumer consents. This Comment then analyzes the legislative history of the VPPA, the issues with defining consumer and PII, and the societal response to privacy intrusions.

This Comment recommends that the Federal Trade Commission ("FTC") publish business guidance, promote consumer awareness, and continue enforcement actions against businesses who fail to protect consumers. Since another amendment to the VPPA may be unnecessary and easily outdated by new technology, courts should maintain a broad interpretation of videotape service provider, follow the recent trend of rulings on the definition of consumer, and adopt a flexible standard in defining PII. Finally, this comment concludes that while the VPPA serves as the minimum standard to prevent unauthorized disclosures by app developers and providers, new judicial standards and regulatory guidelines are better ways to regulate mobile commerce.

II. HISTORY OF THE VPPA: 1988 ENACTMENT TO 2013 AMENDMENT

Prior to his controversial Supreme Court nomination, Judge Robert Bork stated, "[a]mericans only have the privacy rights afforded to them by direct

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5. 18 U.S.C. § 2710 (2013).

6. *Compare* M.C.L.A. § 445.1712 (2016), *with* CONN. GEN. STAT. § 53–450 (1988) (effective Jul. 1, 2016) (comparing state–enacted versions of the VPPA that differ on whether the VPPA is expressly limited to videotapes).

7. *The Video Privacy Protection Act: Hearing Before the Subcomm. on Privacy, Technology and the Law of the Comm. on the Judiciary*, 112th Cong. 85–88 (Jan. 31, 2012) (Letter from Director Laura W. Murphy, ACLU to Chairman Al Franken and Ranking Member Tom Coburn) ("As it is currently drafted, the VPPA is in many ways a model statute. While it only covers a narrow class of records, it does so in an exemplary fashion.").

legislation."[8] Ironically, he would have to swallow his own words after a journalist simply asked a video store for Bork's rental history and published it in the *Washington City Paper*.[9] The article raised questions about privacy rights associated with an indivdual's private viewing habits, such as whether a person should be allowed to portray a man's character by the types of videos he privately watches.[10] In response, Congress enacted the Video Privacy Protection Act of 1988 to prevent videotape providers from disclosing a customer's viewing history to a third party without consent.[11] At the time, the statute generally applied to in–person transactions between VHS rental stores like *Blockbuster* and customer information primarily listed on hand–written records.

The purpose of the Act is to prevent videotape service providers from knowingly disclosing their consumers' PII to third parties without consent subject to certain exceptions.[12] Subsequently, videotape service providers could only disclose PII to the consumer, a person who has informed and written consent from the consumer, a person incident to the ordinary course of business, a law enforcement agency pursuant to a warrant, or a person directed by court order. In addition, videotape service providers could also disclose a consumer's name and address if the consumer had an opportunity to refuse the disclosure.[13] Furthermore, court orders in a civil proceeding must show a "compelling need" for the information and consumers must have reasonable notice of the court proceeding with the opportunity to contest the civil claim.[14] An aggrieved consumer may bring a civil action for actual damages up to $2,500 against businesses for unauthorized disclosures within two years from the violation or the date of discovery.[15]

Since 1988, the terms "videotape service provider," "consumer," and "personally identifiable information" within the VPPA have become increasingly vague due to evolving technology. After litigation ensued over the release of customer viewing histories by online streaming providers to social media websites, specifically *Netflix* to *Facebook*,[16]

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8. MICHAEL DOLAN, *The Bork Tapes Saga*, *in* THE AMERICAN PORCH: AN INFORMAL HISTORY OF AN INFORMAL PLACE (2002).

9. *Id.*

10. *Id.* ("While I stewed in a sudden outbreak of conscience — what if Robert Bork only rented homosexual porn?").

11. Video Privacy Protection Act, Pub. L. No. 100–618, 102 Stat. 3195 (1988).

12. S. REP. NO. 10–599, at 5 (1988).

13. 18 U.S.C. § 2710(b)(2) (2013).

14. *Id.* § 2710(b)(2)(F).

15. *Id.* § 2710(c).

16. No. 5:11–00379, 2012 WL 2598819 (N.D. Cal. July 5, 2012).

business–backed lobbying firms prompted Congress to amend the VPPA in early 2013.[17] This amendment allowed consumers to meet the statutory requirement of giving "informed and written consent" via electronic means that would be valid for a period up to two years or until withdrawn.[18] Allegedly this would simplify the process for businesses without lowering privacy expectations.[19] Although Congress intended the amendment to reflect the realities of the twenty–first century, Congress did not alter the definition of videotape service provider, consumer, or PII, which has left courts to determine the boundaries of those terms.[20]

A. Statutory Definitions

"Videotape service provider" is defined as "any person, engaged in the business, in or affecting interstate or foreign commerce, of rental, sale, or delivery of prerecorded video cassette tapes or similar audio visual materials."[21] Most courts have broadly construed the meaning of "videotape service provider" to include online streaming providers (Netflix, Hulu, and YouTube), DVD and video game kiosks (Redbox), and a variety of mobile apps (USA Today and Cartoon Network).[22]

The online–streaming company, Hulu, contested this broad interpretation by arguing that the VPPA only applies to businesses that rented or sold prerecorded physical video cassettes or other similar audio visual material, and therefore, modern video platforms are excluded from the VPPA.[23] The court, however, rejected this argument because "similar audio visual material" is defined as "text or images in printed or electronic form," and the digital content that Hulu provides falls within that definition.[24]

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17. *See* OFFICE OF THE CLERK, H.R., http://disclosures.house.gov/ld/ldsearch.aspx (search client name as "Netflix," amount reported as "1," and year as "2013").

18. 18 U.S.C. § 2710(b)(2)(B).

19. Video Privacy Protection Act, Pub. L. No. 112–258, 126 Stat. 2414 (2013).

20. 18 U.S.C. § 2710(a)(4); *see also* Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1253 (11th Cir. 2015) (citing 158 Cong. Rec. H6849–01 (Dec. 18, 2012)).

21. "Similar audiovisual materials" could include short video clips that are popular online and on mobile apps, but no case has decided the issue. A compilation of short video clips, such as Vine videos, could equally be indicative of an individual's private interests, which likely would not be protected based on *Ellis*.

22. *See, e.g.*, Yershov v. Gannett Satellite Info. Network, Inc., 820 F.3d 482 (1st Cir. 2016); Sterk v. Redbox Automated Retail, LLC, 770 F.3d 618 (7th Cir. 2014); *In re* Hulu Privacy Litig., 86 F. Supp. 3d 1090 (N.D. Cal. 2015).

23. Kathryn E. McCabe, *Just You and Me and Netflix Makes Three: Implications for Allowing "Frictionless Sharing" of Personally Identifiable Information under the Video Privacy Protection Act*, 20 J. INTELL. PROP. L. 413, 431 (2013).

24. *See In re* Hulu Privacy Litig., No. C 11–03764 LB, 2012 WL 3282960, at *5–6 (explaining that the plain reading of statutory language on videotapes and similar audiovisual material and the Senate Report focuses on video content regardless of the media format or business model involved).

Furthermore, the Senate Report also states that the scope of the VPPA reaches beyond businesses that primarily offer video content.[25] For example, a department store that sells videotapes would be required to extend privacy protections to transactions involving videos.[26]

Although VPPA claims are generally made against videotape service providers, some courts have allowed lawsuits against a person or an entity that has received personal information from a videotape service provider.[27] For example, in *Amazon v. Lay*,[28] the court allowed a VPPA claim by Amazon against the Department of Revenue for coercing the company to list all names, addresses, and video sales of its North Carolina residents.[29] However, in *Daniel v. Cantrell*,[30] the Sixth Circuit dismissed a VPPA claim made by a criminal defendant against the district attorney's office that requested and received a list of pornographic videos watched by the defendant without a warrant or the defendant's consent.[31]

The VPPA defines "consumer" as "any renter, purchaser, or subscriber of goods or services from a videotape provider," but lately, the definition of the word "subscriber" has been disputed in the context of electronic and mobile commerce when content is available for free.[32] Since the VPPA does not define "subscriber," the court in *Austin–Spearman v. AMC*[33] used the plain meaning of the word and concluded that a person who visits a website to watch videos, without more, is not a subscriber.[34] The court held that a subscriber must have a "deliberate and durable affiliation with the provider, whether or not for payment," which is "generally undertaken in advance and by affirmative action [by the] subscriber" to "supply the provider with sufficient personal information to establish the [on–going]

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25. *See* S. REP. NO. 100–599, at 13 (1988) (providing example of a golf shop that rents or sells videos).

26. *Id.*

27. *See* Amazon v. Lay, 758 F. Supp. 2d 1154, 1167 (W.D. Wash. 2010) (holding that North Carolina's Department of Revenue violated the VPPA when it required Amazon to disclose personal information about its customers). *But see infra* footnote 28 and accompanying text.

28. 758 F. Supp. 2d 1154 (W.D. Wash. 2010).

29. *Id.* at 1171–72.

30. 375 F.3d 377 (6th Cir. 2004).

31. *See id.* at 381–84 (finding that the video store defendants were the only proper parties, even though they were complying with the district attorney's office's request).

32. 18 U.S.C. § 2710(a)(1) (2013); Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1255 (11th Cir. 2015) ("The VPPA does not define the term 'subscriber,' and we, as a circuit, have yet to address what that term means. The few districts courts that have weighed in on the issue appear to be divided.").

33. 98 F. Supp. 3d 662, 669 (S.D.N.Y. 2015).

34. *Id.* at 669.

relationship."[35] In *Ellis v. Cartoon Network*,[36] the Eleventh Circuit considered nearly identical factors of subscribership as the court in *Austin-Spearman* in holding that a person who downloads a free mobile app, without more, is not a subscriber.[37] *Ellis* analogized downloading a free app to marking a website as a favorite within your Internet browser because "a user is free to delete the app without consequences whenever he likes and never access the content again."[38] In *Yershov v. Gannett Satellite Info. Network, Inc.*,[39] the USA Today app user did not pay, register, make any commitment, receive emails, or receive access to restricted content.[40] However, since the app automatically sent the defendant's Android ID, GPS location, and the title of the watched video, the First Circuit reasoned that the user provided sufficient personal information to fall within the definition of subscriber, even though arguably he did not provide the information; the app simply took it from him.[41]

Furthermore, PII includes "information which identifies a person as having requested or obtained specific video materials or services from a videotape service provider."[42] A uniform definition of PII does not exist[43] and the VPPA does not define the boundaries of PII.[44] Some courts have construed PII as information that identifies a specific person and links that specific person to his or her viewing history.[45] Generally, courts do not dispute that a person is identifiable by name and address, social security

35. *Id.* at 668–69.

36. 803 F.3d 1251, 1255 (11th Cir. 2015).

37. *See Ellis*, 803 F.3d at 1257 (affirming the dismissal of a VPPA claim because the mobile app user did not register, pay, provide personal information, or access exclusive content).

38. *Id.*

39. 104 F. Supp. 3d 135 (D. Mass. 2015), *rev'd on other grounds*, 820 F.3d 482 (1st Cir. 2016).

40. *Id.* at 137–138.

41. *Id.* at 489.

42. 18 U.S.C. § 2710(a)(3) (2013).

43. *See* Paul Schwartz & Daniel Solove, *The PII Problem: Privacy and a New Concept of Personally Identifiable Information*, 86 N.Y.U. L. REV. 1814, 1828–32 (2011) (comparing VPPA, Gramm–Leach–Bliley Act, and Children's Online Privacy Protection Act).

44. 18 U.S.C. § 2710.

45. *See* Robinson v. Disney Online, No. 14–CVn4146, 2015 WL 6161284, at *3 (S.D.N.Y. Oct. 20, 2015) (referring to the Eleventh Circuit and U.S. District Courts in Georgia, New Jersey, and Washington). *But see* Yershov v. Gannett Satellite Info. Network, Inc., 104 F. Supp. 3d 135, 145 (D. Mass. 2015) ("[T]he conclusion that PII is information which must, without more, itself link an actual person to actual video materials is flawed.") (internal quotations omitted), *rev'd on other grounds*, 820 F.3d 482 (1st Cir. 2016).

number, and date of birth.[46] Most litigation is about whether a specific person is identifiable from an Internet–specific or a device–specific identity, and whether a sufficient nexus exists between that identity and a video that the user watched.[47] Thus far, courts have held that usernames, IP addresses, and streaming media device players' identification number, without more, does not identify individual persons to their viewing history.[48] Some courts have held that PII is information that by its nature identifies an individual or video and not a numeric or alphanumeric code.[49] Although many numeric and alphanumeric codes can be traced to an individual (e.g. a social security number), courts are looking for a more tangible, immediate link.[50]

For example, Hulu wrote its own code for its watch pages to allow a browser to properly display videos on the video player.[51] Each watch page includes a Facebook "Like" button, and when a Hulu user visits a watch page, the code sends a request to Facebook to load the button.[52] If a user logged into Facebook within the past month, his Facebook ID and the title of the video he was watching would be sent directly to Facebook in the form of a "c_user" cookie and URL.[53] Although the combination of this information is PII, the district court held that no VPPA violation occurred because Hulu sent the user's identity and video material separately (albeit simultaneously) to a social media website.[54] Since Facebook did not receive the two pieces of information in the same transmission, which would have implied a connection between the user's identity and video material, the court held Hulu could not be liable under the VPPA unless it knew that Facebook was reverse engineering PII.[55]

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46. *See* 18 U.S.C. § 2710(b)(2)(D) (consumer's name and address, if the videotape service provider did not provide notice and an opportunity for the consumer to refuse disclosure); *Yershov*, 820 F.3d at 486 (social security number); *see generally In re* Pharmatrak, Inc., 329 F.3d 9, 18 (1st Cir. 2003) (date of birth).

47. *See, e.g.*, Robinson v. Disney Online, 152 F. Supp. 3d 176, 179–80 (S.D.N.Y. 2015); *In re* Hulu Privacy Litig., 86 F. Supp. 3d 1090, 1095–97 (N.D. Cal. 2015).

48. *See Robinson*, 152 F. Supp. 3d at 184 (online streaming media device's serial number); *In re* Nickelodeon Consumer Privacy Litig., No. 15–1441, 2016 WL 3513782, at *20 (3d Cir. Jun. 27, 2016) (an IP address).

49. *See Robinson*, 152 F. Supp. 3d at 184 (holding that an anonymized device serial number, unlike a name or address, does not itself identify a particular person).

50. *See Nickelodeon*, 2016 WL 3513782, at *15–20.

51. *Hulu*, 86 F. Supp. 3d at 1092.

52. *Id.* at 1093.

53. *Id.* at 1093–94.

54. *Id.* at 1096.

55. *Id.* at 1097.

B. Explaining the Technology: How Do Mobile Apps Reveal Personal Information to Third Parties?

Some background on the mechanics of smartphones, mobile apps, and the Internet is necessary to understand the gravity of the potential privacy harms posed by such technology. Smartphones are sold with some pre–installed mobile apps, and the rest are available in app stores owned by mobile operating systems, such as: Apple iOS, Google Android, and Windows Phone OS.[56] When a user pays for a mobile app, the purchase cost is divided between the app provider and the app developer.[57] Since developers may want to provide apps as inexpensively as possible to increase the volume of purchasers, they often choose a "freemium" business model.[58] In a "freemium" business model, when a user downloads a mobile app for free, app developers earn money from upgrade costs, in–app purchases, sponsorship, and advertisements.[59] Advertisers often offer to pay and supply app developers with a software code that properly displays the ad, but the code also collects data from the user's phone and transmits it back to the advertiser.[60]

A common misconception among consumers is that they remain anonymous by not registering or expressly disclosing personal information within a mobile app. Each mobile phone is assigned a unique mobile identification number ("MIN"), which its owner cannot change or opt out of being tracked.[61] A smartphone can identify its real time geographic location by cell–site data (identifying radio cell towers nearest to the device), GPS (receiving radio signals from satellite systems in geosynchronous orbit), and wireless geolocation (comparing access points used to connect to the internet against a database of known routers).[62] The only way to disable all geolocation technologies is by turning off the

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56. *See* FTC, UNDERSTANDING MOBILE APPS, http://www.consumer.ftc.gov/articles/0018-understanding-mobile-apps#privacy (last visited Feb. 4, 2016).

57. *See generally* Tristan Louis, *How Much Do Average Apps Make?*, FORBES (Aug. 10, 2013, 5:30 PM), http://www.forbes.com/sites/tristanlouis/2013/08/10/how-much-do-average-apps-make (referring to Apple and Google paying $5 billion and $900 million, respectively, to app developers in 2012).

58. *See* FTC, *supra* note 56.

59. *Id.*

60. *See generally* Wei Meng ET AL., *The Price of Free: Privacy Leakage in Personalized Mobile In–App Ads*, GA. INST. TECH., 1, 3 (2016) (explaining that advertisers partner with app developers to provide in–app advertising, which collect user information like demographics and geolocation, in exchange for payment).

61. Nancy King, *Direct Marketing, Mobile Phones, and Consumer Privacy: Ensuring Adequate Disclosure and Consent Mechanisms for Emerging Mobile Advertising Practices*, 60 FED. COMM. L. J. 229, 243 (2008).

62. *In re* Smartphone Data Application, 977 F. Supp. 2d 129, 137 (E.D.N.Y. 2013).

smartphone.[63] Yet, Pew Research Center reported that 83% of adult smartphone users rarely, if ever, turn off their phones.[64] In 2010, nearly all of the top fifty iPhone and Android apps including apps that contained video content transmitted a person's MIN and location to third parties.[65] By 2013, the FTC found that nearly 60% of apps collected geolocation, contacts, call logs, unique identifiers, and other personal information stored on a mobile phone, and those apps later transmitted that information to third parties.[66] The market for the mass collection of personal data, known as the "big data industry," thrives on selling consumer data to businesses who want to efficiently target their sale efforts to realize a better return on their marking investment.[67] In the words of former Path CEO David Morin, uploading phone contacts from users' phones to company servers is referred to as "an industry's best practice."[68]

C. Federal Trade Commission Efforts to Regulate Mobile Businesses

The Federal Trade Commission ("FTC") is the primary federal administrative agency that regulates business practices involving the use, disclosure, or access to personal data on mobile phones.[69] While the VPPA provides a remedial measure, the FTC has the authority to investigate and

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63. *Id.* at 138.

64. Lee Rainie & Kathryn Zickuhr, *Americans' Views on Mobile Etiquette: Always on Connectivity*, PEW (Aug. 25, 2015), http://www.pewinternet.org/2015/08/26/chapter-1-always-on-connectivity ("Most smartphone owners say they rarely (47%) or never (36%) turn their phones off").

65. *See What They Know — Mobile*, WALL ST. J. (Dec. 18, 2010, 12:01 AM), http://blogs.wsj.com/wtk-mobile (reporting the results of a study by technology consultant David Campbell).

66. *FTC Report Faults Mobile App Makers on Privacy*, FRANKFURT KURNIT KLEIN & SELZ, PC (Jan. 7, 2013), http://fkks.com/news/ftc-report-faults-mobile-app-makers-on-privacy.

67. *See generally* ADAM TANNER, WHAT STAYS IN VEGAS: THE WORLD OF PERSONAL DATA — LIFEBLOOD OF BIG BUSINESS — AND THE END OF PRIVACY AS WE KNOW IT (2014).

68. Nick Bilton, *Disruptions: So Many Apologies, So Much Data Mining*, N.Y. TIMES (Feb. 12, 2012, 11:00 AM), http://bits.blogs.nytimes.com/2012/02/12/disruptions-so-many-apologies-so-much-data-mining.

69. *See* King, *supra* note 61, at 247. Note the D.C. Circuit June 2016 decision may allow for the Federal Communications Commission ("FCC") to regulate consumer privacy concerns. *See* U.S. Telecom Ass'n v. FCC, No. 15–1063, 2016 WL 3251234 at *699, *716 (D.C.C. 2016) (reclassifying internet service providers (ISPs) as offering telecommunications services and classifying mobile broadband service as a "commercial mobile service" subjected to common carrier regulations); 15 U.S.C. § 45(a)(2) (2006) (prohibiting the FTC from regulating common carriers). However, U.S. Telecomm has filed a petition for an *en banc* hearing of the case and may appeal to the the United States Supreme Court to reverse the D.C. Circuit's ruling, which will allow the FTC to have continued jurisdiction over mobile app consumer privacy concerns.

prosecute businesses for unfair or deceptive business practices.[70] Unfair or deceptive business practices are "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[71]

In the past few years, the FTC has pursued app providers and developers for violating consumer protections: Apple and Google each paid out $32.5 million and $22.5 million in settlements.[72] The FTC also seeks to prevent consumer protection violations through business guidance, consumer awareness, and policy recommendations.[73] For businesses, the FTC reports establish a privacy framework by recommending that companies have a privacy policy, collect information only necessary for the operation of the mobile app, and/or seek affirmative consent before collecting and sharing information.[74] For consumers, the FTC provides general strategies for protecting personal data by hosting public workshops aimed at raising privacy awareness by discussing mobile device tracking and big data.[75]

III. PAYING PRIVACY FOR FREE APPS

Privacy is governed by federal and state laws, enforced by federal agencies, and self-regulated by the industry. This Section will analyze the legislative history of the VPPA, issues the statutory definitions of consumer and PII, and the societal response to privacy intrusions.

A. Legislative History of the VPPA

The legislative history of the VPPA demonstrates strong concerns about preserving the confidentiality of an individual's private viewing history regardless of the business model or media format involved. The VPPA followed a string of federal statutes intended to protect privacy interests: Fair Credit Reporting Act of 1970, Privacy Act of 1974, Electronic Funds Transfer of 1980, Cable Communications Policy Act of 1984, and

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70. 15 U.S.C. § 45(a) (2006).

71. *Id.* § 45(n).

72. *See* FTC Enforcement, https://www.ftc.gov/enforcement/cases-proceedings (search "Apple Inc.," click the only available case, and view "Decision and Order" then search "Google Inc.," choose the federal case, and view the district court order).

73. *See Privacy & Data Security Update*, FTC, https://www.ftc.gov/reports/privacy-data-security-update-2015 (last visited Feb. 4, 2016).

74. Christopher G. Cwalina ET AL., *Mobile App Privacy: The Hidden Risks*, HOLLAND & KNIGHT (2013) (referring to FTC, *Protecting Consumer Privacy in an Area of Rapid Change* (2012) and FTC, *Marketing Your Mobile App: Get it Right From the Start* (2013)).

75. *See* Matthew Hettrich, *Data Privacy Regulation in the Age of Smartphones*, 31 TOURO L. REV. 981, 985–86 (2015).

Electronic Communication Privacy Act of 1986.[76] These statutes embodied a central principle that information obtained for one purpose should not be used for an unintended purpose without consent.[77] The American Civil Liberties Union ("ACLU"), the Video Software Dealers Association ("VSDA"),[78] and the Direct Marketing Association ("DMA") briefed Congress on the importance of the privacy legislation in the advent of computers, "which we are forced to turn over an enormous quantity and variety of personal information in exchange for doing business."[79] Rather than focus on a specific video format or medium, the opening statement of S. 2361 expressed that the First and Fourth Amendments protect the "freedom to obtain information from whatever source and whatever medium" from unauthorized and unconsented intrusions.[80] When private and public actors reveal or share a consumer's identifiable information with content–based transactions, they affect a consumer's freedom of choice by increasing the risk that his interests will negatively reflect on his identity or character.[81] If a consumer perceives that the benefit of a transaction is outweighed by the risk that the transaction will become publicly known, then the resulting effect may be that "individuals are chilled in their pursuit of ideas and their willingness to experiment with ideas outside of the mainstream."[82]

B. Issues with Defining Consumer and PII

Another amendment to the VPPA is not a permanent solution because applying the statutory definitions of subscriber and PII are inherently problematic in the context of technology. If Congress amended the VPPA or courts broadened "subscriber" to include unregistered mobile app users, then the word "consumer" may have little difference from the word "any

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76. *See Video and Library Privacy Protection Act of 1988: HEARING ON H.R. 4947 and S. 2361 Before the H. Comm. on the Judiciary*, 100th Cong. 20–21 (1988) [hereinafter *VPPA of 1988*] ("Beginning in 1970 with the passage of the [FCRA] and ending with last Congress with the [ECPA], the Congress has shown its concern with the expanding computerization of our society and the protection of each and every individual's 'right to be let alone.'").

77. *See generally* S. REP. NO. 10–599, at 2–3 (1988) (describing the purposes behind the privacy statutes enacted from 1970–1988).

78. In 2006, VSDA merged with Interactive Entertainment Merchants Association to form the Entertainment Merchants Association. *See* EMA History, http://www.entmerch.org/about-ema/ema-history.html (last visited Aug. 23, 2016).

79. *VPPA of 1988*, *supra* note 76, at 54.

80. *Id.* at 22.

81. *Id.* at 41 ("Even today, there are people in every community who believe that a person's interest in a subject must reflect not merely his intellectual interests, but his character and attitudes.")

82. S. REP. NO. 10–599, at 7 (1988) (statement by American Civil Liberties Union).

person" within the statute,[83] and legislative bodies may be hesitant to amend its definition.[84] To trigger VPPA protection, a mobile app user must fall within the definition of "consumer" as "any renter, purchaser, or subscriber of goods or services from a videotape provider."[85] Under this definition, a user, who uses a free mobile app to view video content, is neither a renter nor a purchaser; he is only protected if he falls within the meaning of a subscriber.[86]

A subscription–based mobile app is a business model that offers more than the basic version, which is usually free and ad–supported, and sells a premium version that allows full access to content at a monthly or annual fee.[87] Under this business model, free mobile app users would either have to upgrade to a premium version or register to be a subscriber under the VPPA.[88] *Austin–Spearman*, *Ellis*, and *Yershov* considered payment, registration, access to restricted content, commitment, expressed association, and delivery as factors of subscription.[89] However, the last four factors are misleading because they require payment or registration. A user is almost always required to pay before accessing restricted content.[90] A user's commitment or expressed association to a mobile app or the company that owns the app is evidenced by a financial commitment or

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83. Austin–Spearman v. AMC Network Entm't LLC, 98 F. Supp. 3d 662, 670 (S.D.N.Y. 2015).

84. *See generally* Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1256–57 (11th Cir. 2015) ("Congress could have employed broader terms in defining 'consumer' when it enacted the VPPA (e.g., 'user' or 'viewer') or when it later amended the Act (e.g., 'a visitor of a web site or mobile app'), but it did not.").

85. 18 U.S.C. § 2710(a)(1) (2013).

86. *See supra* notes 30–36 and accompanying text.

87. *See* Mark Hoelzel, *Subscriptions are Enjoying a New Prominence as a Revenue Engine for Digital Content and Apps*, BUS. INSIDER (Jul. 7, 2015, 2:35 PM), http://www.businessinsider.com/subscriptions-for-app-and-website-revenue-2015-3 ("Many digital media companies have embraced monthly and annual subscriptions. The business model allows digital media companies to provide a premium experience that offers more than the basic, often ad–supported service level."); *see also* Yershov v. Gannett Satellite Info. Network, Inc., 104 F. Supp. 3d 135, 148 (D. Mass. 2015) (discussing paid, free, and subscription apps), *rev'd on other grounds*, 820 F.3d 482 (1st Cir. 2016).

88. *See Austin–Spearman*, 98 F. Supp. 3d at 669 ("'Subscription' entails an exchange between subscriber and provider whereby the subscriber imparts money and/or personal information . . . .").

89. *See Yershov*, 104 F. Supp. 3d at 147; *Ellis*, 803 F.3d at 1256; *Austin–Spearman*, 98 F. Supp. 3d at 669.

90. After reading a limited number of free articles, NY Times and WSJ require that the user pay a subscription before accessing more articles. *See Subscribe Now*, N.Y. TIMES (last visited Sept. 14, 2016), http://www.nytimes.com; *Subscribe Now*, WALL ST. J (last visited Sept. 14, 2016), https://buy.wsj.com/wsjpstlabor16/?inttrackingCode=aaqnz4za&icid=WSJ_ON_PHP_ACQ_NA.

registration.[91] Delivery under the subscription–based business model is "an individual making periodic payments . . . for delivery of magazines, newspapers, or other content," or a person who adds his personal information to a company's mailing list to receive or contribute to its contents.[92]

The basic version of free mobile apps do not always prompt users for registration, and without registration, the circuits are split about whether a relationship can exist between the user and the mobile app or the company that owns it.[93] Even if a free mobile app requires signing up or logging in, users often have the option to login using their Facebook or Google accounts.[94] In the context of the VPPA, courts have not yet considered whether signing in with a Facebook or Google account is considered the equivalent of registration. Whether courts adopt such a viewpoint will depend upon the user having a "deliberate and durable affiliation" with the mobile app. If signing in with a Facebook or Google account allows the mobile app to access enough personal information to identify a specific person (i.e. name, date of birth, location, e–mail address, and contacts), then the user is likely a subscriber.[95] An added complexity is when a user chooses not to login but has recently logged into Facebook, and the software code transmits his Facebook ID and the title of the watched video without his knowledge.[96] In this situation, a user may be interpreted as having no "deliberate and durable affiliation" with the mobile app because the user, himself, did not log in.[97] When a mobile app allows unregistered

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91. *See Ellis*, 803 F.3d at 1257 ("[P]laintiff did not make any [financial] commitment or establish any relationship that would allow him to have access to exclusive or restricted content.").

92. *See Yershov*, 104 F. Supp. 3d at 147.

93. *Compare id.* (explaining that once downloaded, the free USA Today app did not prompt the user to sign up or log in, but the First Circuit held that the user was a subscriber because he established a relationship or commitment to the USA Today when the app took his Android ID, GPS location, and the title of the watched video) *with Ellis*, 803 F.3d 1251 (stating that the free Cartoon Network app did not require the user to sign up or log in, and even though the app transmitted the user's Android ID and the title of the watched video, the Eleventh Circuit held that the user was not a subscriber because he had no ongoing relationship with Cartoon Network).

94. *See Austin–Spearman*, 98 F. Supp. 3d at 664 ("[S]ites can include a 'Facebook Login,' which lets visitors log into a website using their Facebook credentials.").

95. *See id.* at 669 ("[A] subscriber's deliberate and durable affiliation with the provider . . . require[s] some sort of ongoing relationship between provider and subscriber, one generally undertaken in advance and by affirmative action on the part of the subscriber, so as to supply the provider with sufficient personal information to establish the relationship and exchange.").

96. *Id.* at 664.

97. *See id.* at 670 (rejecting the defendant's proposition that when a website can access information about a user, who previously logged into Facebook albeit not

users to view free content and does not provide notice to a user that by not registering he waives VPPA protection, these websites and mobile apps can share PII to third parties without violating the VPPA.[98]

Courts apply the same analysis of "subscriber" for consumers who access content between their computer, tablet, phone, and other devices, which is problematic.[99] Many companies use cross–device tracking that involves two techniques: (1) "deterministic" linking based on information a user provides to a device, such as an email account, and (2) "probabilistic" linking based on inferences from information that the user has no control over, such as shared IP addresses between two devices that are consistently used together in the same location.[100] For example in *Ellis*, a user watched a video, and the app sent the user's Android ID and the title of the video, without consent, to a third party analytics company, who had the ability to track the user across devices.[101]

The current definition of PII is identical to its previous version, which is unhelpful in resolving disputes over Internet–specific and device–specific identities.[102] As a standard, the definition remains open and flexible to new technological developments.[103] For example, VCR and VHS tapes became affordable in the 1980s, but DVDs became the dominant medium by the late 1990s.[104] Now, online streaming is gaining traction against DVDs and cable television with Netflix alone reporting 43.2 million subscribers.[105] Since video platforms tend to phase out with new technology, the legislature could amend the definitions in the VPPA, but such amendments

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through the website itself, he or she is a subscriber). *But see Yershov*, 104 F. Supp. 3d at 147.

98. *See id.* at 671 (dismissing VPPA claim).

99. *See* Eichenberger v. ESPN, Inc., No. C14–463 TSZ, 2015 WL 7252985, at *1, *2 (W.D. Wash. May 7, 2015).

100. *See* FTC Cross–Device Tracking Workshop (Nov. 16, 2015), https://www.ftc.gov/news-events/events-calendar/2015/11/cross-device-tracking (click "video," "Part 1," and "transcript").

101. *See* Ellis v. Cartoon Network, Inc., 803 F.3d 1251, 1254 (11th Cir. 2015) ("Bango[, an analytics company,] uses Android IDs 'to identify and track specific users across multiple electronic devices, applications, and services.'").

102. *Compare* 18 U.S.C. § 2710 (2013), *with* Video Privacy Protection Act, Pub. L. No. 100–618, 102 Stat. 3195.

103. Schwartz & Solove, *supra* note 43, at 1829.

104. *See* Johnnie L. Roberts, *The VCR Boom: Prices Drop as their Popularity Grows*, WALL ST. J. (Sept. 22, 1985).

105. *See* Christopher Palmeri, *U.S. DVD Sales Continue to Slide as Digital Viewing Soars*, BNA (Jan. 6, 2015, 11:46 AM), http://www.bloomberg.com/news/articles/2015-01-06/u-s-dvd-sales-continue-to-slide-as-digital-viewing-soars; Scott Moritz & Gerry Smith, *Pay–TV Losing 300,000 Users is Good News Amid Cord–Cutting*, BNA (Oct. 19, 2015, 11:39 AM), http://www.bloomberg.com/news/articles/2015-10-19/pay-tv-losing-300-000-customers-is-good-news-in-cord-cutting-era.

would serve for a limited amount of time.[106] If PII is defined too narrowly, it will fail to protect privacy interests because new technology will render the statute irrelevant and obsolete.[107] Conversely, a broad definition of PII could encompass too much information, which may blur the distinction between PII and non–PII.[108]

The problem with an open–ended definition is that it fails to differentiate PII from non–PII. The definition simply states that PII "includes information which identifies a person as having requested or obtained specific video materials or services."[109] In the context of smartphones, a mobile identification number in isolation does not reveal its user's viewing history unless pieced together with other information.[110] When a business sends a user's MIN to an analytics company, however, that company can automatically link the MIN to a specific person and across multiple devices.[111] *In re Hulu Privacy Litigation*[112] held that a business is liable if it disclosed both the user's MIN and a correlated reference table to the analytics company — but is not liable if the business only disclosed the MIN and the analytics company had a reference table of their own.[113]

One method of distinguishing between PII and non–PII is comparing the consumer's identity to traditional notions of personal information, such as comparing MIN as more private than a residential address but not akin to a name.[114] However, when courts are "on the fence" about categorizing a term as PII because they do not think it is readily apparent that the information can identify a specific person, courts will often classify the term as non–PII.[115] The Tenth Circuit reasoned that when a statute

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106. *See generally* Schwartz & Solove, *supra* note 43, at 1827.

107. *See id.*

108. *See id.*

109. 18 U.S.C. § 2710(a)(3) (2013).

110. *See* Yershov v. Gannett Satellite Info. Network, Inc., 104 F. Supp. 3d 135, 142 (D. Mass. 2015).

111. *See id.* at 146 (discussing that third parties may have access to databases that link Android IDs to specific persons); Ellis v. Cartoon Network, 803 F.3d 1251, 1254 (11th Cir. 2015) (referring to the district court's analysis).

112. 86 F. Supp. 3d 1090 (N.D. Cal. 2015).

113. *Id.* at 1097 (requiring proof that the recipient knew that the company used a code, the recipient is capable of decoding the contents, and the company and the recipient had some mutual understanding that there has been a disclosure).

114. *See Yershov*, 104 F. Supp. 3d at 141, 482 ("It requires no great leap of logic to conclude that the unique identifier of a person's smartphone or similar device — its "address," so to speak — is also PII. A person's smartphone 'address' is an identifying piece of information, just like a residential address.").

115. *See In re* Nickelodeon Consumer Privacy Litig., No. 15–1441, 2016 WL 3513782, at *21 (3d Cir. 2016) ("[I]n our view, personally identifiable information under the [VPPA] means the kind of information that would readily permit an ordinary person to identify a specific individual's video–watching behavior.").

involving PII does not provide an exhaustive definition of the term, the disclosure of a device's unique identification number and user's pay–per–view history is not PII.[116] Instead, the court found that, rather than identify an individual, the disclosure by itself provided "nothing but a series of numbers."[117] As a result, courts may defer to the legislature or make a conservative decision.

Another method of classifying PII is if a person or entity aggregates enough non–PII, what was originally non–PII can become personally identifying.[118] For example, in *Northwestern Memorial Hospital v. Ashcroft*,[119] the court quashed a subpoena for the patient records of women who had undergone partial abortions because it violated privacy rights.[120] Although the hospital redacted the patients' names, Judge Posner expressed concern that "skillful Googlers" would be able to discern a patient's identity by piecing together public information, redacted medical records, and sexual history.[121]

By construing a narrow reading of the word "consumer" with an open–ended definition of PII, the privacy loopholes that remain between the statutory definition and the case law leave free mobile app users open to exploitation. Free mobile app users may be unprotected under the VPPA unless the app requires registration or expressly discloses the types of information it collects and shares prior to use.

C. Societal Response to Privacy Intrusions

Privacy concerns attached to smartphones remain a significant public concern, and both the President and Congress have made efforts to address those concerns. In 2015, President Barack Obama recognized that "consumers feel like they no longer have control over their personal information" and announced a proposal for several new cyber security initiatives including the Consumer Privacy Bill of Rights.[122] In the past

116. *See* Eichenberger v. ESPN, Inc., No. C14–463, 2015 WL 7252985, at *3 (Wash. May 7, 2015) (citing Pruitt v. Comcast Cable Holdings, LLC, 100 F. App'x 713 (10th Cir. 2004)).

117. *Id.* at *3.

118. *See* Schwartz & Solove, *supra* note 43, at 1841–43.

119. 362 F.3d 923 (7th Cir. 2004).

120. *See generally id.*

121. *Id.* at 929 ("Some of these women will be afraid that when their redacted records are made a part of the trial record . . . skillful 'Googlers,' sifting the information contained in the medical records concerning each patient's medical and sex history, will put two and two together . . . [and] expose them to threats, humiliation, and obloquy.").

122. *See* Hettrich, *supra* note 75, at 1008.

few years, Congress has amended the Children's Online Privacy Protection Act ("COPPA")[123] and enacted the Health Information Technology for Economic and Clinical Health ("HITECH") to protect information transmitted over mobile apps.[124]

In a study by UC–Berkeley, 78% of respondents reported that mobile phone data was as private as, or more private than, computer data.[125] Since Edward Snowden revealed NSA's mass surveillance programs in 2013, 25% percent of Americans have reported changing their behavior on technological platforms including mobile phones,[126] but more than 50% of Americans consider it difficult to find tools and strategies to remain private on the Internet or mobile phones.[127] When businesses advocate that consumers should self–regulate their privacy, it results in the average consumer failing to take advantage of technological measures to protect their information.[128] Most companies provide constructive notice at best, and consumers are usually required to "take it or leave it."[129]

Although the Millennial Generation may have broader expectations about what is public information, adults between eighteen and twenty–four are more likely than any other age group to report that data stored on mobile phones is more private than on personal computers.[130] The majority of young adults disapprove of the government collecting data for national security,[131] and 60% of mobile app users have chosen not to install apps that require the user to divulge more personal information than necessary to operate the app.[132]

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123. *See* COPPA, 16 C.F.R. § 312 (2013) (amending the Rule to apply to commercial websites and online services including mobile apps directed to children under thirteen that collect, use, or disclose personal information from children).

124. *See* HITECH, 42 U.S.C. § 17938 (2009) (increasing penalties for HIPAA violations).

125. Jennifer M. Urban ET AL., *Mobile Phones and Privacy*, BERKELEY CENTER OF L. & TECH. 12 (2012).

126. Mary Madden & Lee Raine, *Americans' Privacy Strategies Post–Snowden,* PEW (Mar. 16, 2015) http://www.pewinternet.org/2015/03/16/americans-privacy-strategies-post-snowden.

127. Madden & Raine, *supra* note 126.

128. *See* Clark D. Asay, *Consumer Information Privacy and the Problems of Third–Party Disclosures*, 11 NW. J. TECH. & INTELL. PROP. 321, 334 (2013).

129. *See* Asay, *supra* note 128.

130. *See* Urban, *supra* note 125, at 23.

131. *See* Drew Desilver, *Young Americans and Privacy: It's Complicated*, PEW (Jun. 30, 2013), http://www.pewresearch.org/fact-tank/2013/06/20/young-americans-and-privacy-its-complicated.

132. Monica Anderson, *8 Conversations Shaping Technology*, PEW (Mar. 10, 2016), http://www.pewresearch.org/fact-tank/2016/03/10/8-conversations-shaping-technology.

Consumer awareness and education through unconventional means is a promising solution. For example, the political satirist John Oliver on *Last Week Tonight* has gained recognition for speaking in layman's terms and using humor when educating Americans about complex topics.[133] When the Federal Communications Commission ("FCC") sought public comment on net neutrality rules, John Oliver encouraged his one million viewers to comment on the FCC website.[134] After the episode's release, the FCC received 45,000 comments and 30,000 emails, whereas previous proposals received roughly 2,000 comments.[135] The FCC stated, "[w]e've been experiencing technical difficulties with our comment system due to heavy traffic. We're working to resolve these issues quickly."[136] The FCC ultimately voted in favor of net neutrality.

If privacy violations result in minimal or isolated privacy harms, consumers may consider them offset by the benefit of the free flow of information, which include the advantages of free content, expedited services, and relevant advertising.[137] For example, Josh Mohrer, an Uber executive, used the service's "God mode" to track the movements of journalist Johana Bhuiyan without her permission and emailed her a copy of all of her Uber rides; however, the isolated event did not affect the demand for Uber.[138] In the VPPA context, when content contains sensitive information, the greater the demand is for ensuring that persons or entities privy to or entrusted with that information, such as videotape service providers, do not share that information.[139] For example, if a person watched a documentary on a male–to–female transition, as opposed to a popular film, he may have a higher interest in protecting his viewing

133. *See* Paeste v. Guam, 798 F.3d 1228, 1231 (9th Cir. 2015) (citing to John Oliver's episode on U.S. territories in its opinion); Terrance F. Ross, *How John Oliver Beats Apathy*, ATLANTIC (Aug. 14, 2014), http://www.theatlantic.com/entertainment/archive/2014/08/how-john-oliver-is-procuring-latent-activism/376036.

134. *Last Week Tonight with John Oliver: Net Neutrality*, YOUTUBE (June 1, 2014), https://www.youtube.com/watch?v=fpbOEoRrHyU.

135. Elise Hu, *John Oliver Helps Rally 45,000 Net Neutrality Comments to FCC*, NPR (June 3, 2014, 11:56 AM), http://www.npr.org/sections/alltechconsidered/2014/06/03/318458496/john-oliver-helps-rally-45-000-net-neutrality-comments-to-fcc.

136. Ben Brody, *How John Oliver Transformed the Net Neutrality Debate Once and For All*, BNA POLITICS (Feb. 26, 2015, 10:00 AM), http://www.bloomberg.com/politics/articles/2015-02-26/how-john-oliver-transformed-the-net-neutrality-debate-once-and-for-all.

137. *See generally* Fred H. Cate, *Principles of Internet Privacy*, 32 CONN. L. REV. 877 (2000).

138. *See* Katherine Gnadinger, *The Apps Act: Regulation of Mobile Application Privacy*, 17 SMU SCI. & TECH. L. REV. 415, 426 (2014).

139. *See* Jay Stanley, *A Supply and Demand Curve for Privacy*, ACLU (Dec. 15, 2014, 11:15 AM), https://www.aclu.org/blog/freefuture/ supply-demand-curve-privacy.

history from potentially conservative employers.[140] If the price of free apps is allowing a business to collect and share specific identifiers attributable to consumers' viewing history, privacy concerns may influence consumers, depending on the content, to shift to encrypted apps that do not collect information on its users.[141] When business practices become highly intrusive and publicly known or widespread, consumers begin to consider the legitimacy of that business, rather than just price, in choosing between competitors.

IV. FTC, CONSUMER AWARENESS, AND PII FACTORS TEST

The FTC should promulgate a rule stating that a mobile app cannot access a phone's content unless the app requires registration or an express privacy disclosure prior to use and requests consent to access its content.[142] For app developers who choose to use a privacy disclosure, the FTC should work with the mobile app community to standardize the plain language of these disclosures to explain what information is collected, when the information is collected, and why it is collected.[143] Another possibility is for the FTC to consider initiatives that relay information to consumers in an understandable way, such as through television shows that address social and legal issues.[144]

Regulations should require companies that collect PII to present the consumer with notice of the intended third party recipients of such PII and the third parties' proposed uses. While policymakers cannot force a consumer to pay attention to a privacy notice, they can make it more likely for the consumer to do so by requiring notices to be accessible and in a format that attracts more interests from the consumer.[145]

Since amendments to the VPPA are unnecessary or easily outdated by new technology, courts should maintain a broad construction of "videotape service provider," follow the trend of recent rulings on who is a "consumer," and adopt a flexible standard to determine PII.[146] In addition,

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140. John Vandiver, *Report Finds Army Discriminated Against Transgender Civilian Employee*, STARS & STRIPES (Oct. 21, 2014), http://www.stripes.com/news/report-finds-army-discriminated-against-transgender-civilian-employee-1.310017.

141. Stanley, *supra* note 139. For example, Telegram is an encrypted messaging app that allows users to send, among other things, videos, but these messages have a self-destruct timer.

142. H.R. 4048, 113th Cong. (2014).

143. *See* Asay, *supra* note at 128, at 34.

144. *See* Hettrich, *supra* note 75, at 985–86 (explaining how the FTC promotes public education but no mention of innovative methods).

145. *See generally* Kate Crawford & Jason Schultz, *Big Data and Due Process: Toward a Framework to Redress Privacy Harms*, 55 B.C. L. REV. 93 (2014).

146. *See* Schwartz & Solove, *supra* note 43, at 1841.

courts should consider using a factors test to determine whether, given the context, information is PII.

If the plaintiff and the defendant meet the definitions of a "videotape service provider" and a "consumer," respectively, courts should review three factors: (1) the nexus between the alleged personal identifiable information to traditional notions of PII, (2) the consequences of disclosing the alleged personal identifiable information in a modern context, and (3) the proximity between the transfers of information related the consumer's identity and the video's title or description.

First, courts should consider the nexus between the alleged PII and traditional notions of PII. For example, if a complainant claimed that a video provider collected and disclosed a video title and the location of his or her home by accessing location–tracking enabled on her mobile phone, a court may consider the location akin to an address that is traditionally considered PII.[147] Since the location is not attached to other unique information similar to a name or credit card number, a court may also consider the location not private information given that a residential address is publically disclosed.

Second, courts should weigh the consequences of the type of information disclosed. If the information is readily understandable (e.g. a video title or explicit URL) or requires little effort by third parties to piece the information together, courts would be more inclined to consider it PII.[148] Another consideration is whether the type of information is one that society has an interest in keeping private, such as a young woman viewing videos about the physical and emotional effects of having an abortion.[149]

Third, the courts should consider whether the individual's information and the video title or description is transmitted separately or together, and if separately, the length of time between the transmissions. In *Hulu*, the court began this analysis by holding that simultaneously transmitting a user's URL and "c_user" cookie as separate pieces of information to a third party, such as Facebook, did not constitute PII.[150] However, the court did not discuss how much information Facebook could expect to receive at the same time it received information from Hulu.[151] If no other information was received from Hulu at the same time, then Hulu transmitting the two pieces of information separately is no different than transmitting the information together.

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147. *See* Yershov v. Gannett Satellite Info. Network, Inc., 104 F. Supp. 3d 135, 140 (D. Mass. 2015).

148. *See In re* Hulu Privacy Litig., 86 F. Supp. 3d 1090, 1092 (N.D. Cal. 2015).

149. *See generally* Schwartz & Solove, *supra* note 43.

150. *See Hulu Privacy Litig.*, 86 F. Supp. 3d at 1097.

151. *See generally id.* at 1090.

CONCLUSION

The VPPA serves as an important but minimum standard when preventing app providers and developers from collecting and sharing a user's personal information. Although a videotape service provider is prohibited from knowingly disclosing a consumer's PII without consent, recent court decisions favor traditional notions of PII. The VPPA as amended in 2013 does not add any protection for consumers using the Internet or other mobile devices.

NOTES

THE E–2 TREATY INVESTOR VISA DILEMMA: VIOLATIONS OF LAW AND LIMITATIONS ON FOREIGN INVESTMENT

TIANA J. CHERRY*

Although the Immigration and Nationality Act established the E–2 treaty investor visa ("E–2 visa") to attract foreign investors to the United States, the visa requirements limit many individuals from being eligible to invest in the United States' economy. To be eligible for the E–2 visa, the potential investor must show that he or she is a citizen of a country that the United States has negotiated a treaty of Friendship, Commerce, and Navigation ("FCN"), a Bilateral Investment Treaty ("BIT"), or the equivalent. This requirement is in direct conflict with the Most Favoured Nation ("MFN") nondiscrimination obligation, which the United States agreed to under the General Agreement on Trade in Services ("GATS"). This Note considers the treaty requirement of the E–2 visa and evaluates how it conflicts with the MFN resulting in limits on potential foreign investment. It then analyzes the proposed E–2 Visa Improvement Act's ability to remedy the conflict. Ultimately, the E–2 Visa Improvement Act provides no solution and the E–2 visa, as currently written, is discriminatory. This Note concludes that the E–2 visa requirements drive potential investors to other countries and the United States must comply with the MFN

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* Associate Managing Editor, *American University Business Law Review*, Volume 6; J.D. Candidate, 2017, American University Washington College of Law; B.A., *magna cum laude*, Political Science, International Studies, and Spanish, Wittenberg University. I would like to express my sincere gratitude to the American University Business Law Review staff for devoting their time and effort in helping me prepare this Note for publication. I would also like to thank Professor Jayesh Rathod for providing me invaluable insight into the legal analysis of this topic. Further thanks are due to Dr. Michael Mattison and Professor Heather Ridenour for constantly encouraging me to strengthen my writing. Finally, I would like to give a heartfelt thank you to my parents, especially my mother, my siblings, friends, and family who have provided me with their never–ending love and support.

obligation by broadening the E–2 visa to increase foreign investment.

INTRODUCTION

"Entrepreneurship is as a much a part of the American experience as baseball, jazz, and Disneyland."[1] Immigrants have a long history of contributing to the American experience by starting successful businesses in the United States.[2] Immigrants founded many of America's most iconic companies, such as: AT&T, Capital One, Colgate–Palmolive, Goldman Sachs, Kohl's, Kraft, Pfizer, and Procter & Gamble.[3] In fact, immigrants

1. Larry W. Cox, *Five of Your Neighbors Who Are Starting Companies*, *in* THE ENTREPRENEUR NEXT DOOR: CHARACTERISTICS OF INDIVIDUALS STARTING COMPANIES IN AMERICA 28 (2002).

2. *See* Jason Wiens ET AL., *Immigrant Entrepreneurs: A Path to U.S. Economic Growth*, EWING MARION KAUFFMAN FOUND. (Jan. 22, 2015), http://www.kauffman.org/what–we–do/resources/entrepreneurship–policy–digest/immigrant–entrepreneurs–a–path–to–us–economic–growth (stating that immigrants have consistently been more entrepreneurial than native–born Americans for more than a century).

3. *See* PARTNERSHIP FOR A NEW AMERICAN ECONOMY, THE "NEW AMERICAN" FORTUNE 500 1 (2011) (identifying the aforementioned companies among the most influential fortune–500 companies founded by immigrant entrepreneurs).

or children of immigrants founded more than forty percent of Fortune 500 companies in 2010.[4] Despite the obvious economic benefits that many immigrants bring to the United States, the treaty requirement of the E–2 treaty investor visa ("E–2 visa")[5] has a discriminatory impact that prevents many potential investors from contributing to the United States' economy.[6]

This Note considers the treaty requirement of the E–2 visa and how it impacts foreign investment in the United States. It begins by discussing the origin and purpose of the E–2 visa and introduces the discriminatory treaty requirement for E–2 visa eligibility.[7] Next, it provides a thorough analysis of the treaty requirement to reveal how it is in direct conflict with the Most Favoured Nation ("MFN") obligation of the General Agreement on Trade in Services ("GATS").[8] It then discusses ways that exemptions to the MFN obligation cause discrimination within the treaty requirement and evaluates whether the E–2 Visa Improvement Act provides a solution to the problematic impact of the treaty requirement. It also considers the impact that the E–2 Visa Improvement Act, if adopted, could have on the MFN obligation. It recommends that the E–2 Visa Improvement Act be rejected, that the United States remedy the discriminatory component of the treaty requirement by complying with its MFN obligation, and that all members of the World Trade Organization be eligible for E–2 visas.[9] Finally, it concludes that the treaty requirement of the E–2 visa, as currently written, is discriminatory, it violates the United States' MFN obligation, and the aforementioned changes should be made to increase foreign investment.[10]

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4. *See* Dane Stangler & Jason Wiens, *The Economic Case for Welcoming Immigrant Entrepreneurs*, EWING MARION KAUFFMANF FOUND. (Sept. 8, 2015), http://www.kauffman.org/what–we–do/resources/entrepreneurship–policy–digest/the–economic–case–for–welcoming–immigrant–entrepreneurs (reporting on Partnership for a New American Economy's finding that forty percent of Fortune 500 companies in 2010 were founded by an immigrant or the child of an immigrant).

5. *See generally* Immigration and Nationality Act ("INA"), 8 U.S.C. § 1101 (a)(15)(E)(ii) (2015) [hereinafter *E–2 visa*].

6. *See* Stangler & Wiens, *supra* note 4 (asserting that U.S. law "provides no dedicated means for immigrant entrepreneurs to launch innovative companies in the United States").

7. *See infra* Part II.

8. *See infra* Part III.

9. *See infra* Part IV.

10. *See infra* Part V.

II. THE DISCRIMINATORY NATURE OF THE E–2 TREATY REQUIREMENT

A. Development of the E–2 Nonimmigrant Visa

The United States offers immigrant and nonimmigrant visas to foreign nationals interested in entering the United States.[11] The United States Code defines an "immigrant" as "every alien" except those listed within the various nonimmigrant categories.[12] Immigrant visas, which are also known as "green cards," allow foreign nationals to obtain Lawful Permanent Residency ("LPR") status and permanently live and work in the United States.[13] Conversely, nonimmigrant visas allow foreign nationals to enter the United States with temporary residency.[14] Section 1101 of the United States Code describes the classes of aliens who are specifically excluded from the definition of immigrant.[15] To qualify as a nonimmigrant, an individual must fit within one of the nonimmigrant statutory categories outlined in the Immigration and Nationality Act ("INA"), such as: tourists, business visitors, students, temporary workers, and temporary business investors.[16]

Nonimmigrant visas were incorporated into federal law through the Immigration and Nationality Act of 1924 ("1924 Act").[17] The 1924 Act created the numerical categories of nonimmigrant visas and codified the

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11. *See* Leslie K. L. Thiele & Scott T. Decker, *Residence in the United States Through Investment: Reality or Chimera?*, 3 ALB. GOV'T L. REV. 103, 106 (2010) (explaining that the two visa categories were developed for foreigners seeking to enter the United States independent from family or employment relationships).

12. *See* 8 U.S.C. § 1101(a)(15) (2015) (defining the term "immigrant" and identifying the visa categories that do not qualify as "immigrant" visas).

13. *See* Stephen M. Hader & Scott D. Syfert, *The Immigration Consequences of Mergers, Acquisitions, and Other Corporate Restructuring: A Practitioner's Guide*, 24 N.C.J. INT'L L. & COM. REG. 547, 555 (1999) (stating that the common name for LPR status is the "green card" and further explaining that "permanent" residency is permitted provided that the LPR holder does not engage in criminal activity or actions that could result in the removal of the LPR's permanent status and deportation from the United States).

14. *See* Palma R. Yanni, *Business Investors: E–2 Non Immigrants and EB–5 Immigrants*, 92–08 IMMIGR. BRIEFINGS 1 (1992) (explaining nonimmigrant visas as "temporary").

15. *See* Hader & Syfert, *supra* note 13, at 555 n.19–20 (explaining that the term nonimmigrant is not specifically defined in the statute, but instead, the term immigrant is described and visa categories that do not qualify as immigrant visas are provided).

16. 8 U.S.C. § 1101(a)(15)(a)–(v) (2015) (listing the nonimmigrant categories); *see also* Stephen H. Legomsky & Cristina Rodriguez, IMMIGRATION AND REFUGEE LAW AND POLICY 360–61 (6th ed. 2015) (listing various nonimmigrant visa categories).

17. *See* Stephen Pattison, *The Curious Case of the Treaty Trader/Investor Visa: How Diplomacy and Immigration Law Intersect to Promote the Trade and Investment in the United States*, 12–06 IMMIGR. BRIEFINGS 1 (2012) (explaining that nonimmigrant visas were first established through the 1924 Act).

treaty merchant category, which later became known as the E–1 visa.[18] When the United States began receiving a significant increase in international investment, the Immigration and Nationality Act of 1952 ("1952 Act") expanded the 1924 Act to create an "E" visa category, which includes both E–1 (treaty merchant) and E–2 (treaty investor) visas.[19]

The 1952 Act further established the treaty requirement for E–2 visas.[20] The 1952 Act, as amended in 1990,[21] states that E–2 visa holders may only enter the United States pursuant to a "treaty of commerce and navigation between the United States . . . to develop and direct the operations of an enterprise in which he has invested, or of an enterprise in which he is actively in the process of investing, a substantial amount of capital . . . ."[22] Today, the E–2 visa category remains in Title 8 of the United States Code, § 1101(a)(15)(E)(ii).[23]

B. The Purpose and Structure of the E–2 Visa

The purpose of the E visa category is to permit the temporary admission of nationals from countries that the United States has a treaty of Friendship, Commerce, and Navigation ("FCN"), a Bilateral Investment Treaty ("BIT"), or comparable treaty arrangement to increase foreign investment in the United States.[24] The North American Free Trade Agreement ("NAFTA") and the more recent Free Trade Agreements with Chile and

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18. *See id.* (explaining the foundation of the E visa category); *see also* Hedayat Tahbaz, *E Visas: An Analysis of the Legislative History and Proposed Governing Regulations*, 3 U. MIAMI Y.B. INT'L L. 151, 155 (1995) (noting that the E–1 visa was established prior to the E–2 visa).

19. *See* Catherine Sun, Note, *The E–2 Treaty Investor Visa: The Current Law and the Proposed Regulations*, 11 AM. U. J. INT'L L. & POL'Y 511, 514 (1996) (explaining the E visa category development and stating that the E–2 visa was specifically created due to an increase in foreign investment).

20. *See* Immigration and Nationality Act of 1952, Pub. L. No. 82–414, § 101, 66 Stat. 163 (1952) (codified at 8 U.S.C.A. § 1101(A)(15)(E) (1952)) (allowing both traders and investors to enter the U.S. on E visas); *see also* Pattison *supra* note 17 (establishing that only nationals from countries in which the U.S. had particular treaties with would eligible for E visas).

21. *See* Immigration and Nationality Act of 1990, Pub. L. No. 101–649, §101, 104 Stat. 4978 (1990) (explaining that the requirements include the national being from a country with a requisite treaty with the U.S. amongst additional requirements).

22. *Id.*

23. 8 U.S.C. § 1101(a)(15)(E)(ii).

24. *See* Elizabeth Espin Stern, *Intracompany Transferees (L–1) and Treaty Traders/Treaty Investors (E–1/E–2)*, A.L.I.–A.B.A. 105, 112 (2005) (explaining that "the basic purpose of the E visa category is to permit temporary admission of nationals of countries with which the United States has these treaty arrangements"); *see also* Sun, *supra* note 19, at 514 (explaining that the E–2 visa was specifically created with the purpose of increasing foreign investment in the United States).

Singapore allow nationals of these countries to apply for E treaty visas.[25] The Department of State and the United States Citizenship and Immigration Services ("USCIS") oversee E–2 visas to ensure that treaty countries are able to apply for the E treaty visas.

The Department of State maintains a list of treaty countries with the effective date of the treaty.[26] It also identifies whether certain treaties authorize nationals to receive the E–1 visa, the E–2 visa, or both.[27] Provisions for adjudicating E–2 visas are located in the Department of State's Foreign Affairs Manuel ("FAM").[28] Under the FAM, consular officers are instructed to adjudicate E visa cases "to facilitate international investment in accordance with the terms of a *ratified treaty*."[29] The consular officer ensures that a treaty exists between the United States and the country of the applicant's nationality.[30] The consular officer then acts as both the adjudicator and the court of last appeal by determining whether the evidence satisfies the provisions of the statute and regulations.[31] Afterward, this officer determines whether the visa application will be approved or denied.[32] Alternatively, the USCIS's role is to approve or deny E–2 visa holder's adjustment of status applications.[33]

Together, these organizations develop the requirements to obtain and maintain E–2 visas, thus empowering the E–2 visas' operability. Although E–2 visas are functional, E–2 visas discourage the growth of foreign investment in the United States.[34] Specifically, the treaty requirement for an E–2 visa limits who is eligible to apply for an E–2 visa and it conflicts with the United States' MFN obligation to the World Trade Organization under the GATS.[35]

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25. Stern, *supra* note 24, at 112.

26. *See generally Treaty Countries*, U.S. DEP'T OF STATE (last visited June 19, 2016), https://travel.state.gov/content/visas/en/fees/treaty.html (maintaining the list of treaty countries for both E–1 and E–2 visa holders).

27. *See id.* (identifying the countries that are eligible E–1 classification and E–2 classification and listing the countries twice when they are eligible for both).

28. *Id.*

29. *See* Pattison, *supra* note 17 (explaining the consular officer's role in determining treaty status).

30. *Id.*

31. *See id.* (stating that "the consular officer is both the adjudicator and the court of last appeal").

32. *Id.*

33. *See id.* at n.12 (explaining that the USCIS only deals with the adjudication aspect of E visas when an applicant is seeking to adjust their immigrant status).

34. *See infra* Part III.

35. *See id.*

C. The Discriminatory Treaty Requirement

Most comparable treaties exist as Free Trade Agreements ("FTAs") between the United States and other countries.[36] If a potential investor is from a country without a FCN, BIT, or a comparable treaty listed by the United States, they are not eligible to obtain an E–2 visa.[37] Although "comparable" treaties are not specifically defined,[38] the E–2 visa classification is extended to Canadian,[39] Mexican,[40] Singaporean,[41] Chilean,[42] and Jordanian[43] nationals under their respective FTAs. However, there is no widely accepted rule that all FTAs are considered comparable treaties.[44] Countries that have FTAs with the United States are not always able to determine whether their country has an agreement comparable to FCNs or BITs because FTAs were not enacted as treaties.[45] The lack of description on comparable treaties leaves many potential investors clueless as to whether they qualify as an eligible foreign investor for an E–2 visa.[46] While most Western European countries are parties to FCNs, BITs, or comparable treaties with the United States,[47] non–Western European countries, such as mainland China, Brazil, and India, do not have the requisite treaties with the United States that enable their citizens to qualify for E–2 visas.[48]

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36. *Id.*

37. *See generally Treaty Countries*, *supra* note 26 (listing all countries that have a requisite treaty with the United States, which provides those countries' citizens eligibility to apply for the E–2 visas).

38. *See* William T. Worster, *Conflicts Between United States Immigration Law and The General Agreement On Trade in Services: Most–Favored–Nation Obligation*, 42 TEX. INT'L L. J. 55, 97 (2006) (explaining that it is not entirely clear that FTAs are properly classified as FCNs or BITs).

39. North American Free Trade Agreement Implementation Act, Pub. L. No. 103–182, § 341, 107 Stat. 2057 (1992) (codified at 19 U.S.C. § 3401 (2006)).

40. *Id.*

41. U.S.–Sing. Free Trade Agreement Implementation Act, Pub. L. No. 108–78, § 401, 117 Stat. 948 (2003).

42. United States–Chile Free Trade Agreement Implementation Act, Pub. L. No. 108–77, § 401, 117 Stat. 909, 939–46 (2003).

43. United States–Jordan Free Trade Area Implementation Act, Pub. L. No. 107–43, § 301, 115 Stat. 243 (2001).

44. *See* Worster, *supra* note 38, at 97 (stating that "it is not entirely clear that FTAs are properly classified as FCNs or BITs since they were not enacted as treaties.").

45. *Id.*

46. *Id.*

47. *See* Hader & Syfert, *supra* note 13, at 567 (explaining that "most Western European countries are parties to such treaties").

48. *See generally* U.S. DEP'T OF STATE, *supra* note 26.

D. The MFN Obligation Not to Discriminate

In 1994, the United States agreed to the World Trade Organizations' ("WTO")[49] MFN obligation in the General Agreement on Trade in Services.[50] The MFN obligation states that all WTO members "shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country."[51] This provision prohibits WTO members from discriminating against other member nations.[52]

There are two standards for discrimination under the MFN: "de jure" discrimination and "de facto" discrimination.[53]

> De jure discrimination occurs when the nationality of the service provider is expressly noted as a criterion for qualifying admission, regardless of the scope of its applicability. De facto discrimination exists when a measure operates in such a way as to create a discriminatory effect against a particular nationality, compared to other nationalities . . . [and] regardless of intent.[54]

A footnote within the MFN obligation regarding the Annex on Movement of Persons states that "the sole fact of requiring a visa for natural persons of certain Members and not for those of others shall not be regarded as nullifying or impairing benefits under a specific commitment."[55] This footnote implies that exempting some countries and not others is a form of discrimination. By allowing some citizens of countries that are WTO members to obtain E–2 visas, but not others, the United States has committed a per se violation of the "no less favorable" MFN treaty provision.

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49. *See generally* General Agreement on Trade in Services Part II, Art. II (1), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183 (binding the United States to the Most Favoured Nation ("MFN") agreement).

50. *See id.* (stating that the MFN clause in Article II of the agreement applies "[w]ith respect to any measure covered by this Agreement").

51. *See id.* (stating that there is a requirement under the WTO that all member nations be treated equally).

52. *Id.*; *see also* WORLD TRADE ORGANIZATION, PRESS PACK, 4TH MINISTERIAL CONFERENCE, (Nov. 9–13, 2001) (explaining that WTO member nation's standards "should not discriminate between countries").

53. *See* Worster, *supra* note 38, at 74 (enumerating the standards of discrimination under the MFN).

54. *Id.* at 74–75.

55. *See* General Agreement on Trade in Services Part II, *supra* note 49, at 306 n.1 (explaining the WTO's interpretation of the MFN obligation).

III. THE E–2 TREATY REQUIREMENT VIOLATES THE MFN OBLIGATION NOT TO DISCRIMINATE AND LIMITS POTENTIAL FOREIGN INVESTMENT

A. Exemptions to the MFN Obligation Allow WTO Member Nations to Discriminate Against Other Countries

The twist to de jure and de facto discrimination under the MFN obligation is that all WTO member nations that negotiated the GATS had a single opportunity to schedule country–specific exemptions for certain measures that would otherwise violate the MFN obligation.[56] These exemptions allow WTO member nations to continue discriminatory measures past the effective date of the GATS.[57] If a member nation did not schedule the exemption on or before the GATS took effect, the nation was precluded from doing so without prior consent of other WTO member nations.[58]

In addition to scheduling the exemption, the WTO member nations were required to enter the date that the exemption would expire, which was not to exceed ten years.[59] The ten–year duration was not to be viewed as a minimum period of exemptions, but as a maximum period of transition during which members were required to actively seek ways to bring these inconsistent measures into conformity with the MFN.[60]

The United States requested that nonimmigrant aspects of bilateral treaties for trade and investment be exempted from the MFN obligation.[61] The exemption states:

> Government issuance of treaty trader or treaty investor non–immigrant visas that extend a special visa category to nationals of treaty partners in executive and other personnel category engaged . . . solely to develop

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56. *See* General Agreement on Trade in Services Part II, *supra* note 49, at 286 (stating that "a Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions"); *see generally* THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, USITC 78 (Dec. 13, 1997) (listing exemptions, the countries to which exemptions apply, intended duration, and the conditions that create the need for each exemption in categories such as the movement of persons, taxation measures, and transport services).

57. *Id.*

58. *See* Worster, *supra* note 38, at 82 (stating that "[a]s new nations join the WTO, they are likewise granted an initial opportunity to schedule and are barred from amending thereafter without consent").

59. *See* General Agreement on Trade in Services Annex on Art. II Exemptions, *supra* note 49, at 305 (stating that "[i]n principle, such exemptions should not exceed a period of 10 years.").

60. *See* Worster, *supra* note 38, at 83 n.211 (interpreting the ten–year expiration of the MFN exemption).

61. *Id.* at 85.

> and direct the operations of an enterprise in which a natural person has invested or is actively in the process of investing a substantial amount of capital.[62]

The exemption clarifies that this measure applies to "countries with whom the United States has a [FCN], a [BIT], or certain countries as described in Section 204 of the Immigration Act of 1990."[63] In other words, the United States specifically requested that E–2 visas be allowed to violate the MFN obligation by asking for this exemption.[64]

B. The Treaty Requirement Conflicts with the MFN Obligation

The E–2 visa requirement conflicts with the MFN obligation because the United States discriminates against citizens of countries without a FCN or BIT by prohibiting those citizens from receiving E–2 visas.[65] The language of the E–2 visa requirement states "an alien is entitled to enter the United States under and in pursuance of the provisions of a treaty of commerce and navigation between the United States and the foreign state of which he is a national."[66] However, the E–2 visa is in violation of the MFN obligation for three reasons.

First, the E–2 visa imposes a discriminatory effect on individuals from nations without requisite treaties.[67] Specifically, individuals from countries with the requisite treaty can enter the United States on an E–2 visa, while individuals who are from countries without the requisite treaty cannot enter.[68] The language of the E–2 visa reveals that the E–2 visa requirements are effectively an example of de facto discrimination, which is in violation of the United States' obligation under the MFN.[69] By

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62. *See* THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, USITC 78 (Dec. 13, 1997) (providing a chart that outlines the United States' final list of Article II MFN exemptions regarding the movement of persons).

63. *Id.*

64. *See* Worster, *supra* note 38, at 98 (2006) (stating that "the very fact that the United States has listed this category as needing an exemption from MFN implies that the United States believes that the discriminatory E category inherently violates MFN").

65. *Compare* Yanni *supra* note 14, at 1 (stating the treaty requirement of the E–2 visa) *with* Worster, *supra* note 38, at 74 (enumerating the standards of discrimination under the MFN).

66. Immigration and Nationality Act of 1952, 8 U.S.C. § 1101(a)(15)(E) (2014).

67. *See* Worster, *supra* note 38, at 96 (concluding that the nationality requirement is "potentially discriminatory" after stating that nations such as Brazil, India, and Cuba are ineligible for the E–2 visa).

68. *Id.*

69. *Id.* at 116.

allowing only foreign nationals from countries that have a FCN, BIT, or comparable treaty with the United States to apply for the E–2 visa, a de facto discriminatory effect arises because without these treaties, some WTO member nations are ineligible to invest in a U.S. business through the E–2 visa.[70]

Second, although the United States requested that the E–2 visa be exempted from its MFN obligation,[71] the E–2 visa can no longer be considered an exemption because the ten–year maximum transition period has already expired.[72] Although the exemption is listed as indefinite,[73] it was slated for elimination on January 1, 2005, the ten–year anniversary of the entry into force of the GATS.[74] In 2001, the Secretariat of the WTO also made it clear that exemptions to the MFN obligation were meant to be temporary, despite certain country–specific requests.[75] The WTO has since expressed goals to eliminate all exemptions to the MFN obligation in their entirety.[76]

Third, even if the exemption were in effect, FTAs are not covered under this exemption.[77] The treaty requirement limits E–2 visa eligibility to citizens of nations with a FCN, BIT, or comparable treaties with the United States.[78] However, the "comparable" portion of the treaty requirement

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70. *Treaty Countries*, *supra* note 26 (listing countries that have treaty investor provisions in effect with the United States).

71. THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, *supra* note 62, at 78 (listing the U.S. exemption from the MFN obligation).

72. *See* Worster, *supra* note 38, at 86 (stating that this exception was "slated for elimination on January 1, 2005, the ten–year anniversary of the entry into force of the GATS").

73. THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, *supra* note 62, at 78.

74. Worster, *supra* note 38, at 86; *see also* General Agreement on Trade in Services Annex on Art. II Exemptions, *supra* note 49, at 305 (stating that the "exemptions should not exceed a period of 10 years").

75. Special Session of the Council for Trade in Services, Report of the Meeting Held on 5, 8 and 12 Oct. 2001, Note by the Secretariat, ¶ 84, S/CSS/M/12 17 (Nov. 28, 2001) ("The Annex on Article II Exemptions allowed for a temporary deviation from the MFN principle, but recognized that these exemptions constituted an irregular situation and that all Members would have to eliminate them eventually.").

76. Worster, *supra* note 38, at 83 ("[T]he Council has already issued Procedures for the Certification of Terminations, Reductions and Rectifications of Article II (MFN) Exemptions," which eliminate exemptions to the discrimination requirement).

77. *See generally* THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, *supra* note 62, at 78 (omitting FTAs from the list of MFN exemptions).

78. Hader & Syfert, *supra* note 13, at 567 n.90 (stating that section 101(a)(15)(E) of the Immigration and Nationality Act "requires the existence of a Treaty of Friendship, Commerce, and Navigation (or a comparable treaty) between the United States and

used to provide E–2 visas to citizens from nations with which the United States has negotiated an FTA is not covered under the MFN exemption.[79] The MFN exemption only applies to "countries with whom the United States has a FCN, BITor certain countries as described in Section 204 of the Immigration Act of 1990."[80] Since section 204 of the Immigration Act of 1990 is only specific to treaty traders and not treaty investors, the countries listed in section 204 cannot be used to identify a "comparable" treaty.[81] Although the E–2 visas have been extended to Canadian,[82] Mexican,[83] Singaporean,[84] Chilean,[85] and Jordanian[86] nationals under their respective FTAs, there are no indications that these agreements are exempt because there is no widely accepted rule that all FTAs are considered "comparable" treaties.[87] Therefore, FTAs are not exempted from the MFN obligation because these countries are not considered FCNs or BITs, despite the fact that the United States has allowed citizens from countries with FTAs to obtain E–2 visas.

C. The Treaty Requirement Limits Potential Foreign Investment

The treaty requirement is in direct conflict with the United States' entrepreneurial history. A study has shown that immigrants or their children founded more than 40% of the 2010 Fortune 500 companies.[88] Furthermore, just shy of 20% of the newest Fortune 500 companies between the periods of 1985 and 2010 have an immigrant founder.[89] For

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another nation to receive E visa status").

79. THE U.S. SCHEDULE OF COMMITMENTS UNDER THE GENERAL AGREEMENT ON TRADE IN SERVICES, *supra* note 62, at 78.

80. *See id.* (citing the reference to "countries to which the measure applies").

81. *See* Immigration and Nationality Act of 1990, Pub. L. No. 101–649, 104 Stat. 4978, Sec. 204 (1990) (noting that the point heading for section 204 is for "treaty traders" and that section 204 only makes amendments to "section 101(a)(15)(E)(i)").

82. North American Free Trade Agreement Implementation Act, Pub. L. No. 103–182, § 341, 107 Stat. 2057 (1992) (codified at 19 U.S.C. §3401 (2006)).

83. *Id.*

84. U.S.–Sing. Free Trade Agreement Implementation Act, Pub. L. No. 108–78, § 402, 117 Stat. 948 (2003).

85. United States–Chile Free Trade Agreement Implementation Act, Pub. L. No. 108–77, § 402, 117 Stat. 909, 939–46 (2003).

86. U.S.–Jordan Free Trade Area Implementation Act, Pub. L. No. 107–43, § 301, 115 Stat. 243 (2001).

87. Worster, *supra* note 38, at 97 (explaining that it is not entirely clear that FTAs are properly classified as FCNs or BITs).

88. Steven A. Ballmer ET AL., *The "New American" Fortune 500*, NEW AM. ECON. 2 (2011), http://www.renewoureconomy.org/sites/all/themes/pnae/img/new–american–fortune–500–junE–2011.pdf (statistically showing that the United States has profited from foreign entrepreneurs).

89. *Id.* (showing that the newest Fortune 500 companies were founded by

example, in 2005, Indian immigrants founded 26% of startups in Silicon Valley.[90] Despite the United States' history of creating new businesses through foreign investment, entrepreneurs from countries without the requisite treaties have not been able to temporarily reside in the United States to start their businesses.[91]

The treaty requirement reveals that the options currently available to foreign–national entrepreneurs are outdated and inadequate in the United States immigration system.[92] Restrictive policies, like the treaty requirement, are problematic because they cause foreign entrepreneurs to invest their money in countries other than the United States.[93] Limiting who can invest in the United States through the treaty requirement essentially pushes foreign investors to countries like Australia, Canada, Chile, China, and Singapore because these countries do not have such requirements and offer incentives such as stipends, labor subsidies for employees, expedited visa processes for bringing in startups, which the United States does not offer through the E–2 visa.[94] The result is that companies that might have launched in the United States are now taking root elsewhere.[95]

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immigrants or their children).

90. Vivek Wadhwa, *Foreign Born Entrepreneurs: An Underestimated American Resource*, EWING MARION KAUFFMAN FOUND. 177, 178 (Nov. 24, 2008), http://www.kauffman.org/what–we–do/articles/2008/11/foreignborn–entrepreneurs–an–underestimated–american–resource.

91. *See* Pam Prather, *The E–2 Visa: U.S. Misses Out on Foreign Entrepreneurs*, BASHYAM & SPIRO LLP (Jan. 16, 2012), http://www.bashyamspiro.com/immigration–meditation/2012/01/16/the–E–2–visa–u–s–misses–out–on–foreign–entrepreneurs/(expressing that the lack of options creates a serious need for immigration reform in the United States).

92. Stuart D.P. Gilgannon, *The Land of Opportunity: Why More Must Be Done to Encourage Immigrant Entrepreneurship In the United States*, 15 DUQ. BUS. L. J. 1, 26 (2015) ("[O]pportunities for immigrant entrepreneurs do exist within our present system, [but] such measures are outdated and fail to adequately recognize the value that allowing highly–skilled and educated foreign nationals to create small startup enterprises can have on our national economy.").

93. *See generally* VIVEK WADHWA, THE IMMIGRANT EXODUS: WHY AMERICA IS LOSING THE GLOBAL RACE TO CAPTURE ENTREPRENEURIAL TALENT 16–18 (2012) ("Restrictive US immigration policies and the rise of other countries' economies are driving talent elsewhere.").

94. *See* Gilgannon, *supra* note 92, at 16 (stating that these countries recognize the opportunities that come with attracting entrepreneurs).

95. *See id.* (explaining how aggressive recruitment policies detract entrepreneurs from investing in the United States).

D. The Impact of Proposed Changes to the E–2 Visa through the E–2 Visa Improvement Act

Representative David Jolly (R–Florida) proposed the E–2 Visa Improvement Act.[96] On April 16, 2015, proposed bill H.R. 1834 was assigned to a congressional committee for consideration before sending it on to the House or Senate as a whole.[97] The bill seeks to amend the INA to permit a nonimmigrant E–2 visa holder who has been in the United States for at least ten years and who has created full–time employment for at least two individuals the opportunity to apply for permanent residency.[98] Additionally, the bill seeks to limit the amount of issuable E–2 visas to 10,000 visas per fiscal year and to change the age requirement of the accompanying child of a visa holder from twenty–one to twenty–six years of age.[99] What the proposed bill does not attempt to change is the discriminatory treaty requirement of the E–2 visa, a change that has the potential to increase foreign investment opportunities in the United States.

Instead of resolving the treaty requirement that violates the United States' MFN obligation, the E–2 Visa Improvement Act creates a further detriment because it proposes to place a cap on how many E–2 visas are issued each fiscal year.[100] Proposing to reduce the number of visas available would likely lead to further discrimination regarding which individuals are eligible to enter the United States under the E–2 visa. This is because there would have to be a process to determine which 10,000 visa applicants was eligible to obtain the E–2 visa under the new proposal. Since the E–2 Visa Improvement Act fails to identify the ways that preference will be given to E–2 visa applicants, there is no way to determine that the proposal will in any way remedy the United States' failure to comply with its obligations under the MFN.

IV. RECONCILING LIMITATIONS OF THE E–2 VISA

Given the strong role that immigrants have played throughout the history of the United States in the creation of new businesses, the United States should be more welcoming to foreign entrepreneurs from countries without FCN, BIT, or comparable treaties with the United States by changing the treaty requirement. Since foreign investment is a leading contributor to the United States economy, it is imperative that E–2 visa remain attractive.

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96. E–2 Visa Improvement Act of 2015, H.R. 1834, 114th Cong. (2015).

97. *Id.*

98. *Id.* (suggesting ways to improve the E–2 visa).

99. *Id.*

100. *Id.* (proposing to place a cap of "[n]ot more than 10,000 [E–2] visas" issuable to foreign entrepreneurs each year).

A. The United States Should Comply with its MFN Obligation

The United States' failure to comply with its MFN obligation creates challenges for citizens of many countries.[101] Notable WTO member nations excluded from E–2 visa eligibility are South Korea, Brazil, India, and Cuba.[102] When citizens from these countries are excluded from obtaining E–2 visas, the United States loses investment from people who could substantially drive the economy.[103] To remedy the loss of potential foreign investment, the treaty requirement should be expanded to include all WTO member nations.[104] Although the E–2 visa treaty requirement has withstood some challenges,[105] it still conflicts with the MFN obligation under the WTO and the United States should start addressing the limitations of the E–2 visa.

The United States should also make an effort to eliminate its de facto discrimination because the United States' ten–year exemption to the MFN obligation is expired. As a result, all foreign nationals from WTO member nations would be eligible to apply for the E–2 visa.[106] This change would widen the pool of eligible E–2 visa applicants and in turn increase the amount of foreign investment in the United States, which would greatly stimulate economic development.[107]

B. The E–2 Visa Improvement Act Should Not be Adopted

Although the E–2 Visa Improvement Act provides beneficial suggestions to changing the E–2 visa requirements, it should not be adopted as it currently reads because it does not encompass a solution that remedies the discriminatory treaty requirement. The proposed bill is beneficial because it would allow E–2 visa holders to have a smoother transition from temporary residency in the United States to permanent residency.[108] A path

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101. *See* Worster, *supra* note 38, at 96 (stating that the challenges exist primarily because the United States has not complied with the MFN obligations).

102. *See id.*, for a list of countries excluded from E–2 visa eligibility.

103. *See* Prather, *supra* note 91 (explaining the consequences of excluding certain classes of entrepreneurs).

104. *See* Ballmer *supra* note 88, at 1 (stating that the newest Fortune 500 companies were founded by immigrants or their children).

105. *See* Worster, *supra* note 38, at 96 (naming discriminatory workplace legislation as a challenge that the E–2 treaty requirement has withstood).

106. *See id.* at 86 (explaining the impact of the United States' conformity to its MFN obligations).

107. Thiele & Decker *supra* note 11, at 146 ("[I]ncreasing the number of investments to the United States . . . would be a greater benefit to the United States, with a larger increase in economic development.").

108. *See generally* E–2 Visa Improvement Act of 2015, H.R. 1834, 114th Cong. (2015).

toward citizenship is imperative. By allowing a path towards citizenship, the United States can guarantee a continuation of foreign investment,[109] which is the purpose of the E–2 visa.[110]

Furthermore, the E–2 Visa Improvement Act is helpful for future legislation because it proposes to change the age of dependents from twenty–one to twenty–six years of age.[111] By increasing the age limit of dependents from twenty–one to twenty–six, dependents of E–2 visa holders will have a longer amount of time to apply to remain in the United States. This change will serve as an incentive for foreign investors to invest in the United States and challenge other countries' attempts to compete with the United States' investment measures.

The remaining proposed amendment to the Act, however, is not beneficial. The E–2 Visa Improvement Act's proposal to place a cap on the amount of E–2 visas will further limit foreign investment in the United States because it reduces the number of investors on E–2 visas. Moreover, there is no suggestion that any proposal stated in the E–2 Visa Improvement Act will remedy the United States' failure to comply with its obligations under the MFN. Therefore, it should not be adopted.

CONCLUSION

The E–2 visa treaty requirement is discriminatory and it violates the United States' MFN obligation signed under the GATS. In reforming the E–2 visa, the United States should comply with its MFN obligation to expand the amount of applicants eligible to apply for the E–2 visa and to increase foreign investment in the United States.

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109. Sun, *supra* note 19, at 557 ("[T]he United States would benefit if the treaty investors, who have proven their capability and commitment to contribute to the United States economy, are allowed to reside in the United States permanently, thereby guaranteeing the continuation of their investments.").

110. *Id.* at 514 (explaining that the E–2 visa was specifically created "to promote the goals of increasing international investments and attracting foreign investments to the United States").

111. H.R. 1834.

INDIVIDUAL ACCOUNTABILITY FOR CORPORATE CRIMES AFTER THE YATES MEMO: DEFERRED PROSECUTION AGREEMENTS & CRIMINAL JUSTICE REFORM

PAOLA C. HENRY*

Since the financial crisis of 2008, the Department of Justice has increasingly used deferred prosecution agreements to resolve corporate crimes. In these agreements, the government agrees not to prosecute a corporation for its misconduct in exchange for fines, agreements to increased monitoring for a set time frame, or both. The vast majority of the banks and institutions responsible for the 2008 financial crisis have received deferred prosecution agreements, with the leaders of these institutions largely escaping prosecution altogether. Over the past decade, only a small fraction of corporations that have received deferred prosecution agreements have also had responsible officers or employees prosecuted.

In response to the criticism regarding lack of accountability for individual corporate wrongdoers, Deputy Attorney General Sally Quillan Yates of the Department of Justice issued a memo on September 9, 2015, outlining new guidelines for individual accountability. These guidelines have since been

* J.D. Candidate, 2017, American University Washington College of Law; B.A. University of Maryland, College Park. I would like to thank Professor Amy Tenney for her invaluable knowledge and guidance in navigating this topic. Special thanks are due to my friends and family, especially my mom and sister, for their unwavering support. This Note is dedicated in loving memory of my dad, who inspired me to pursue a career in service to others. It is my hope that this Note facilitates dialogue on inequities in the criminal justice system and how we might begin to resolve them.

incorporated into the United States Attorney's Manual. Even so, the Department of Justice has entered into several deferred prosecution agreements since the issuance of the Yates Memo where no individual wrongdoers were charged, raising concerns about adherence to the new policy.

Several months before the release of the Memo, Judge Richard Leon of the District Court for the District of Columbia refused to approve a deferred prosecution agreement because he found the agreement to be overly lenient for the corporate crime at issue. The D.C. Court of Appeals subsequently overturned District Judge Leon's decision, holding that separation of powers mandates that there cannot be judicial review of deferred prosecution agreements.

This Note will argue that the new Yates Memo policy on individual accountability should be strictly adhered to when entering into deferred prosecution agreements. Next, this Note asserts that deferred prosecution agreements should be subject to judicial review to ensure compliance with the new Yates Memo policies. Lastly, this Note examines the inconsistency between the mens rea requirement of the Sentencing Reform and Corrections Act of 2015 and the Yates Memo, arguing instead for an extension of the Park *doctrine for the most egregious corporate crimes.*

INTRODUCTION

According to a July 2015 Department of Justice ("DOJ") Report, federal prosecution of white–collar crimes has hit a twenty–year low.[1] Rather than prosecuting individual corporate wrongdoers, the government often utilizes deferred prosecution agreements ("DPAs") for corporate crimes.[2] A deferred prosecution agreement is an agreement between the government and a corporate defendant in which the government agrees to suspend prosecution in exchange for the corporation paying a fine, agreeing to a period of increased monitoring, or other conditions.[3] The government uses DPAs for a myriad of corporate crimes including offenses that severely threaten the United States' national security and crimes that led to the deaths of more than one hundred Americans.[4] The current use of DPAs for egregious corporate crimes and lack of individual accountability raises concerns about the ability to deter future corporate misconduct.[5] For example, most of the financial institutions and banks responsible for the 2008 global financial crisis were granted DPAs leading to a notable lack of accountability for the individual executives and employees of these

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1. David Sirota, ET. AL., *US Prosecution of White Collar Crime Hits 20–Year Low: Report*, INT'L BUS. TIMES (Aug. 4, 2015), http://www.ibtimes.com/us-prosecution-white-collar-crime-hits-20-year-low-report-2037160.

2. Court E. Golumbic & Albert D. Lichy, *The "Too Big to Jail" Effect and the Impact on the Justice Department's Corporate Charging Policy*, 65 HASTINGS L.J. 1293, 1295 (2014); David Dayen, *Congress is Making it Even Harder to Crack Down on White–Collar Crime*, FISCAL TIMES (Nov. 20, 2015) [hereinafter Dayen, *Congress*], http://www.thefiscaltimes.com/Columns/2015/11/20/Congress-Making-It-Even-Harder-Crack-Down-White-Collar-Crime; Brandon L. Garrett, *The Corporate Criminal As Scapegoat*, 101 VA. L. REV. 1789, 1792 (2015) [hereinafter Garrett, *The Corporate Criminal*].

3. Jeffrey B. Coopersmith & Ashley L. Vulin, *If You Give a Judge a Case: Judicial Oversight of Deferred Prosecution Agreements*, CHAMPION, Jan. – Feb. 2016.

4. *See, e.g.*, United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160 (D.D.C. 2015) (regarding a company that conspired to ship military equipment to Iran, Sudan, and Burma in violation of U.S. sanctions and national security interests); United States v. HSBC Bank USA, N.A., No. 12–CR–763, 2013 WL 3306161 (E.D.N.Y. July 1, 2013) (regarding HSBC Bank money laundering millions of dollars in narcotics proceeds for Mexican and Colombian drug cartels and facilitating transactions with Cuba, Iran, and other jurisdictions in violation of U.S. sanctions); Ben Protess & Danielle Ivory, *U.S. Said to Have Settled With G.M. Over Deadly Defect*, N.Y. TIMES (Sept. 16, 2015), http://www.nytimes.com/2015/09/17/business/prosecutors-said-to-be-near-a-criminal-settlement-with-gm.html?_r=0 (noting that GM recalled 2.6 million cars with defective ignition switches after a decade of being aware of the problem and after 124 individuals had died due to the defect).

5. *See* Protess & Ivory, *supra* note 4; David Dayen, *In Market–Rigging Case, US Justice Department Treats Corporate Criminals like Juvenile Offenders*, GUARDIAN (Nov. 13, 2014) [hereinafter Dayen, *Market–Rigging*], http://www.theguardian.com/business/2014/nov/13/us-justice-department-criminals-juvenile-offenders.

entities.[6] Furthermore, recent proposed federal legislation, if passed, would make individual accountability for corporate crimes even less likely.[7]

This Note will explore the evolution of DPAs from their original intended use per the legislative history of the Speedy Trial Act to their current widespread use in the resolution of corporate crime. In doing so, it will discuss the DOJ's Yates Memo and how the continued use of DPAs without any individual accountability is inconsistent with this policy. It will provide background on recent precedent concerning judicial review of DPAs and will analyze the arguments for and against judicial review of DPAs. Additionally, this Note will introduce the proposed Sentencing Reform and Corrections Act of 2015 and discuss its potential impact on the prosecution of corporate crimes. Finally, this Note will recommend (1) that DPAs be accompanied by individual accountability, (2) that there should be judicial review of DPAs, (3) that the Speedy Trial Act should be amended to further clarify the role of judges in reviewing a DPA, and (4) that the mens rea requirement of the proposed Sentencing Reform and Collections Act be rejected and the *Park* doctrine be accepted in its place.[8]

II. THE HISTORY OF DEFERRED PROSECUTION ACTS

Under a DPA, a criminal information is filed against the defendant, and the parties simultaneously enter into a DPA to defer the prosecution.[9] Thus, while there is a criminal charge on the defendant's criminal record, there will be no conviction for that particular charge.[10] The federal government obtains its power to enter into these agreements from the Speedy Trial Act. Section (h)(2) of this Act grants federal prosecutors the power to enter into DPAs, which are now widely used to resolve corporate crime.[11] Yet, this was not the legislative intent of DPAs when the Speedy

6. *See* Golumbic & Lichy, *supra* note 2, at 1295 (noting that the Justice Department failed to bring criminal charges against financial institutions for their perceived role in causing the financial crisis of 2008).

7. *See* Sentencing Reform Act of 2015, H.R. 3713, 114th Cong. (2015) (proposing a showing of mens rea for individual corporate criminal liability).

8. *See* United States v. Park, 421 U.S. 658, 676 (1975) (holding that corporate officials who were in a position of power to be able to prevent violations of the Food, Drug, and Cosmetic Act are strictly liable and can be convicted for the violations even if they lacked mens rea).

9. Coopersmith & Vulin, *supra* note 3.

10. *Id.*

11. Speedy Trial Act, 18 U.S.C. § 3161(h)(2)(2012); *see also* United States v. Saena Tech Corp., No. CR 14–211 (EGS), 2015 WL 6406266, at *10 (D.D.C. Oct. 21, 2015) (noting the Speedy Trial Act was originally intended to rehabilitate low–level offenders, but is now used to avoid the prosecution of corporations and their employees).

Trial Act was drafted in 1974.[12] DPAs were considered alternative solutions, only to be used in circumstances to rehabilitate individuals charged with nonviolent, low–level criminal offenses.[13] Section (h)(2) of the Speedy Trial Act "was intended to encourage practices that had been ongoing in certain courts, which permitted the deferral of prosecution on the condition that a defendant participate in a rehabilitation program."[14] These agreements were frequently used for nonviolent drug offenders, juveniles, or defendants who had particularly sympathetic or compelling cases.[15]

Although the Speedy Trial Act created DPAs to rehabilitate low–level offenders, today these agreements are rarely used to encourage individual rehabilitation.[16] Instead, DPAs are used to defer prosecuting corporations that commit crimes in exchange for large fines paid to the federal government, and sometimes agreements to be monitored for a set period of time.[17] The current use of DPAs for large–scale corporate misconduct is a far departure from Congress' original intent in drafting Section (h)(2) of the Speedy Trial Act.[18]

Since the global financial crisis of 2008, the DOJ has increasingly used DPAs for white–collar crimes.[19] The use of DPAs for corporate crimes has become so prevalent that the former chief of the DOJ's criminal division, Lanny Breuer, referred to these agreements as a "mainstay of white–collar criminal law enforcement."[20] What is most troubling about the increased use of DPAs is that two–thirds of DPAs granted for corporate crimes since 2008 have not been accompanied with any charges against responsible

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12. *Saena*, 2015 WL 6406266, at *10.

13. *Id.*

14. *Id.* ("The Senate Judiciary Committee specifically cited a successful project in New York City, the Manhattan Court Employment Project, as well as the District of Columbia's Project Crossroads as examples of the types of deferred prosecution it intended with this provision.").

15. *Id.*

16. *See* BRANDON L. GARRETT, TOO BIG TO JAIL 263 (1st. ed. 2014) [hereinafter GARRETT, TOO BIG] ("Prosecutors rarely offer leniency to encourage individuals to rehabilitate.").

17. *Id.*

18. *Saena*, 2015 WL 6406266, at *27, *30 ("At this time . . . deferred–prosecution agreements appear to be offered relatively sparingly to individuals, and instead are used proportionally more frequently to avoid the prosecution of corporations, their officers, and employees."); *see also* Mike Koehler, *Measuring the Impact of Non–Prosecution and Deferred Prosecution Agreements on Foreign Corrupt Practices Act Enforcement*, 49 U.C. DAVIS L. REV. 497, 499 (2015); Golumbic & Lichy, *supra* note 2, at 1304.

19. Dayen, *Market–Rigging*, *supra* note 5.

20. *Id.*

individual employees.[21]

Prior to the evolution of DPAs from agreements intended to rehabilitate non–violent, low–level drug offenders to their current use, the DOJ only had two choices in their approach to corporate crime: to pursue criminal charges, or not.[22] Since the 1990s, however, the DOJ has released several policy memos expanding the use of DPAs to corporate crimes and establishing these agreements as a "middle ground."[23]

DPAs are now widely used for Foreign Corrupt Practices Act ("FCPA") violations, product safety and securities violations, environmental crimes, money laundering, fraud, and other corporate crimes.[24] The departure from the Speedy Trial Act's original legislative intent has raised concerns from critics about leniency and accountability for corporate wrongdoers.[25] After years of criticism about the lack of prosecution of individual corporate wrongdoers, the DOJ's Deputy Attorney General Sally Quillian Yates released a policy memo ("Yates Memo") in September 2015 that called for increased accountability for corporate misconduct.[26]

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21. GARRETT, TOO BIG, *supra* note 16, at 295 ("In about one–third deferred prosecution or non–prosecution agreements, corporate officers or employees were prosecuted for related crimes . . . .").

22. Koehler, *supra* note 18, at 499.

23. *Saena* , 2015 WL 6406266, at *69–70; *see also* Jillian Berman, *Eric Holder's 1999 Memo Helped Set The Stage For 'Too Big To Jail'* , HUFFINGTON POST (June 4, 2013), http://www.huffingtonpost.com/2013/06/04/eric-holder-1999-memo_n_3384980.html (noting that the Holder Memo has resurfaced now that the DOJ faces increased criticism for its reluctance to bring charges against white–collar criminals because the Memo laid the groundwork for subsequent policies that allowed leeway when prosecuting large corporations).

24. *See* GARRETT, TOO BIG, *supra* note 16, at 296; *see generally* Garrett, *The Corporate Criminal*, *supra* note 2 (providing data on corporate and individual prosecutions and arguing for increased individual accountability).

25. *See* Sheelah Kolhaktar, *Has It Become Impossible to Prosecute White–Collar Crime?*, BLOOMBERG BUS. (Oct. 21, 2015), http://www.bloomberg.com/news/articles/2015-10-21/has-it-become-impossible-to-prosecute-white-collar-crime- (noting that only one high–level banker has gone to prison since the financial crisis despite public cries to hold the bankers accountable who committed fraud leading to millions of lost jobs and foreclosed homes).

26. Matt Apuzzo & Ben Protess, *Justice Department Sets Sights on Wall Street Executives*, N.Y. TIMES (Sept. 9, 2015), http://www.nytimes.com/2015/09/10/us/politics/new-justice-dept-rules-aimed-at-prosecuting-corporate-executives.html ("Stung by years of criticism that it has coddled Wall Street criminals, the Justice Department issued new policies . . . that prioritize the prosecution of individual employees — not just their companies.").

III. THE YATES MEMO AND A NEW APPROACH TOWARDS INDIVIDUAL ACCOUNTABILITY

A. Background

The Yates Memo, issued on September 9, 2015, lists six steps to strengthen the accountability of individual corporate criminals.[27] The Yates Memo's six steps state:

> (1) In order to qualify for any cooperation credit, corporations must provide to the Department *all* relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (3) criminal and civil attorneys handling corporate investigations should be in routine communication with one another (4) absent extraordinary circumstances or approved departmental policy, the Department will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation; (5) Department attorneys should not resolve matters with a corporation without a clear plan to resolve individual related cases, and should memorialize any declinations as to individuals in such cases; and (6) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.[28]

On November 16, 2015, two months after issuing the Yates Memo, Deputy Attorney General Yates gave a speech further clarifying the new policy. She announced that the policy was incorporated into the section of the United States Attorney's Manual ("USAM") entitled "Principles of Federal Prosecution of Business Organizations."[29] Yates noted the

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27. *See* Memorandum from Sally Quillian Yates, Deputy Att'y Gen., U.S. Dep't of Justice, to All U.S. Att'ys ET AL., Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015) [hereinafter Yates Memo], https://www.justice.gov/dag/file/769036/download (describing the Department of Justice's new policy of individual accountability).

28. *Id.* (emphasis added); *see also* Mary Beth Buchanan & Jovana Crncevic, *Corporate Employees at Risk: Strategic and Practical Implications of the Yates Memo*, LEGAL BACKGROUNDER, Feb, 26, 2016, at 4 (noting that Yates Memo's all–or–nothing approach to cooperation credit in the first factor is the most significant change).

29. *See* Sally Quillan Yates, Deputy Att'y Gen., U.S. Dep't of Justice, Remarks at American Banking Association and American Bar Ass'n Money Laundering Enforcement Conference (Nov. 16, 2015) [hereinafter November Yates Remarks], https://www.justice.gov/opa/speech/deputy-attorney-general-sally-quillian-yates-delivers-remarks-american-banking-0; U.S. Dep't of Justice, U.S. Att'y's Manual § 9–28.000 (2015), http://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations ("The revised factors now emphasize the primacy in any corporate case of holding individual wrongdoers accountable and list a variety of steps that prosecutors are expected to take to maximize the opportunity to achieve that goal.").

importance of the USAM is that it applies to all DOJ prosecutors whether in the DOJ trial divisions or in U.S. Attorneys' offices, thereby demonstrating that the new policy should be applied in all federal prosecutions.[30] Yates also stated that to ensure compliance with the new policy, language would be added to the USAM that codifies internal reporting and approval requirements.[31]

After the release of the Yates Memo, the DOJ continued to use DPAs in several cases where no individual employees were charged.[32] For example, just one week after the release of the Yates Memo, the DOJ settled with General Motors ("GM") through a DPA without charging any individual corporate officer or employee.[33] GM employees intentionally failed to disclose a safety defect for over a decade, which ultimately led to at least 124 deaths.[34] The government gave GM cooperation credit and a DPA despite the fact that not a single employee or executive from the company was charged as the Yates Memo requires.[35] GM's DPA included a $900 million fine and a term of monitoring for three years without any individual accountability.[36] Rather than abiding by Step (2) of the Yates Memo and focusing the investigation on the executives and employees who intentionally did not disclose the defective parts, the entirety of the

30. November Yates Remarks, *supra* note 29.

31. *Id.*

32. Protess & Ivory, *supra* note 4; Evan Weinberger, *Yates Memo Fails To Trigger Charges In Morgan Stanley Deal*, LAW360 (Feb. 11, 2016), http://www.law360.com/articles/758250/yates-memo-fails-to-trigger-charges-in-morgan-stanley-deal.

33. Protess & Ivory, *supra* note 4; *see also* United States v. Saena Tech Corp., No. CR 14–211 (EGS), 2015 WL 6406266, at *25 (D.D.C. Oct. 21, 2015) ("Just a week after announcing this policy shift . . . in a shocking example of potentially culpable individuals not being criminally charged, the Department of Justice announced that it had entered into a Deferred–Prosecution Agreement with General Motors Company regarding its failure to disclose a safety defect.").

34. *See* Protess & Ivory, *supra* note 4; *Critics Rip GM Deferred Prosecution Agreement in Engine Switch Case*, CORP. CRIME REP. (Sept. 17, 2015) [hereinafter *Critics Rip GM DPA*], http://www.corporatecrimereporter.com/news/200/critics-rip-gm-deferred-prosecution-in-switch-case/ (discussing the harsh criticism the government received for granting GM a DPA without charging any individual employees despite over 100 deaths due to GM's nondisclosure); *see also Toyota Gets Prosecution Deferred, No Corporate Crime Plea, No Individuals Charged*, CORP. CRIME REP. (Mar. 19, 2014), http://www.corporatecrimereporter.com/news/200/toyota-gets-prosecution-deferred-no-corporate-crime-plea-no-individuals-charges/ (discussing the DPA granted to Toyota without any individual criminal charges for culpable employees after Toyota misled consumers about dangerous safety defects).

35. *Critics Rip GM DPA*, *supra* note 34; Elizabeth E. Joh & Thomas W. Joo, *The Corporation As Snitch: The New DOJ Guidelines on Prosecuting White Collar Crime*, 101 VA. L. REV. 51, 51–52 (2015) (noting that the criminal investigations into GM and Toyota for safety defects yielded no individual charges for culpable employees).

36. *Critics Rip GM DPA*, *supra* note 34.

investigation agreement was between the corporation as a whole and the DOJ.[37]

More recently, Morgan Stanley was given a DPA for misleading investors about the quality of mortgages that it packed into mortgage–backed securities prior to the 2008 financial crisis.[38] While the DOJ cited the DPA settlement of $3.2 billion as a victory in its attempt to hold banks accountable for the global financial crisis of 2008, there were no civil or criminal charges against *any* employees of Morgan Stanley, despite incriminating emails.[39] Morgan Stanley's DPA mirrors those seen prior to the Yates Memo, lacking individual accountability.[40] Critics argue that the Morgan Stanley DPA "opens a vein on the Yates memo" and causes the Memo's policy to appear as an empty threat to Wall Street.[41]

The lack of individual accountability in the GM and Morgan Stanley cases calls into question the effectiveness of the Yates Memo and whether DPAs properly deter corporate misconduct.[42] Thus, the government's continued use of DPAs without any individual accountability undermines the Yates Memo.

B. Applying the Yates Memo Approach to Future DPAs

In *New York Central & Hudson River Railroad v. United States*,[43] the Supreme Court held that a corporation could be prosecuted for a federal crime based on the criminal conduct of a single employee.[44] As a result, while a company can be prosecuted or forced to enter into a DPA for the criminal acts of a single employee, the culpable individual employees are rarely prosecuted themselves.[45] The Yates Memo seeks to correct this imbalance by encouraging the prosecution of individuals responsible for corporate misconduct.[46] Future DPAs must reflect this new policy shift and must have terms that are consistent with the Yates Memo.

To be consistent with the new policy set forth in the Yates Memo, a DPA

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37. *Id.*; Yates Memo, *supra* note 27 ("[C]riminal and civil corporate investigations should focus on individuals from the inception of the investigation.").

38. Weinberger, *supra* note 32 (leading to the home foreclosure crisis).

39. *Id.*

40. *Id.*

41. *Id.* ("Unless a criminal indictment of individuals follows soon, it will perish as meaningful prosecutorial policy.").

42. *See generally* Protess & Ivory, *supra* note 4; Weinberger, *supra* note 32.

43. 212 U.S. 481 (1909).

44. *Id.* at 489.

45. Garrett, *The Corporate Criminal*, *supra* note 2, at 1796.

46. *See generally* Yates Memo, *supra* note 27.

should not be granted to a corporation unless the corporation provides the appropriate information regarding potential culpable individuals in accordance with Step (1). Additionally, the DOJ should focus on investigating these individuals from the beginning of the investigation in accordance with Step (2).[47] The Yates Memo's all–or–nothing cooperation credit policy should receive strict adherence. In a post–9/11 world, corporations that finance and/or commit crimes that benefit terrorist and criminal networks must be deterred.[48] Additionally, banks and financial institutions whose criminal acts have the ability to severely impact the global economy, as seen in 2008, must be held accountable to deter future similar conduct.[49] Consistently enforcing the Yates Memo's all–or–nothing policy for cooperation credit is essential to protect the national security and financial interests of the United States.

Corporate crimes have the potential to affect millions of Americans. Recent corporate crimes that received DPAs involved the financing of criminal or terrorist networks, the unexpected deaths of hundreds of Americans due to safety defects, and the shipping of military equipment to United States adversaries.[50] These crimes are severe and responsible corporate employees and executives must be held accountable.[51] To comply with the Yates Memo, federal prosecutors should only grant DPAs to corporations that provide information about culpable employees and allow for subsequent charges to be filed against these employees.

IV. JUDICIAL REVIEW OF DEFERRED PROSECUTION AGREEMENTS

A. The Recent Jurisprudence on Judicial Review of DPAs

In February 2015, in *United States v. Fokker*,[52] District Judge Richard Leon of the District of Columbia denied a DPA that the DOJ sought to enter with Fokker.[53] Judge Leon disagreed with the terms of the DPA,

47. Yates Memo, *supra* note 27 ("(1) In order to qualify for any cooperation credit, corporations must provide to the Department all relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation.").

48. *See Too Big to Indict*, N.Y. TIMES (Dec. 11, 2012) [hereinafter *Too Big to Indict*], http://www.nytimes.com/2012/12/12/opinion/hsbc-too-big-to-indict.html.

49. *Id.*

50. *See, e.g.*, United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160, 166 (D.D.C. 2015); United States v. HSBC Bank USA, N.A., No. 12–CR–763, 2013 WL 3306161, at *1 (E.D.N.Y. July 1, 2013); *see generally* Protess & Ivory, *supra* note 4.

51. *See Fokker*, 79 F. Supp. 3d at 166; *HSBC*, 2013 WL 3306161, at *1; *see generally* Protess & Ivory, *supra* note 4.

52. 79 F. Supp. 3d 160 (D.D.C. 2015).

53. *Id.* at 166–67.

stating that it was entirely too lenient given the egregious nature of Fokker's crimes.[54]

For five years Fokker, a Dutch company that conducts business in the United States, knowingly exported aircraft parts to Iran, Sudan, and Burma in violation of U.S. sanctions and regulations.[55] The proposed DPA struck down by Judge Leon required a $10.5 million fine, implementation of an internal compliance program, and eighteen–months of government oversight.[56] However, the DPA failed to mandate independent compliance monitoring, instead allowing Fokker to self–report infractions.[57] Additionally, the proposed fine was $10.5 million *less* than the revenue Fokker earned from its illegal business transactions, which was twenty–one million dollars in total.[58] Further, no Fokker employees were criminally charged, fired, or dismissed despite evidence that for years many executives and employees had intentionally and knowingly violated the U.S. sanctions.[59]

The government and Fokker appealed the District Court's decision on the grounds that the Court unconstitutionally exceeded its scope of authority when it denied the DPA.[60] In their appeal the government and Fokker also questioned whether judicial review of DPAs, in general, is ever appropriate under the separation of powers doctrine.[61] While courts have some discretionary power to decide whether to accept or reject a plea agreement, there is a presumption in favor of following the prosecutor's proposed agreement.[62] Furthermore, the appellants argued that if a judge

54. *See id.* at 165–67 (noting that the court would not "rubber stamp" a DPA that was "grossly disproportionate to the gravity of Fokker's . . . [crimes] in a post 9/11 world.").

55. *See id.* at 161–64 (emphasizing that Fokker continued to conduct these illegal transactions despite Fokker's in–house counsel and the Dutch authorities' warnings that the company was violating U.S. sanctions).

56. *See id.* at 166.

57. *Id.*

58. *See id.* (noting that the majority of this illegal revenue was gained through selling avionic parts to the Iranian military in violation of U.S. law).

59. *Id.* at 166–67.

60. *See generally id.*

61. *See* Thomas Zeno & Dalia Abu–Eid, *DC Circ. May Sidestep Clarifying A Judge's Role In DPAs*, LAW360 (Sept. 14, 2015), http://www.law360.com.proxy.wcl.american.edu/articles/702286/dc-circ-may-sidestep-clarifying-a-judge-s-role-in-dpas (discussing the September 11, 2015 District of Columbia Circuit panel in the Fokker appeal and the panel's skeptical questioning of the government's argument against judicial review of DPAs).

62. *See* Reply Brief for Defendant–Appellant at 23, United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160 (D.D.C. 2015) (No. 15–3016, 15–3017) [hereinafter Defendant–Appellant's Reply Brief] (citing United States v. Ammidown, 497 F.2d

does depart from the parties' agreed–upon terms he or she must provide a legal basis for doing so and cannot merely reject a guilty plea because the judge's personal "conception of the public interest differ[s] from that of the prosecuting attorney."[63]

On April 5, 2016 the U.S. Court of Appeals for the District of Columbia decided in favor of the appellants and vacated the District Court's ruling.[64] The Court of Appeals held that the decision to grant a DPA and determine what its terms will be is a decision "for the Executive — not the courts — to make," regardless of whether the judge agreed with its terms.[65] The court also rejected the argument that the Speedy Trial Act justifies judicial review of DPAs and declined to define when a judge may use his or her discretion to reject a DPA as contrary to the public interest.[66] Instead, the opinion read as a "blanket" decision with vague and broad language indicating that judges should not interfere with DPAs.[67] The Court of Appeal's decision in *Fokker* was contrary to the Yates Memo and left open the question of when it is appropriate for the courts to review DPAs.[68] The *Fokker* decision has since been met with widespread criticism and has created significant concern about the continued use of overly lenient DPAs.[69]

In *United States v. HSBC*,[70] the Eastern District of New York addressed the same issue that was before the court in *Fokker*, as to when courts can uphold or deny DPAs. Although the Eastern District of New York noted its supervisory role over the implementation, approval, and denial of DPAs, the Court declined to use this supervisory power in *HSBC* and accepted the proposed DPA.[71] Thus, although the Court acknowledged judicial supervisory power over DPAs as District Court Judge Leon did in *Fokker*, the *HSBC* court did not go as far as to reject the DPA, as was done in *Fokker*. HSBC was charged with willfully laundering money; diverting $881 million in narcotics proceeds to Mexican and Colombian drug cartels

615, 621 (D.C. Cir. 1973)).

63. *Id.* at 22.

64. United States v. Fokker Servs. B.V., 818 F.3d 733, 738 (D.C. Cir. 2016).

65. *Id.*

66. *See University of Virginia Law Professor Brandon Garrett Says DC Circuit Wrong on* Fokker, CORP. CRIME REP. (Apr. 19, 2016) [hereinafter *DC Circuit Wrong on* Fokker], http://www.corporatecrimereporter.com/news/200/brandon-garrett-says-dc-circuit-wrong-on-fokker/.

67. *Id.*; *see generally Fokker*, 818 F. 3d 733.

68. *DC Circuit Wrong on* Fokker, *supra* note 66.

69. *Id.*

70. No. 12–CR–763, 2013 WL 3306161 (E.D.N.Y. July 1, 2013).

71. *Id.* at *3–4.

and other groups linked to terrorism; and facilitating transactions with entities in Cuba, Iran, and other jurisdictions that were subject to U.S. government sanctions.[72]

The proposed DPA that HSBC received included the largest bank forfeiture ever seized and the most severe government oversight measures.[73] The oversight measures required HSBC to replace its CEO and other executives and also required HSBC to expand its money–laundering prevention program.[74] Even so, the agreement garnered criticism from both sides of the political spectrum.[75]

B. Deconstructing the Argument Against Judicial Review of DPAs

When the government enters into a DPA with a company, judges are asked to keep the case on their dockets and to act as monitors to ensure that the terms of the DPA are fulfilled.[76] In asking the judges to take on this supervisory role, it would reasonable for judges to be able to review the terms of a DPA.[77] In *HSBC*, the court cited its supervisory power, holding that by entering into a DPA "the parties had chosen to implicate the court in the resolution and had subjected their DPA to the legitimate exercise of the court's authority."[78] Judges Leon and Sullivan subsequently adopted this reasoning in *Fokker* and *United States v. Saena*[79] in their opinions in favor of judicial review of DPAs.[80]

In an amicus brief filed in support of Judge Leon's decision, counsel argued that, "it is the [appellants'] position that violates the separation of powers."[81] The appellants' "remarkable suggestion that the District Court

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72. *Id.* at *9; Golumbic & Lichy, *supra* note 2, at 1295, 1318–19.

73. Golumbic & Lichy, *supra* note 2, at 1320.

74. *Id.*

75. Republican Senator Charles Grassley stated that the DPA was "no more than a parking ticket that does little to discourage lawbreakers, and leaves the U.S. financial system highly vulnerable to exploitation by drug cartels and terrorists." Golumbic & Lichy, *supra* note 2, at 1322–23. Democratic Senator Elizabeth Warren also harshly criticized the DPA as being grossly disproportionate to the severity of HSBC's crimes, standing in stark contrast to the severe punishment low–level criminals often face and contributing to an imbalanced criminal justice system. *Id.* at 1322.

76. *HSBC*, 2013 WL 3306161, at *5.

77. *Id.*

78. *Id.*

79. No. CR 14–211 (EGS), 2015 WL 6406266 (D.D.C. Oct. 21, 2015). (reviewing a DPA for a government subcontractor that was charged with bribing a public official).

80. *Id.* at *12; United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160, 164–65 (D.D.C. 2015).

81. Brief of Court–Appointed Amicus Curiae in Support of Order Below at 54, United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160 (D.D.C. 2015) (No. 15–3016, 15–3017) [hereinafter Amicus–Curiae Brief].

was constitutionally required to blindly rubber–stamp the [appellants'] motion is fundamentally inconsistent with an independent Judiciary."[82] A judge's role is to act independently from the prosecution to approve or deny a DPA.[83] In comparison, judges can affirm or deny the government's plea agreements or motions and can impose a higher or lower sentence than the government's recommendation without violating the constitutional separation of powers.[84] Conversely, judges can never be involved in the negotiations of plea agreements or the terms of a DPA because this is a prosecutorial function.[85] However, judges can reject DPAs they find to be too lenient without raising constitutional concerns, and should do so when in the public's interest.[86]

The language of the Speedy Trial Act itself supports judicial review of DPAs.[87] Section (h)(2) of the Speedy Trial Act grants the government the power to enter into DPAs and the phrase "with the approval of the court" indicates that Congress intended for the judiciary to review and give approval over DPAs.[88] Additionally, this is evidenced by the legislative history that shows that Congress considered and rejected a draft of this provision that did not require judicial approval.[89] Furthermore, five other delayed prosecution provisions in the Speedy Trial Act do not include any requirement of "approval [by] the court."[90] Therefore, eliminating "approval of the court" from other sections of the statute and including "approval of the court" in Section (h)(2) demonstrates that Congress intended to allow judicial review on the merits of DPAs.[91]

The D.C. Circuit's holding in *Fokker* that the Speedy Trial Act does not support judicial review should be reassessed. It is critical for judges to be able to review and reject overly lenient DPAs with the public's interest in mind. Additionally, the text of the Speedy Trial Act and the independent constitutional power of the judiciary both support judicial review of a DPA.

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82. *Id.*

83. *Id.*

84. *Id.*

85. *See id.* (noting when judges become involved with plea agreements or terms of a DPA they are violating the constitutional separation of powers).

86. *Id.*

87. *Id.*; *see generally* Speedy Trial Act, 18 U.S.C. § 3161 (2012).

88. Speedy Trial Act, 18 U.S.C. § 3161(h)(2) ("Any period of delay during which prosecution is deferred by the attorney for the Government pursuant to written agreement with the defendant, with the approval of the court, for the purpose of allowing the defendant to demonstrate his good conduct.").

89. Amicus–Curiae Brief, *supra* note 81, at 54.

90. Speedy Trial Act, 18 U.S.C. §§ 3161(h)(1), (3–6).

91. *Id.*

To resolve this issue, Congress should revise or amend the Speedy Trial Act to further clarify the judicial role in granting or denying DPAs and when judges may use this discretion. Adjusting the Speedy Trial Act to clarify the role of judicial oversight on DPAs will allow judges to ensure that a DPA meets the terms of the Yates Memo and is not overly lenient.[92]

V. THE SENTENCING REFORM AND CORRECTIONS ACT OF 2015 AND DEFERRED PROSECUTION AGREEMENTS

The use of DPAs for corporate crimes has skyrocketed in recent years, with the use of these agreements reaching historical highs in 2015.[93] At the same time, mass incarceration has also greatly increased.[94] When the Speedy Trial Act was drafted DPAs were intended for defendants who committed non–violent drug offenses and other low–level crimes.[95] The evolution of DPAs toward its current use for major corporate crimes has contributed to a large discrepancy between the poor and wealthy in the United States criminal justice system.[96] Recently, there has been increased attention to this problem in our criminal justice system. President Obama addressed these issues last year when he became the first president to visit a federal prison.[97]

As a result of this increased scrutiny of the imbalances in the criminal justice system, Congress has endeavored to address many of the system's longstanding issues through the Sentencing and Corrections Reform Act of 2015.[98] The bill seeks to revise and retroactively reduce mandatory

92. *See* Yates Memo, *supra* note 27; United States v. Fokker Servs. B.V., 818 F.3d 733, 738 (D.C. Cir. 2016).

93. United States v. Saena Tech Corp., No. CR 14–211 (EGS), 2015 WL 6406266, at *24 (D.D.C. Oct. 21, 2015).

94. Garrett, *The Corporate Criminal*, *supra* note 2, at 1834; *see also* GARRETT, TOO BIG, *supra* note 16, at 263 (stating that the United States has had the largest prison population and highest incarceration rate in the world since the 1970s).

95. *Saena*, 2015 WL 6406266, at *10.

96. Garrett, *The Corporate Criminal*, *supra* note 2, at 1834; GARRETT, TOO BIG, *supra* note 16, at 263.

97. *Saena*, 2015 WL 6406266, at *26–27; Scott Horsley, *Obama Visits Federal Prison, A First For A Sitting President*, NPR (July 16, 2015), http://www.npr.org/sections/itsallpolitics/2015/07/16/423612441/obama-visits-federal-prison-a-first-for-a-sitting-president ("President Obama toured a federal prison in Oklahoma . . . and said the nation needs to reconsider policies that contribute to a huge spike in the number of people behind bars.").

98. Carl Huse & Jennifer Steinhauer, *Sentencing Overhaul Proposed in Senate With Bipartisan Backing*, N.Y. TIMES (Oct. 1, 2015), http://mobile.nytimes.com/2015/10/02/us/politics/senate-plan-to-ease-sentencing-laws.html?_r=0&referer=https://www.google.com/ ("[T]he new legislation is seen by supporters as an overdue corrective response to a mandatory sentencing program that has punished offenders out of proportion to their crimes.").

minimum sentences for non–violent offenders, encourage alternative sentencing, address mental health issues, and do away with outdated policies.[99]

In a subsequent amendment to the bill, House Republicans added a requisite showing of mens rea for white–collar criminal prosecutions. This amendment would make it more difficult for prosecutor's to hold corporate criminals accountable.[100] If passed, prosecutors would have to meet a high bar to show that a corporate employee intentionally violated the law.[101] Thus, corporate executives and employees will not be prosecuted for their crimes due to negligence, recklessness, and situations where prosecutors know there was criminal conduct but lack evidence to show that these individuals knowingly acted unlawfully.[102] Both the DOJ and the Obama Administration voiced their opposition to the mens rea amendment.[103] A White House official commented that, "in the President's view, criminal justice reform should make the system better, not worse."[104]

If Congress passes the Sentencing Reform and Corrections Act with the mens rea requirement, it would only decrease the likelihood that culpable corporate executives and employees would be prosecuted or convicted.[105] This proposal and the weakening of individual accountability are directly inconsistent with the new Yates Memo.[106] "At a time when the Justice

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99. Sentencing Reform Act of 2015, H.R. 3713, 114th Cong. (2015); *see also* Huse & Steinhauer, *supra* note 98 (noting that the legislation proposes an extensive set of changes in federal sentencing requirements and many that are retroactive).

100. *Holding Sentencing Reform Hostage*, N.Y. TIMES (Feb. 16, 2016), http://mobile.nytimes.com/2016/02/07/opinion/sunday/holding-sentencing-reform-hostage.html?referer=https://www.google.com/.

101. *Id.*

102. *Id.*; *see also* Zach Carter, *White House Comes Out Against Effort To Block White–Collar Crime Prosecutions*, HUFFINGTON POST (Nov. 19, 2015), http://www.huffingtonpost.com/entry/corporate-crime-criminal-justice-reform_us_564cc371e4b031745cef33d4 (noting that large corporations have complex structures through which they can diffuse responsibility, making it difficult for prosecutors to gather the evidence to show that corporate misconduct was intentional and willful).

103. Dayen, *Congress*, *supra* note 2.

104. Zach Carter, *White House Comes Out Against Effort To Block White–Collar Crime Prosecutions*, HUFFINGTON POST (Nov. 19, 2015), http://www.huffingtonpost.com/entry/white-collar-crime-white-house-response_us_564dd06be4b00b7997f95240.

105. Dayen, *Congress*, *supra* note 2; Matt Apuzzo & Eric Lipton, *Rare White House Accord With Koch Brothers on Sentencing Frays*, N.Y. TIMES (Nov. 24, 2015), http://www.nytimes.com/2015/11/25/us/politics/rare-alliance-of-libertarians-and-white-house-on-sentencing-begins-to-fray.html (noting that the proposed standard, if in effect at the time, might have prevented guilty pleas in a variety of pharmaceutical, medical, food safety cases that led to deaths in 2011, 2012, and 2013).

106. Dayen, *Congress*, *supra* note 2; Yates Memo, *supra* note 27.

Department has pledged to intensify its efforts to pursue white–collar crimes, the proposed legislation would significantly weaken the government's hand."[107] This legislation must be reassessed for its inconsistency with the Yates Memo and the DOJ's new approach to corporate accountability.

A. Extending the Park *Doctrine to Crimes Threatening National and Economic Security*

Congress should also incorporate an extension of the *Park* doctrine to corporate crimes that severely threaten the national security or economic stability of the United States.[108] In *United States v. Park*,[109] the president of a national retail food chain was convicted of violating the Food, Drug, and Cosmetics Act ("FDCA") by receiving food at the company's unsanitary warehouses and exposing the food to rat excrement.[110] Two years prior to the conviction, the Park president had received a letter regarding the unsanitary conditions of the company's Philadelphia warehouses and was later made aware of rodent infestation in food at the Baltimore warehouse.[111] The Supreme Court ultimately held that corporate employees could be criminally liable for violations of the FDCA even if they were unaware of the violations, as long as they were in a position of authority to stop the violations at the time they occurred.[112]

Under the *Park* ruling, corporate officials are strictly liable and have an affirmative duty to find and prevent violations of the FDCA.[113] Since the 1975 *Park* decision, the Food and Drug Administration ("FDA") has extended this doctrine of strict liability to cases involving over–the–counter and prescription drugs.[114] Yet, while corporate wrongdoers can be

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107. *See* Apuzzo & Lipton, *supra* note 105 (discussing how the new mens rea requirement would make prosecution of white–collar criminals more difficult).

108. *See* United States v. Park, 421 U.S. 658 (1975) (holding that the government may seek a conviction against a company for violating the FDCA without needing to prove that the employee was aware of the violations).

109. 421 U.S. 658 (1975).

110. *Id.* at 660–61.

111. *Id.* at 661.

112. *Id.* at 661 n.9; *see also* Paul M. Hyman, *FDA Cites Park Doctrine in a Different Context*, FDA LAW BLOG (May 28, 2013), http://www.fdalawblog.net/fda_law_blog_hyman_phelps/2013/05/fda-cites-park-doctrine-in-a-different-context.html.

113. Hyman, *supra* note 112.

114. *See* Joanne S. Eglovitch, *FDA Resurrects Park Doctrine in Enforcement of Pharmaceutical GMPs*, THE GOLD SHEET 15, 18 (2011), http://www.skadden.com/sites/default/files/entity_pdf/FDA_Resurrects_Park_Doctrine_in_Enforcement_of_Pharmaceutical_GMPs.pdf (noting the resurgence of the *Park* doctrine and its recent extension to drug cases as seen in the prosecution of Johnson & Johnson for quality control lapses

convicted without a showing of mens rea for food contamination or drug cases, the same is not true for corporate crimes that severely threaten national security, economic stability, or even those crimes that lead to the deaths of Americans.[115]

It is in the United States' financial and security interests to extend the *Park* doctrine to impose the same affirmative duty required of food, drug, and healthcare companies to corporate officials in other industry sectors.[116] The consequences of some corporate crimes, as seen in *HSBC*, can be as severe as financing terrorist groups and criminal enterprises that wreak havoc throughout the world.[117] The financial crash of 2008 demonstrated that corporate misconduct, if not prevented, can lead to a global economic downturn.[118] As such, it is imperative for federal prosecutors to be able to hold corporate officials accountable for their negligent or active roles in these crimes to protect Americans' physical safety and economic security.[119] Due to the complexity of the corporate structure and the insulation of corporate employees during internal investigations, it can be extremely difficult for prosecutors to gather the information and evidence necessary to prove the mens rea of corporate wrongdoers.[120] The *Park*

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that led to drug recalls).

115. *See* United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160, 166 (D.D.C. 2015) (rejecting the government's proposed DPA to Fokker for intentionally violating U.S. sanctions to ship military equipment to Iran); United States v. HSBC Bank USA, N.A., No. 12–CR–763, 2013 WL 3306161, at *8 (E.D.N.Y. July 1, 2013) (granting HSBC a DPA for money laundering $881 million for drug cartels and terrorist groups); Protess & Ivory, *supra* note 4 (noting that GM received a DPA without any individual employees being charged for intentionally failing to disclose a safety defect that caused 124 Americans to lose their lives in fatal car accidents and injured many others).

116. *Park*, 421 U.S. at 676; *see also* Peter R. Reilly, *Justice Deferred Is Justice Denied: We Must End Our Failed Experiment in Deferring Corporate Criminal Prosecutions*, 2015 B.Y.U. L. REV. 307, 341–42 (2015) (noting that the failure of the government to bring to justice the individual corporate employees responsible for the financial crisis and only granting the corporations or financial institutions DPAs exposed weaknesses in our prosecution system).

117. *HSBC*, 2013 WL 3306161, at *8–9.

118. *See* Jessie Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis,* N.Y. TIMES (Apr. 30, 2014), http://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html (noting the role corporate criminals played in causing the 2008 global financial crisis).

119. *Too Big to Indict*, N.Y. TIMES (Dec. 11, 2012) [hereinafter *Too Big to Indict*], http://www.nytimes.com/2012/12/12/opinion/hsbc-too-big-to-indict.html ("When prosecutors choose not to prosecute to the full extent of the law in a case as egregious as [HSBC], the law itself is diminished. The deterrence that comes from the threat of criminal prosecution is weakened, if not lost.").

120. Dayen, *Market–Rigging*, *supra* note 5 ("[W]e already have serious hurdles to piercing the 'corporate veil' by untangling the layers of management and reaching those ultimately responsible for fraud and abuse.").

doctrine should be extended to crimes that threaten economic and national security, not only for the safety of thousands of Americans, but also for the world at large.[121] The *Park* rationale of protecting American consumers from harmful foods or drugs should certainly be extended to other sectors where corporate crimes pose similar, if not greater, risks.[122]

Extending this doctrine to crimes that have the potential to severely threaten the economic or national security of the United States is consistent with the Yates Memo's policy to increase individual accountability for corporate crimes.[123] The Supreme Court's intention in *Park* was to enable the government to hold corporate employees accountable for endangering Americans with unsafe food, drugs, or cosmetics, even if the employee lacked mens rea for the violation.[124] The same rationale should apply to instances of national security or economic security. The economic crash of 2008 was in large part due to corporate misconduct and affected thousands of Americans.[125] Crimes like those in *HSBC* and *Fokker*, have the potential to affect hundreds of thousands of Americans' safety or financial security.[126] Rather than passing the proposed mens rea requirement of the Sentencing Reform and Corrections Act of 2015, Congress should make it easier for prosecutors to hold corporate criminals accountable for misconduct that threatens large segments of the American population.[127] Congress should instead extend the *Park* Doctrine's and corporate criminals accountable for their actions even if a showing of mens rea requirement is not met.

The prosecution of a single company that engaged in crimes that threaten the national security or economic stability of the country can have enormous repercussions on the national and global economy.[128] Other

121. United States v. Park, 421 U.S. 658, 676 (1975); *see also* GARRETT, TOO BIG, *supra* note 16, at 252 (noting the concern about the failure to prosecute banks that are vital to the global financial system when their crimes have a negative impact on the national and world economy).

122. *Park*, 421 U.S. at 676.

123. Yates Memo, *supra* note 43.

124. *Park*, 421 U.S. at 677; Hyman, *supra* note 150.

125. Sirota, *supra* note 1.

126. *See, e.g.*, United States v. Fokker Servs. B.V., 79 F. Supp. 3d 160, 166 (D.D.C. 2015) (regarding a company shipping aircraft equipment to Iran, Sudan, and Burma in violation of U.S. sanctions and national security interests); *see also* United States v. HSBC Bank USA, N.A., No. 12–CR–763, 2013 WL 3306161, at *8 (E.D.N.Y. July 1, 2013) (regarding HSBC bank money laundering illicit funds for drug cartels and terrorist organizations).

127. *See generally* Sentencing Reform Act of 2015, H.R. 3713, 114th Cong. (2015); *Too Big to Indict*, *supra* note 119.

128. GARRETT, TOO BIG, *supra* note 16.

corporations will be deterred from engaging in this egregious misconduct if individual employees and executives are held accountable through the extension of the *Park* doctrine.[129] At present, in two–thirds of cases involving DPAs, the company was punished but no employees were prosecuted.[130] After the Yates Memo, prosecution of corporate individuals as a term to DPAs must be consistently enforced.

CONCLUSION

The continued use of DPAs that exclude individual accountability is not consistent with the policy set forward in the September 2015 Yates Memo. The current use of DPAs in the resolution of corporate crimes where employees intentionally and willfully violated the law is inadequate and does not protect the United States' security or economic stability.

The egregious nature of these mass corporate crimes and the leniency of recent DPAs towards corporate employees calls for judicial review of DPAs. DPAs should not be exempt from judicial review, as the courts have a longstanding supervisory role over the use of prosecutorial discretion. Congress should amend the Speedy Trial Act to further clarify the appropriate role of judicial oversight for DPAs and reject the mens rea amendment to the Sentencing Reform and Corrections Act of 2015 to prevent undermining individual accountability for white–collar crimes. Congress should instead adopt an amendment to the bill extending the *Park* doctrine, requiring strict liability for crimes that threaten the United States' national security or economic stability. Lastly, when the government decides to enter into a DPA, the government should require that the company comply with turning over information about individual wrongdoers before receiving cooperation credit, in accordance with the Yates Memo. These DPAs should be accompanied with individual charges for corporate wrongdoers. By implementing these adjustments to the prosecution of companies and their employees the United States will continue on a road to a secure nation and a stable economy that will allow the nation to prosper.

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129. *Park*, 421 U.S. at 676; GARRETT, TOO BIG, *supra* note 16; *Too Big To Indict*, *supra* note 119.

130. GARRETT, TOO BIG, *supra* note 16.

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