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SYMPOSIUM ARTICLES INTRODUCTION

STEVEN G. SHAPIRO*

In the vast arena of American commerce, there are political decisions, regulations, and court decisions that, in compression with volatile economic forces, create a combustible mix across industries. Hints of change, expressions of public policy shifts, and exercise of political might that threaten established principles and market expectations can create instability among participants, often resulting in crippling uncertainty. At the same time, there is persistent tension with calls for policy shifts, advocating to correct perceived unfairness among participants.

The first two Articles contained within this Issue are written by two panelists who presented at the American University Business Law Review's recent symposium, *Hospitality for the Employee: Where Business, Employment, and the Hospitality Industry Intersect*, on March 27, 2015 at Arent Fox LLP. They look at the somewhat stunning evolution, maybe even revolution, in recent decisions on "joint-employer liability," a cornerstone of the important American franchising economic model. The shifting interpretation of what it means to be a joint employer creates a blurry line with bright consequences. That line is the demarcation of actions and consequent liability of a franchisor for the business operations of a franchisee.

Until recent rulings by the National Labor Relations Board ("NLRB"), industries had fairly reasonable certainty of boundaries defining the limits of action by a franchisor. The accepted notion was that to be a joint employer the franchisor must have actually exercised direct control over the employees of the franchisee. Such essential terms of control included hiring, discipline, supervision, wages, scheduling, and work assignments.

In the new rulings, the NLRB has declared that joint-employer status can

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be created by the possession of authority to control essential terms or conditions of employment of the franchisee's employees. More starkly, joint-employer status can be applied even if the franchisor does not actually exercise such authority. As a result, the new analysis includes indirect as well as direct control.

Franchising encapsulates a variety of economic models, but the concept has evolved in a steady progression as a way to bring often disparate participants together and to match idiosyncratic strengths and weaknesses. In hotel operations, a franchisor licenses the intellectual property of the brand name, embedded with operating manuals for guidance, plus standards for maintaining the brand. In fast food operations, the franchisor provides logos and operating manuals, plus furnishes equipment and inventory. Regardless of the type of industry, the franchisor generally seeks to be removed from routine decisions. The franchisor has selected a model so that it is entitled to earn a fee for providing intellectual capital and expertise to the franchisee operating the fundamental business, while at the same time limiting its exposure to legal liability of the operations.

To be sure, there are entrepreneurs able to create a valuable concept for a business, raise funding to develop and launch the idea, and expertly manage the many tasks of operations. To "create a valuable concept" can mean excruciating experimenting and tinkering, finally resulting in intellectual property to protect the business idea. To "raise funds" can mean equity funding and debt, often daunting tasks for a new business. To "expertly manage a business" includes management, marketing, and financial engineering, difficult tasks when a company is thriving and growing. Or, perhaps, the business owner must manage a failing operation, needing clear direction and steady guidance.

Each of these seemingly simple conceptual steps can be wildly difficult in practice, and parties are often not equipped, or do not care, to assume risks better managed by others. An investor, with access to funds and experience in a business, may look for the next idea and ways to expand. At the same time, the entrepreneur, having created a concept, may lack access to financing or lack the ability to manage a thriving business. In reaction to these realities, franchising is a tool to bring the various parties together with complex legal documents detailing the nature of the relationships. By authority of the franchise agreement, the franchisee becomes the principal operator of a business, working in proximity with customers and employees.

Like other areas of business, legal tools and bargaining power have been used to correct abuse, reward success, and mandate government oversight when needed. The fundamental concept of the joint-employer definition is that certain parties should be beyond the reach of liability for issues where they have no real control or authority to act. In the blur of history, regulation, and practice, industries have relied on basic expectations in franchise arrangements regarding exposure to liabilities as a joint employer. Franchisors, in carefully drafted agreements, and in practice, have been mindful to honor these mandates. The legal interpretations, embodied in the laws, reinforced in the courts, and honored in practice, have created these expectations.

We cannot pretend that rules and traditions should remain static or are intended to be inflexible to change. There are constant political pressures from interested parties, plus shifts in response to changes in technology and innovation. The result is a tension, sometimes exquisite and often fierce, between stability and tradition pushing against needs for dramatic change.

The NLRB—by a process mixed with policy, politics, and economics—has upset the known precedents. In sudden and sweeping changes, the NLRB has restated or redefined the liability of the franchisor for actions of the underlying company. By tradition, the franchisor was protected from these notions of liability unless it was a direct participant. Under the proposed rules for indirect or possible control, franchisors could face liability for franchisee actions, *i.e.*, labor unions organizing employee actions for unfair practices.

We cannot comment on rational economics, cannot pass judgment on the exercise of political might, and cannot offer our vision of fairness. For our purposes, we are concerned with the many possible impacts from this stated change by the NLRB.

With the NLRB rulings, there have been screaming responses by franchisors, who are sure to take action aimed at minimizing the impact of these current administrative rulings. It is unclear if the rulings, issued at the administrative level, will be confirmed by the courts or honored by other agencies. It is unclear if the next Presidential administration will confirm these results. And, of course, Congress may enact laws to specifically delineate a new view of joint-employer liability.

If the revisions to joint-employer definitions remain in effect, there will likely be procedural and practical changes in the various franchise communities. For example, the price of franchising may increase as risk of liability increases, or the parties to franchise agreements may begin to seek profound contract modifications in response to the NLRB rulings.

A teaching colleague of mine often says that "everything costs something." It is, of course, a shorthand reminder that, in commerce and in business transactions, decisions and posturing often result in a calculation: weighing the explicit measure of expected cost and the implicit sense of risk judgment in the willingness of a parties in a transaction to raise or lower price. The shift in joint-employer rulings will certainly "cost something."

In the Articles that follow, the authors will explore the reasoning of the recent rulings and offer predictions about whether the rulings will likely stand. If we are indeed in this new era of joint-employer liability, the authors will plot the trajectory for a new understanding of franchising and the relationships among franchisor, franchisee, employees, and, ultimately, the consumer.

SYMPOSIUM ARTICLES

IT IS TIME FOR SOMETHING NEW: A 21ST CENTURY JOINT-EMPLOYER DOCTRINE FOR 21ST CENTURY FRANCHISING

STEVEN A. CARVELL* AND DAVID SHERWYN**

The United States is competing in a 21st century global economy, and this leads to 21st century employment relations issues. Unfortunately, the government, courts, and administrative agencies are trying to solve these 21st century global problems with agency theory, joint-employer doctrine, single entity doctrine, and apparent authority, 20th, 19th, 18th . . . century legal doctrines.

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INTRODUCTION

The joint-employer doctrine is perhaps the hottest issue in labor and employment law for 2015 and the foreseeable future. In the September 2015 *Browning-Ferris* ("*BFI*") decision,[1] the National Labor Relations Board (the "NLRB" or the "Board"), the administrative agency that enforces the National Labor Relations Act (the "NLRA" or the "Act"), issued what is expected to be the first of two decisions, expanding the joint-employer doctrine. In the *BFI* decision, the so-called putative employer (*e.g.*, the lessor of employees or a franchisor) is now considered the employer of individuals who had in the past been considered employees of the supplier employer. Like in *Browning-Ferris*, a number of McDonald's employees and the Service Employees International Union ("SEIU") are arguing that the world's largest franchisor is the joint employer of all its franchisees' employees.[2] At first blush, one might believe that this is another esoteric labor and employment law issue that only lawyers and scholars care about. However, depending on how the Board and courts rule on this issue, the joint-employer doctrine could fundamentally change business in the United States by destroying the franchise model.

The purpose of this Article is to fully explore the joint-employer doctrine in the franchise industry. It provides a quick overview of the history and breadth of the franchise industry. Included in this Section is an analysis of

1. *See generally* Browning-Ferris Indus., Inc., 362 N.L.R.B. No. 186 (2015).

2. *See NLRB Office of the General Counsel Issues Consolidated Complaints Against McDonald's Franchisees and their Franchisor McDonald's, USA, LLC as Joint Employers*, NLRB (Dec. 19, 2014), https://www.nlrb.gov/news-outreach/news-story/nlrb-office-general-counsel-issues-consolidated-complaints-against.

why employers/people become franchisors and franchisees. Section II analyses the joint-employer doctrine with regard to franchisees and franchisors. This section not only explores the current state of the law, but it also discusses the arguments presented by the Board, the EEOC, and other employee advocates to expand the doctrine. Section III discusses the latest administrative decision on the joint-employer doctrine. Section IV notes that expanding the joint-employer doctrine will be counterproductive to employees unless all, or at least substantially all, franchisees' employees are joint employees of their franchisors. Section V explains that, because there is now too much focus on legal concerns, our country is ignoring the realities of the modern workplace and the realities of the modern consumer and that governmental entities should look for a "third way" to protect employees while also protecting the franchise model.

I. FRANCHISING HISTORY AND STRUCTURE

At its most basic level, franchising is a business model where the brands/franchisors contract with franchisees to own/operate outlets of the franchisors' business. The franchisees own the business, generally use their own capital to build/build out/lease the property, employ the employees, are liable for any employment or tort lawsuits, and keep all the profits. The franchisors, among other things, charge the franchisee an initial franchise fee and take a royalty fee through a percentage of the gross revenue from on-going operations. In addition, the franchisor charges the franchisee additional fees for marketing and advertising. The sum of these fees can be substantial, often exceeding ten percent of total revenue.[3]

In exchange, franchisors provide their franchisees with a business model, brand recognition, education for the franchisees on how to operate their businesses, and other services. Most importantly, franchisors provide the franchisees with a brand that holds the promise of creating value through brand loyalty, brand awareness, perceived quality/consistency, and brand image.[4] In a world where everything, such as restaurants; clothes; and athletes, are considered "brands," the value of a brand's equity cannot be underestimated. The model works for both sides of the contract because franchisees get a turn-key business with support while franchisors get to expand relatively quickly without absorbing substantial financial risk and while tapping into their own scarce capital resources. This does not mean, however, that there is no risk involved. With each additional new

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3. *See* Stephen Rushmore, Jr. & Erin S. Bagley, *2014 United States Hotel Franchise Fee Guide*, HVS GLOBAL HOSPITALITY SERVICES 2, 9–11 (Oct. 5, 2014), http://www.hvs.com/Jump/Article/Download.aspx?id=7097.

4. *See generally* D.A. Aaker, *Measuring Brand Equity Across Products and Markets*, 38 CAL. MGMT. REV. 102 (1996).

franchisee, the franchisor risks its brand equity. Will the franchisees fail to live up to brand standards? If they fail to comply with brand standards, will the consistency and quality that drives the consumer to choose the brand be compromised? The value to a firm of their brand equity, or loss thereof, is substantial and is of paramount importance to the ongoing concern.[5] To mitigate this risk, franchisors require their franchisee partners to sign long, complex contracts in which the franchisees promise to uphold brand standards (*e.g.*, the prescribed type of TV in a hotel room, a standard of cleanliness, and/or quality of the product). Franchisees who fail to comply with these brand standards are generally given a period of time to cure the defect and to comply with the contractual terms, or the franchisees can have their agreements terminated, risking "losing" the franchise.

Franchisees also face risk. Franchisees are responsible for all of the initial capital expenses—money that is lost if the business fails or if the franchisor eventually terminates the contract. Of course, failed franchises or franchises that are terminated have the effect of making the franchisors appear less appealing business partners to new franchisees. For the reasons above, the relationships are symbiotic; both sides are invested in each other and truly want the franchise to succeed.

Franchising has been part of the industrial culture since the 1800s, when Isaac Singer, of sewing machine fame, realized he could not sell and service his patented machines nationwide by himself. He therefore "sold" franchises to local employers.[6] The world's most famous franchisor is probably Ray Kroc, a milkshake machine salesman who went into business with, and ultimately purchased the name and concept from the McDonald brothers, who owned several hamburger restaurants.[7] Since that time, other restaurants, hotels, car repair shops, health clubs, and numerous other businesses have used franchising as a method for expanding their businesses in terms of the number of units, revenue, and profits. The International Franchising Association estimates that as of January 2015 there were over 781,794 franchised establishments operating across

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5. *See* Kevin L. Keller, *Conceptualizing, Measuring, and Managing Customer Based Brand Equity*, 57 J. OF MKT. 1, 8–9 (1993). *See generally* Vijay Mahajan et al., *An Approach to Assess the Importance of Brand Equity in Acquisition Decisions*, 11 J. PROD. INNOVATION MGMT, 221 (1994). For franchisors, brand equity is the Holy Grail—it incentivizes franchisees to buy a franchise, it drives consumers to the unit and thus drives revenue. Brand equity is what the franchisor creates, maintains, and sells.

6. *See* Andrew B. Jack, *The Channels of Distribution For an Innovation: The Sewing-Machine Industry in America, 1860-1865*, 9 EXPLORATIONS IN ENTREPRENEURIAL HIST. 113 (1957).

7. *See generally* Claudio Vignali, *McDonald's: "think global, act local" - the marketing mix*, 103 BRITISH FOOD J. 97 (2001).

numerous sectors of the U.S. economy.[8] Moreover, franchising has become a vehicle for entrepreneurs seeking to mitigate risk and improve profitability.[9] Due to its attractiveness, franchising has become an enormous employer of workers, as well as an important source of tax revenue. According to estimates from the U.S. Census Bureau, franchisees employ 7.9 million employees and are responsible for $153.7 billion in total payroll, as well as $1.3 trillion in total sales.[10]

The reason why parties franchise has been the subject of numerous academic studies, and a full analysis is beyond the scope of this Article. However, it is important to quickly address "the why." From the franchisee's standpoint, the motivation for franchising can be readily identified and understood. Franchising reduces the franchisee's risk because of the brand's value to the consumer, the network of support, and the services provided (advertising, hotel reservation systems, loyalty programs etc.). Indeed, financial performances of independent businesses are significantly lower than those of comparable businesses that are franchisees.[11] Also, the probability of financial failure has been shown to be lower for firms that franchise versus those that operate as independent businesses.[12]

For the perspective of the franchisor, the reason for franchising is more complex. At its most basic level, academics have identified two primary motivations for franchising: "capital scarcity" and "agency conflict." Capital scarcity is easy to understand since franchisees use their own (or borrowed) capital and they assume the financial risks. Thus, the franchisors can expand their brands without raising and risking their own capital. Agency conflict is more complicated. Given the existence of

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8. *See Franchise Business Outlook for 2015*, INT'L FRANCHISE ASSOC. 1, 2 (Jan. 2015), http://emarket.franchise.org/FranchiseBizOutlook2015.pdf.

9. *See generally* Patrick J. Kaufmann, *Franchising and the Choice of Self Employment*, 14 J. BUS. VENTURING 345 (1999); Russell M. Knight, *The Independence of the Franchisee Entrepreneur*, 22 J. SMALL BUS. MGMT. 53 (1984).

10. U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, 2007 ECONOMIC CENSUS FRANCHISE REPORT http://www.census.gov/econ/census/pdf/franchise_flyer.pdf. (last visited Nov. 15, 2015).

11. *See* Melih Madanoglu et al., *Franchising and firm financial performance among U.S. restaurants*, 87 J. OF RETAILING 406 (2011) (comparing the risk adjusted financial performance of restaurant firms that were franchised and non-franchised between 1995-2008 using five commonly employed financial performance measures. For each measure, franchising restaurant firms outperformed their non-franchising counterparts.).

12. *See* Paul Ingram & Joel A. C. Baum, *Chain Affiliation and the Failure of Manhattan Hotels, 1898–1980*, 42 ADMIN. SCI. Q. 68 (1997) (finding that, under most circumstances, chain affiliation improved the chances of survival for 558 hotels that operated in Manhattan between 1898 and 1980).

conflict in goals between principals and agents, at least three agency problems may exist when combined under the conditions of incomplete information and uncertainty: 1) moral hazard, where the principal will not be able to ensure that maximum effort is put forth by the agent; 2) adverse selection, whereby the principal may have difficulty assessing and ensuring the agent's quality; and 3) hold-up, where one or both parties will act opportunistically.[13] At its most basic level, agency conflict, in this context, stands for the proposition that, because franchisees are owner/managers, they will be more invested in the efficient and profitable operation of the business than company employees of the franchisor, and thus, they will work harder, be more honest, and do a better job. Furthermore, franchisees are, in the theory, local owners who know the idiosyncrasies of their local market better than the national franchisor and can better understand and serve the local consumer. The franchisor, however, must endure the cost of constantly monitoring franchisees to ensure they comply with their contracts and do not engage in opportunistic behavior that may benefit them at the expense of the franchisor and the brand. This Article considers much of the traditional agency conflict arguments unhelpful because they provide conflicting motivations regarding the tendency to franchise and do not reflect the modern realities of the franchise business environment.

First, it is not at all clear that franchisee owners will work harder than "company managers" seeking to move up the corporate ladder. Both types of managers have incentives to do the best they can, but the franchisee's manager's interests are often less aligned with the brand than are the company's own employee managers. This is the case for two reasons. First, there is a difference in what the franchisors and franchisees value: franchisees benefit from profits, while franchisors benefit from the unit's gross revenue. Second, the franchisee may not be as loyal to the brand as are the company's managers. In the modern world, many franchisees operate numerous brands. Indeed, there are several large hotel franchisees that own and operate Hilton, Marriott, and Choice brand hotels. It stands to reason that managers of hotels who work for these large franchisees, seeking to rise in the organization, will be more loyal to the franchisee company than the brands that they currently manage. Conversely, a manager who works for the brand must value and protect that brand. Unit-level managers who do not protect the brand are easily fired, while franchisees and their managers can free-ride off those who protect the brand and while skimping on brand standards. Company-owned units, therefore, are likely to have lower monitoring costs than franchised outlets,

13. *See* Scott Shane, *Explaining the Distribution of Franchised and Company-Owned Outlets in Franchise Systems*, 24 J. OF MGMT. 717, 717–39 (1998).

especially when the franchisee is a multi-unit owner.

With regard to local ties and local owners, the world has changed. Among large franchise organizations, there are numerous franchisees that operate literally hundreds of franchisees. For example, Carrols Restaurants Group Inc., after a recent $15.8 million transaction, owned a total of 575 Burger King Outlets across the United States, making it the system's largest single owner.[14] Similarly, eighty-eight percent of McDonald's owners own more than one store, with the average franchisee owning about five outlets.[15] The owners of these franchises are not necessarily "on the ground," and they do not necessarily have any more specific local knowledge than does the national franchisor. Instead, they are now, more than ever, large corporations with general managers, regional managers, legal staffs, human resource departments, and the entire range of corporate complexities that are not much different than the franchisor's own corporate structure, including the same concerns relating to agency conflicts and managerial shirking. The motivation to franchise, certainly among the larger brands, has clearly shifted due to some of the following factors: 1) the growth of multi-unit large corporate ownership; 2) the homogenization of the American consumer that has taken away, in many product categories, the need for local knowledge; 3) the availability of capital for large brands (whether they franchise or not); and 4) the company run units have similar or even lower brand monitoring costs than franchised outlets. Thus, the motivation has shifted toward a different paradigm: "capital agency."

The idea behind capital agency is simple: 1) it takes substantial time and the use of capital and other firm resources to operate a business; and 2) franchisors would rather focus on their brands, and the market value of the brand equity derived from it, than on day-to-day operations. The franchisor does not want to invest in the infrastructure to manage hundreds or thousands of employees and properties. Instead, it wants to offload that task to another party: in this case, the franchisee. For instance, there is evidence of this throughout the quick service restaurant industry as companies like McDonald's and Burger King are decreasing the number of owned units. As explained above, contrary to agency conflict theory, the franchisors are not motivated toward a choice between company-owned and franchised units because they believe that the franchisee will have an

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14. Angus Loten, *The Big Get Bigger*, WALL ST. J., (May 18, 2012, 2:04PM), http://www.wsj.com/articles/SB10001424052702304723304577370431589231276?alg=y.

15. *2015 Franchise 500: McDonald's At A Glance*, ENTREPRENEUR MAG. (2015), http://www.entrepreneur.com/franchises/mcdonalds/282570-0.html (last visited Nov. 17, 2015).

owner on the ground who will be more invested in the brand than a company manager would be.

Instead, our capital agency theory is based on focus, know-how, cost, and risk. Franchisors are experts in brand management. Brand management is a different skill-set than human resource, property, and operational management. The brands recognize this as does Wall Street. Wall Street has long favored hotel companies that do not own real estate (a reason why most publicly traded hotel companies no longer own their hotels), and Wall Street is even more favorable to franchisors who, in addition to having no risk of infrastructure exposure and capital expenses, now have limited management expenses and no employee and tort liability associated with owning and operating the businesses. The franchisor contracts with a franchisee to operate the business. If the franchisee is a single-unit operator, the franchisor hopes that the personal incentive will lead to top performance. If the franchisee is a large company, the franchisor is trusting its brand to an operating expert. Regardless, the franchisor is allowed to greatly limit its focus on operating infrastructure and liability. This Article, therefore, argues that capital agency is the logical driver of the franchise model; unless, of course, the law changes, and capital agency is no longer possible.

II. THE JOINT-EMPLOYER DOCTRINE

The reason that the franchisor/franchisee relationship is now at issue is that the NLRB, the U.S. Department of Labor ("DOL"), the Equal Employment Opportunity Commission ("EEOC"), and plaintiffs' lawyers are bringing employment related lawsuits against franchisors on behalf of franchisee employees. The franchisors' response has been, predictably, to contend that they are not the employer and that they should not be a party to such actions. The administrative agencies listed above, as well as the plaintiffs' lawyers, state this contention by arguing that the franchisee and franchisor are together "joint employers," which means that the employee has two (or more) employers responsible for any employer obligations and liabilities. The question is simple: when are two or more entities "joint employers"? The answer is complex for two reasons. First, different agencies apply different tests, and thus, there are different standards across statutes. Second, as in all areas of administrative law, the agencies often push to change standards. Thus, our country has different standards between statutes and agencies, and agencies are attempting to change the laws that they enforce. Below, this Article tries to make sense of the legal side of the joint-employer doctrine.

In the employment context, there are three different administrative agencies whose use of the joint-employer doctrine is relevant to employers on a day-to-day basis: the EEOC (Title VII of the Civil Rights Act of 1964 ("Title VII"),[16] Age Discrimination in Employment Act ("ADEA"),[17] and Americans with Disabilities Act ("ADA");[18] the DOL (the Fair Labor Standards Act ("FLSA");[19] and the NLRB (the NLRA).[20] As stated above, each agency employs a somewhat different test to determine joint-employer liability.

A. The Joint-Employer Standard under Title VII of the Civil Rights Act of 1964 As It Applies to Franchising

Title VII imposes liability for employment discrimination on "the employer," who is defined by the statute as "a person engaged in an industry affecting commerce who has fifteen or more employees for each working day in each of twenty or more calendar weeks in the current or preceding year, and any agent of such a person."[21]

With regard to franchising in Title VII cases, "[a] franchisor is not a joint employer unless it has significant control over the employment relationship."[22] Under this standard, a franchisor is considered a joint employer only if the franchisor exercises significant actual control over employees' terms and conditions of employment.[23]

For example, in *McFarland v. Breads of World*, the court found no joint-employer relationship between a franchisor and franchisee because the franchisor showed that "it played no role at all in [the franchisee's]

16. 42 U.S.C. § 2000e(2) (2015).
17. 29 U.S.C. §§ 621–634 (2015).
18. 42 U.S.C. §§ 12111–12117.
19. 29 U.S.C. §§ 201–262.
20. *Id.* §§ 151–169.
21. 42 U.S.C. § 2000e(b); *see also* Cook v. Arrowsmith Shelburne, Inc., 69 F.3d 1235, 1240 (2d Cir. 1995) (citing Spirt v. Teachers Ins. & Annuity Ass'n, 691 F.2d 1054, 1063 (2d Cir. 1982)) (describing the term "employer" as "sufficiently broad to encompass any party who significantly affects access of any individual to employment opportunities, regardless of whether the party may technically be described as an 'employer' . . . at common law"); Lima v. Addeco, 634 F. Supp. 2d 394, 399 (S.D.N.Y. 2009) (citing Goodwin v. Orange & Rockland Utils., Inc., No. 04 Civ. 0207(WCC), 2005 U.S. Dist. LEXIS 42466, at *3 (S.D.N.Y. Oct. 14, 2005)) ("The definition of 'employer' has been construed liberally for Title VII purposes 'and does not require a direct employer/employee relationship.'").
22. Courtland v. CGEP-Surprise, LLC, No. CV-12-00349-PHX-GMS, 2013 U.S. Dist. LEXIS 105780, at *7–9 (D. Ariz. July 29, 2013) (finding that no employment relationship existed because the franchisor had independence in making employment decisions. The court reached its determination after evaluating the nature and degree of control that the entities had over the employees, including an assessment of who supervised their work, who determined their compensation, who paid them, and who had the right to hire or fire them.).
23. *Id.*

employee relations issues."[24] The plaintiff was employed by Breads of the World, a franchisee that owned and operated several Panera Bread stores, including the one where the plaintiff worked.[25] Both Panera Bread and the franchisee were named as defendants in this case in which the plaintiff alleged that he was terminated because he opposed discriminatory hiring practices.[26] On a motion to dismiss, the court considered whether the franchisor should be considered the plaintiff's employer by virtue of the franchisor/franchisee relationship between the two entities.[27] Although the court noted that "courts have been nearly uniform in holding that a franchisor should not be deemed an 'employer' for purposes of Title VII when the plaintiff works for an independently owned franchise," it cautioned that "the mere existence of a franchisor/franchisee contract does not insulate the franchisor from liability."[28] Based on the facts presented, the court held that the franchisor was not a joint employer because it offered unrebutted evidence that it played "no role at all in Breads' employee relations issues, including, but not limited to, the day-to-day supervision of Breads' employees."[29]

Similarly, in *Courtland v. GCEP-Surprise, LLC*, franchisor Buffalo Wild Wings maintained more than 470 franchised restaurants around the country.[30] The plaintiff, who alleged sex discrimination and harassment, was hired, trained on employment matters, supervised, and ultimately terminated by the local franchisee.[31] In considering whether the franchisor and franchisee were joint employers for Title VII purposes, the court looked to the nature and degree of control of the workers; the degree of supervision of the work; the power to determine pay rates or methods of payment of the workers; the right to hire, fire, or modify the employment conditions of the workers; and the preparation of payroll and the payment of wages.[32] The franchisee was responsible for hiring, firing, supervising, and training employees.[33] The franchisor was not involved with human resources ("HR") matters nor did it influence the conduct of the

24. McFarland v. Breads of the World, LLC, No. 1:09-cv-929, 2011 U.S. Dist. LEXIS 20703, at *31 (S.D. Ohio Feb. 1, 2011).

25. *Id.* at *17.

26. *Id.* at *3.

27. *Id.* at *20.

28. *Id.* at *20–21.

29. *Id.* at *31.

30. Courtland v. CGEP-Surprise, LLC, No. CV-12-00349-PHX-GMS, 2013 U.S. Dist. LEXIS 105780, at *2 (D. Ariz. July 29, 2013).

31. *Id.*

32. *Id.* at *3.

33. *Id.* at *4.

restaurant's daily operations.[34] Noting that "[a] franchisor is not a joint employer unless it has significant control over the employment relationship," the court found that no joint-employer relationship existed.[35]

Some courts have found, on the facts presented, significant enough ties between a franchisor and franchisee so as to create a joint-employer relationship. The plaintiff in *Myers v. Garfield & Johnson Enterprises, Inc.* worked as a tax preparer at Jackson Hewitt Tax Service Inc. ("Jackson Hewitt"), where as an employee, she received the "Jackson Hewitt Code of Conduct" that prohibited harassment and discrimination in the workplace, completed training modules prepared by Jackson Hewitt, used Jackson Hewitt's intranet site, and interacted with Jackson Hewitt employees.[36] The Jackson Hewitt office, where the plaintiff worked, was a franchise operated by Garfield & Johnson Enterprises, Inc.[37] The plaintiff was paid by the franchisee and not by Jackson Hewitt.[38] According to the allegations in the complaint, Jackson Hewitt had the authority to promulgate work rules, set the conditions of employment, require the franchisee's managers to submit to training and obey employment laws, and require its franchisees codes of conduct to terminate employees in certain circumstances.[39] The complaint also alleged that Jackson Hewitt participated in the daily supervision of Garfield & Johnson employees and that it assumed some degree of control over its employee records.[40] Although Jackson Hewitt did not pay the plaintiff, the court found that ties between the franchisor and franchisee were sufficient to deny the franchisor's motion to dismiss sexual harassment claims.[41]

B. The Joint-Employer Standard under the Fair Labor Standards Act

Under the FLSA, an "employer'" is defined as "any person acting directly or indirectly in the interest of an employer in relation to an employee."[42] The FLSA defines "employ" as "to suffer or permit to work."[43] This is considered among the broadest definitions of "employ" that has ever been included in any legislation, and encompasses working

34. *Id.*

35. *Id.*

36. Myers v. Garfield & Johnson Enter., Inc., 679 F. Supp. 2d 598, 600–601 (E.D. Pa. 2010).

37. *Id.* at 600–01.

38. *Id.* at 601.

39. *Id.* at 610.

40. *Id.*

41. *Id.* at 609–10.

42. 29 U.S.C. § 203(d) (2015).

43. *Id.* § 203(g).

relationships that, prior to the FLSA, were not deemed to fall within an employer-employee category.[44] Title VII's definition of an employer is "much narrower" than the FLSA's definition.[45]

There are significant implications under the FLSA to a finding that a joint-employer relationship exists. The DOL has explained, in its regulations, that when "employment by one employer is not completely disassociated from employment by the other employer(s), all of the employee's work for all of the joint employers during the workweek is considered as one employment for purposes of the [FLSA]."[46] Joint employers thus "are responsible, both individually and jointly" for compliance with all of the applicable provisions of the statute, including overtime provisions.[47] This is a basic and significant distinction between the FLSA and Title VII. As described above, joint employment under Title VII will not cause one employer to become vicariously liable for the discriminatory acts of another entity; each employer remains liable only for its own actions.[48]

As under Title VII, the existence of a franchisor-franchisee relationship does not automatically establish a joint-employer relationship in FLSA cases. Instead, courts will scrutinize the relationships between franchisors and employees of franchisees using the economic reality test.[49] The

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44. Cordova v. SCCF. Inc., No. 13CV05665-LTS-HBP, 2014 U.S. Dist. LEXIS 97390, at *3 (S.D.N.Y. July 16, 2014).

45. Haybarger v. Lawrence Cty. Adult Prob. & Parole, 667 F.3d 408, 415 n.6 (3d Cir. 2012).

46. 29 C.F.R. 791.2(a) (2015).

47. *Id.*

48. *See* Whitaker v. Milwaukee County, 772 F.3d 802, 811 (7th Cir. 2014) ("[E]stablishing a 'joint employer' relationship does not create liability in the co-employer for actions taken by the other employer."); *see also* Torres-Negron v. Merck & Co., 488 F.3d 34, 41 n.6 (1st Cir. 2007) ("[J]oint-employer liability does not by itself implicate vicarious liability [. . . .] [A] finding that two companies are an employee's 'joint employers' only affects each employer's liability to the employee for their *own* actions, not for each other's actions [. . . .]").

49. *See, e.g.*, Cano v. DPNY, Inc., 287 F.R.D. 251, 2582 (S.D.N.Y. Nov. 8, 2012); Orozco v. Plackis, No. A-11 CV-703 LY, 2012 U.S. Dist. LEXIS 91916, at *21 (W.D. Tex. July 3, 2012); *see also* Chen v. Domino's Pizza, Inc., No. 09-107 (JAP), 2009 U.S. Dist. LEXIS 96362, at *10 (D.N.J. Oct. 16, 2009) ("Courts have consistently held that the franchisor/franchisee relationship does not create an employment relationship between a franchisor and a franchisee's employees."). The *Chen* case cited other cases exploring franchisor/franchisee relationships. *See generally* Abdelkhaleq v. Precision Door, No. 5:07CV03585, 2008 U.S. Dist. LEXIS 64464, at *12 (N.D. Ohio Aug. 21, 2008) ("[T]he shared right to use the brand name of a manufacturer or distributor between a franchisor and a franchisee does not make the two a single entity for purposes of FLSA."); Marshall v. Shan-An-Dan, Inc., 747 F.2d 1084, 1088–89 (6th Cir. 1984); Howell v. Chick-Fil-A, Inc., No. 92-30188-RV, 1993 U.S. Dist. LEXIS 19030, at *15 (N.D. Fla. Nov. 1, 1993) (explaining that the owner/operator of a fast food franchise is not an employee of the franchisor, therefore, employees of the

economic reality test generally examines whether the defendant exercised "control" over each individual plaintiffs' work,[50] courts generally look to four factors: whether the putative employer (i) had the power to hire and fire the employees; (ii) supervised and controlled work schedules or conditions of employment; (iii) determined the rate and method of payment; and (iv) maintained employment records.[51] No one factor is determinative, and courts look at the totality of the circumstances in determining whether an entity has enough control to make it a joint employer.[52]

For example, in *Olvera v. Bareburger Group LLC*, the defendant moved to dismiss the complaint alleging violations of the FLSA on the basis that no employment relationship existed between the franchisor and the franchisee's employees.[53] Using the economic reality test, the court pointed to factual allegations that the franchisor defendants guided franchisees on how to hire and train employees; set and enforced requirements for the operations of franchises; monitored employee performance; specified the methods and procedures used by those employees to prepare customer orders; exercised control over the work of employees; required franchises to employ recordkeeping of operations; and exercised control over their franchisees' timekeeping and payroll records.[54] The court found that these allegations were sufficient to state a plausible claim that the franchisor defendants were the plaintiffs' joint employers under the FLSA.[55]

On the other hand, in *Singh v. 7-Eleven, Inc.*, the court found no employment relationship between a franchisor and franchisee when the franchisor retained no control over the store's day-to-day operations.[56] The plaintiff alleged that he was not properly paid for all hours worked and that both the franchisor and franchisee bore responsibility for the miscalculated payments.[57] Applying the economic reality test, the court found that the franchisor was not a joint employer of the plaintiff because there was no evidence that it exercised any control or influence over any terms and

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owner/operator are likewise not employees of the franchisor).

50. *See* Barfield v. N.Y. City Health & Hosp. Corp., 537 F.3d 132, 142 (2d Cir. 2008) (citing Carter v. Duchess Cmty. Coll., 735 F.2d 8, 12 (2d Cir. 1984)).

51. *Id.*

52. Zheng v. Liberty Apparel Co., 355 F.3d 61, 71 n.8 (2d Cir. 2003).

53. Olvera v. Bareburger Grp. LLC, 73 F. Supp. 3d 201, 203 (S.D.N.Y. 2014).

54. *Id.* at 207.

55. *Id.*

56. Singh v. 7-Eleven, Inc., No. 5 Civ. 4534, 2007 U.S. Dist. LEXIS 16677, at *18 (N.D. Cal. Mar. 8, 2007).

57. *Id.* at *4–5.

conditions of employment, including hiring and firing practices, and that the franchisee controlled work schedules.[58] With respect to the determination of the rate and method of payment and the maintenance of employment records, the plaintiff claimed that 7-Eleven Inc. ("7-Eleven") had control over payroll functions such as keeping and generating time records; withholding and paying federal and state taxes, worker's compensation premiums; delivering paychecks; filing returns; and providing employees with annual W-2s.[59] The court held that 7-Eleven's control over "these ministerial functions" did not establish an employment relationship.[60] Because 7-Eleven was not using its own funds to pay plaintiff wages or employment benefits, no joint-employer relationship existed.[61]

C. *Browning-Ferris and the Future of the Definition of "Joint Employer" under the NLRA and the Other Labor and Employment Laws*

For the past three decades the NLRB has determined whether two separate entities are joint employers by assessing whether they exert such direct and significant control over the same employees that they "share or codetermine those matters governing the essential terms and conditions of employment [. . . .]"[62] The Board has long applied this analysis by evaluating whether a putative joint employer "meaningfully affects matters relating to the employment relationship such as hiring, firing, discipline, supervision, and direction" and whether the entity's control over such matters is direct and immediate.[63] This decades-old standard affords

58. *Id.* at *11–16.

59. *Id.* at *17.

60. *Id.*

61. *Id.*

62. TLI, Inc., 271 N.L.R.B. 798, 798 (1984); Laerco Transp. & Warehouse, 269 N.L.R.B. 324, 325 (1984).

63. Airborne Freight Co., 338 N.L.R.B. 597, 597 (2002) (citing *Laerco Transp.*, 269 N.L.R.B. at 325; *see TLI Inc.*, 271 NLRB at 798 (citing *Laerco Transp.*, 269 N.L.R.B. 324 (1984)); *see also* SEIU Local 32BJ v. NLRB, 647 F.3d 435, 443 (2d Cir. 2011) (finding that supervision which is "limited and routine" in nature does not support a joint-employer finding, and that supervision is generally considered "limited and routine" where a "supervisor's instructions consist primarily of telling employees what work to perform, or where and when to perform the work, but not how to perform the work") (citation omitted); Holyoke Visiting Nurses Ass'n v. NLRB, 11 F.3d 302, 307 (1st Cir. 1993) (finding joint-employer status where the putative joint employer had "unfettered" power to refuse to hire certain employees, monitored the performance of referred employees; assumed day-to-day supervisory control over such employees, gave such employees their daily assignments, reports, supplies, and directions; and held itself out as the party whom employees could contact if they encountered a problem during the work day); Carrier Corp. v. NLRB, 768 F.2d 778, 781 (6th Cir. 1985) (finding joint-employer status where the putative joint employer "exercised substantial

companies stability and predictability and allows for effective collective bargaining between unions and the employer that actually sets the terms and conditions of employment.

In 2014, in *BFI*, the NLRB invited briefing on whether to alter its long-established "direct control" standard.[64] Multiple briefs were submitted addressing whether the Board should adhere to the established standard and, if not, what standard the Board should adopt.

The General Counsel of the NLRB submitted an amicus brief in *Browning-Ferris* urging that the Board adopt a joint-employer standard that would "make no distinction between direct, indirect, and potential control over working conditions and would find joint-employer status where 'industrial realities' make an entity essential for meaningful bargaining."[65] The General Counsel's brief argued that this expansive test for joint-employer status was necessary because collective bargaining representatives must be capable of addressing their employment conditions with the entity that has the power to implement those terms.[66] The theory is that the exercise of limited control, or even potential control, relevant to even one aspect of an employee's conditions of employment is enough to establish a joint-employer relationship because such a determination would necessitate the putative joint employer's presence at the bargaining table.[67]

The EEOC and DOL similarly became interested in more expansive approaches to the joint-employer standard. In an amicus brief filed in the *Browning-Ferris* case, the EEOC advocated for a broad and flexible definition of "joint employer."[68] The brief quoted the EEOC Compliance Manual, which states that "[t]he term 'joint employer' refers to two or more employers that are unrelated or that are not sufficiently related to qualify as an integrated enterprise, but that each exercise sufficient control of an individual to qualify as his/her employer."[69] The EEOC argued that factors

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day-to-day control over the drivers' working conditions," was consulted "over wages and fringe benefits for the drivers," and "had the authority to reject any driver that did not meet its standards" and to direct the actual employer to "remove any driver whose conduct was not in [the putative joint employer's] best interests").

64. *See generally* Browning-Ferris Indus., Inc., 362 N.L.R.B. No. 186 (2015).

65. Amicus Brief of the General Counsel at 17, *Browning-Ferris Indus. Inc.* 362 N.L.R.B. No. 186 (2015) (No. 32-RC-109684), http://apps.nlrb.gov/link/document.aspx/09031d45817b1e83.

66. *Id.*

67. *Id.* at 23.

68. Amicus Brief of the EEOC at 5–11, *Browning-Ferris Indus. Inc.* 362 N.L.R.B. No. 186 (2015) (No. 32-RC-109684), http://www.eeoc.gov/eeoc/litigation/briefs/browning.html#_ftn1.

69. *See Special Issues Regarding Multiple Entities: Joint Employers*, 2 EEOC COMPLIANCE MANUAL § 2-III(B)(1)(a)(iii)(b) (Aug. 6, 2009), http://www.eeoc.gov/policy/docs/threshold.html#2-III-A-1 [hereinafter EEOC COMPLIANCE MANUAL]; *see also*

derived from common law principles of agency should be applied in determining whether entities exercise sufficient control over employees to establish a joint-employer relationship.[70] In applying these factors, the EEOC suggested that the relevant criteria include who hires and fires, who assigns work, who controls daily activities, who furnishes equipment, where work is performed, who pays the employee, who provides employee benefits, how the worker is treated for tax purposes, and whether the worker and the putative employer believe that they are creating an employer-employee relationship.[71]

The EEOC brief stated that "[i]n light of the remedial purposes of Title VII and the NLRA, the EEOC's joint-employer definition more accurately reflects congressional intent than the Board's definition."[72] Varied workplace relationships, in which the increasing "contracting-out of work is blurring . . . distinctions between employer and client contractor," require a flexible definition of joint employer.[73] The EEOC urged the NLRB to accept its flexible approach and to abandon the "direct and immediate control" analysis currently used by the Board.

Dr. David Weil, the Wage and Hour Division ("WHD") Administrator at the DOL since May 2014, authored a report in 2010 in which he described his view of the joint-employer standard. In the report to the WHD titled *Improving Workplace Conditions Through Strategic Enforcement: Report to the Wage and Hour Division* ("WHD Report") Dr. Weil called for clarification of the meaning of joint employment.[74]

In describing the characteristics of industries that make workers vulnerable to violations of labor standards, workplace safety, and other rights in the workplace, the WHD Report points to the "fissuring" of the employment relationship as a cause of such problems.[75] "Fissuring" arises

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EEOC Notice from Gilbert Casellas, Chairman, EEOC, EEOC Enforcement Guidance: Application of EEO Laws to Contingent Workers Placed by Temporary Employment Agencies and Other Staffing Firms (Dec. 3, 1997) (on file at http://www.eeoc.gov/policy/docs/conting.html) [hereinafter EEOC Enforcement Guidance] ("[A]ll of the circumstances in the worker's relationship with each of the businesses should be considered to determine if either or both should be deemed his or her employer.").

70. *See* Amicus Brief of the General Counsel *supra* note 66, at 10, n.17.

71. *See* EEOC COMPLIANCE MANUAL, *supra* note 69, § 2-III(A)(1), n.71 (citing Nationwide Mutual Ins. Co. v. Darden, 503 U.S. 318, 323–24 (1992)).

72. *See* Amicus Brief of the EEOC, *supra* note 68, at 11.

73. *Id.* (quoting Airborne Freight Co., 338 N.L.R.B. 597, 599 (2002) (Member Liebman, concurring)).

74. *See* DAVID WEIL, REP. TO DEP'T OF LABOR: WAGE & HOUR DIV., IMPROVING WORKPLACE CONDITIONS THROUGH STRATEGIC ENFORCEMENT 4 (May 2010), http://www.dol.gov/whd/resources/strategicenforcement.pdf.

75. *Id.* at 18.

in industries where large companies have delegated away employment and the responsibility to oversee the workforce to smaller businesses.[76] The WHD Report points to specific industries—such as retail, construction, and manufacturing—with high percentages of low-wage workers.[77] Although it addressed a variety of factors that may contribute to why "vulnerable" workers may be concentrated in specific industries, the WHD Report pointed to the *structure* of these industries as a direct cause of workforce vulnerability.[78] The employment relationship, according to the WHD Report, has shifted from large employers to a number of fragmented smaller employers, by way of franchising, subcontracting, and other related forms. These smaller entities are pressured to keep their costs as low as possible to offer low prices in a competitive market.[79] As a result, the worker-employer relationship is not clear.[80]

The WHD Report recommended that the WHD "seek to clarify joint employment in the many industries and sectors where the locus of employment has blurred."[81] Noting that there is a need to redefine joint employment as new employment contexts arise, the WHD Report recommended bringing significant cases that will require courts to consider and clarify the boundaries of employment in major industries and also in various organizational forms (*e.g.*, franchising and third-party management).[82]

The WHD Report also recommended that the WHD pursue litigation based on evidence of systemic violations across different owners linked by a common brand or high-level entity as a means of establishing joint-employer responsibility.[83] For example, according to the WHD Report, franchises, which are generally viewed as the direct and sole employer of workers, should be reexamined to determine whether the franchisor/franchisee relationship is in truth a "joint venture" due to the close relationship between the entities.[84] The WHD Report specifically noted that the WHD and Office of the Solicitor should coordinate closely "in pursuing the ambitious litigation agenda directed towards clarifying joint employment and related questions involving employer responsibility under

76. *Id.* at 19.
77. *Id.* at 20.
78. *Id.*
79. *Id.* at 20–21.
80. *Id.* at 21.
81. *Id.* at 79.
82. *Id.* at 80.
83. *Id.*
84. *Id.*

the FLSA."[85]

D. Employment and Labor Laws Differ

Title VII, the FLSA, and the NLRA all serve different purposes. Title VII aims to address discrimination in the workplace. The statute imposes liability for employment discrimination on an "employer," defined as "a person engaged in an industry affecting commerce who has fifteen or more employees for each working day in each of twenty or more calendar weeks in the current or preceding year, and any agent of such a person."[86] The joint-employer test under Title VII is rather inexact, focusing on control over general employment matters.[87] In Title VII cases, if discriminatory acts occur and two or more entities constitute joint employers, only the entity responsible for those acts will be held liable.[88] In one section of the EEOC Compliance Manual, it provides guidance addressing joint-employer relationships and suggests that the purpose of joint-employer status in the context of discrimination claims is to make an entity other than the principal employer liable for conduct relating to a specific employee.[89] The EEOC Compliance Manual, which was written for the context of temporary employment agencies sending employees to clients, specifically addresses whether an agency can be responsible for its client's discriminatory acts.[90] According to the EEOC, the firm is liable *if it participates* in the client's discrimination. For example, if the firm honors its client's request to remove a worker from a job assignment for a discriminatory reason and replace him or her with an individual outside the worker's protected class, the firm is liable for the discriminatory discharge. The firm also is liable if it knew or should have known about the client's discrimination and failed to undertake prompt corrective measures within its control.[91]

Courts, addressing situations where one of the multiple employers engaged in discriminatory conduct, therefore, will hold liable only those entities responsible for the wrongful conduct.[92]

Under the FLSA, by contrast, the issue is whether a putative joint employer may be held liable for violations of the minimum wage and hour

85. *Id.* at 90.
86. 42 U.S.C. § 2000(e)(b) (2015).
87. *See supra* pp. 12–21.
88. *See, e.g.*, Whitaker v. Milwaukee Cnty., 772 F.3d 802, 811 (7th Cir. 2014).
89. *See id.* at 811–12. *See generally* EEOC COMPLIANCE MANUAL *supra* note 69.
90. *See generally* EEOC Enforcement Guidance, *supra* note 69.
91. *See id.* (emphasis added).
92. *See* Courtland v. GCEP-Sunrise, No. CV-12-00349-PHX-GMS, 2013 U.S. Dist. LEXIS 105780, *8–9 (D. Ariz. July 29, 2013).

laws. The statutory language of the FLSA defines "employer" to include anyone acting directly or indirectly in the interest of an employer in relation to an employee, as well as the Congressional purpose of the Act, and it reflects the legal obligation to pay employees fairly.[93] In both of these employment law contexts, joint-employer status bears on economic concerns, should the entity become liable for wrongful conduct. Thus, while the joint employer may become retroactively liable for wrongful conduct, joint-employer status does not necessarily saddle the employer with any prospective, affirmative obligations.

Under the NLRA, however, the joint-employer inquiry has an entirely different purpose. Joint-employer status compels a putative joint employer to undertake myriad duties and responsibilities required under the Act: including collective bargaining and its attendant responsibilities (where the entity establishing the terms and conditions of employment is the direct employer). The NLRA is distinct from other employment laws because it establishes these broad, prospective obligations; a joint employer under the NLRA will be subject to numerous legal obligations, whereas a joint employer under Title VII or the FLSA will have mainly economic responsibilities in relation to its joint-employer status. It is under this backdrop that this Article examines the Board's recent *BFI* decision.

III. BROWNING-FERRIS

BFI is a case about employee leasing/temporary employees and not franchising. This distinction should not, however, lead one to believe that the issues are mutually exclusive and that the holding is not relevant to the franchisor/franchisee/employee relationship. The joint-employer test under the NLRB has never made a distinction between temporary employees and franchisee employees. It is possible, of course, that the Administrative Law Judge ("ALJ") will distinguish the two issues. Thus, this Article examines the *BFI* decision, knowing it applies to the temporary employees while expecting it will be applied to franchising.

As stated above, in determining joint-employer status, the Board's choice in *BFI* seemed to be whether 1) to follow the test of the last thirty years and require proof that the putative employer exerted direct and significant control over employees;[94] or 2) to return to a prior test and find such status if the putative employer simply reserved the right to exercise such control. The Board went with the latter definition. If applied in the broader context, this seemingly innocuous difference can have a

93. 29 C.F.R. § 791.2(a) (1984).

94. *See* TLI Inc., 271 N.L.R.B. 798, 798–99 (1984); Laerco Transp. & Warehouse, 269 N.L.R.B. 324, 325 (1984).

tremendous effect on the franchise industry. The Board's explanation of this new standard has three major problems: 1) it is near impossible to figure out; 2) in application, it expands the joint-employer definition; and 3) it creates perverse incentives.

A. The Standard Is Unclear

There is a threshold issue under the new test. Is the putative employer an employer under the common law definition of employer? Such a determination is, according to the Board, not always a simple task.[95] Indeed, the Board recommends looking to the 1958 Restatement (Second) of Agency ("Restatement") for guidance.[96] The Restatement provides that "a servant is person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control."[97] Clearly, this 1958 standard is nearly impossible to operationalize. To make matters worse, this standard is necessary, but it is not sufficient to establish joint-employer status. The next step, according to the Board, is control. The Board, however, does not define control. Indeed, in response to the dissent's criticism of this inexact test, the Board states the following:

> [W]e do not and cannot attempt to today to articulate every fact and circumstance that could define the contours of a joint employment relationship. Issues related to the nature of a putative joint employer's control over-particular terms and conditions of employment will undoubtedly arise in future cases—just as they do under the current test—and those issues are best examined and resolved in the context of specific factual circumstances. In this area of labor law, as in others, "'the nature of the problem, as revealed by unfolding variant situations' requires 'an evolutionary process for its rational response, not a quick, definitive formula as a comprehensive answer.'"[98]

The Board continued stating that "[t]oday's decision, however, makes it clear that 'all of incidents of the relationship must be assessed'" and that its conclusion that BFI is a joint employer is based on a "full assessment of the facts."[99] This is a long way of saying that the joint-employer status will be determined on a case-by-case basis.

The amorphous standard is not a piece of our imagination. The Board explains that it is probative if a putative employer retains the right to reject or terminate employees, set wage rates, set working hours, approve

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95. Browning-Ferris Indus., Inc., 362 N.L.R.B. No. 186, at 18 (2015).
96. *See generally* RESTATEMENT (SECOND) OF AGENCY (AM. LAW INST. 1958).
97. *Id.* § 220.
98. Browning-Ferris Indus., Inc., 362 N.L.R.B. at 16.
99. *Id.*

overtime, dictate the number of employees to be supplied, determine the manner and method of work performance, inspect and approve work, and terminate the contract at will.[100]

In a vacuum, the Board's statement does not seem so problematic because law develops through cases, and cases are decided on facts. In context, the Board's statement that "uncertainty is acceptable" is unworkable because 1) it applies to too large a percentage of the economy; and 2) its effects can define the business.

The Board notes that temporary employment is one of the largest- and fastest-growing industries in terms of employment.[101] Indeed, by 2022, there will be an estimated 4 million temporary workers.[102] Similarly, franchising is a large and growing component of the economy, accounting for more than 8.569 million employees today with estimates that employment growth in the franchise sector will continue to outpace the growth of employment in all businesses economy-wide.[103] Whether an employer is a joint employer has significant tangible consequences. A franchisor who is not a joint employer cannot enter card-check neutrality with a union (and will not be susceptible to a union's corporate campaign), cannot be picketed, has no obligation to reply to an unfair labor practice, and will not have to bargain with a union. An employer who has such obligations has every incentive to create a sophisticated HR department, will provide training to ensure NLRA compliance, and may create a union-avoidance strategy. An employer who is not a joint employer will avoid all such activities, as such could be seen as evidence of joint-employer status. Such a distinction and certainty could be the driver as to whether a nascent owner/operator franchisor would, in fact, decide to enter into the field of franchising and seek out others for franchise arrangements.

Uncertainty seems like a chamber of commerce/conservative euphemism for being anti-regulation, anti-progressive, and anti-tax. The previous statement is not this Article's argument. Because temporary workers and franchisees' employees are a rising aspect of the workforce, the Board wants such employees to be able to unionize. The Board has the power to define joint employment, and then, it should define it. Parties may litigate over it, but setting a standard, that will need decades to define, and

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100. *Id.* at 9.

101. *Id.* at 11.

102. Richard Henderson, *Industry Employment and Output Projections to 2022*, BUREAU OF LABOR STATISTICS MONTHLY LABOR REVIEW (December 2013), http://www.bls.gov/opub/mlr/2013/article/industry-employment-and-output-projections-to-2022.htm.

103. *Franchise Business Economic Outlook Infographic*, INT'L FRANCHISE ASSOC. (Jan. 2015), http://emarket.franchise.org/EconomicInfographicJanuary2015.pdf.

claiming that this is the proper way to enforce the law is, at best, disingenuous and, at worst, dangerous.

B. The New Test Expands the Reach of the Joint-Employer Doctrine

The fact that the Board is resurrecting a 30-year-old test, and that the EEOC and DOL agree, does not mean that this is not a sea-change in the American business landscape. Overruling a law that putative employers relied on and creating a much more liberal test will, of course, lead to more putative employers being named joint employers. Simply put, the new test makes reserved rights, which are standard in the vast majority of contracts and had not resulted in joint-employer status for decades, now determinative. One need not look any further than *BFI*. The Regional Director, applying the old test, found that BFI was not a joint-employer;[104] the Board, applying the new test, found BFI was a joint-employer.[105] After the *BFI* decision, numerous employers all over the country became joint employers. It is not clear which employers made this exact change.

IV. THE NEW AND OLD TEST RESULT IN HUGE COSTS OR PERVERSE INCENTIVES

The driver of the joint-employer doctrine is control. Putative employers that exercise too much control end up with joint-employer obligations. Knowing this, franchisors have done all they could to ensure that they did not cross the joint-employer line. They did this by limiting the control exercised. These limits resulted in tension between operators and counsel. Counsel wanted to ensure that its franchisor client did not cross the line. However, operators and managers wanted to preserve the brand and the business. Now, the line has been moved, and franchisors are faced with a decision: Should they 1) embrace the joint-employer status; or 2) exercise even less control and suffer the potential market consequences?

Is the *BFI* standard a positive legal development? What are the costs? What are the benefits? The benefits are that unions will be able to engage in top-down organizing, and the EEOC, DOL, and plaintiffs will be able to sue and collect from franchisors. Before exploring the "costs," this Article will examine the "benefits" of applying the new test to franchising. Some of these benefits include 1) increased union organizing; and 2) deeper pocketed defendants to sue.

A. The Benefits of BFI*: Union Organizing*

It is beyond the scope of this Article to argue whether unionization is a

104. *See Browning-Ferris Indus., Inc.*, 362 N.L.R.B. No. 186, at 1.

105. *See id.*

net gain or loss for the economy. Instead, this Article contends that there is no evidence that making franchisors joint-employers will increase unionization. McDonald's, for example, has approximately 1,500 company-owned stores, and none are unionized.[106] Will making McDonald's a joint-employer result in the approximately 13,500 franchisees unionizing? The SEIU, the union arguing that McDonald's is a joint employer, seemingly claims that McDonald's' approximately 75,000 "unit" employees are not worth organizing through top-down organizing.[107] Instead, the union will only engage in representation if it can organize 750,000 workers. Unite-Here, the world's largest hotel and restaurant union, has a total of 270,000 members. The SEIU has approximately 2 million members—half of whom are public employees from municipalities throughout the country. SEIU also represents healthcare workers like nurses, doctors, lab technicians, nursing home aides, janitors, and other employees of office and apartment buildings.[108] It makes no sense to argue that one union with 270,000 members and another with 2 million members (from over 100 occupations, who work for many small municipalities and employers) cannot waste resources on a company with 75,000 employees. Instead, the NLRB needs to change law and policy so SEIU and Unite-Here can both organize 750,000 employees. From a theoretical perspective, mass unionization is speculative. From a practical perspective, it is unrealistic.

To organize franchisee employees, both the SEIU and Unite-Here would likely use their preferred method of top-down organizing. Top-down organizing consists of using leverage to force the employer to sign card-check neutrality agreements.[109] It is worth exploring how this will play out.

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106. Steven Greenhouse, *Fight For $15: The Strategist Going To War To Make McDonald's Pay*, THE GUARDIAN (Aug. 30, 2015), http://www.theguardian.com/us-news/2015/aug/30/fight-for-15-strategist-mcdonalds-unions.

107. *See* Lydia DePillis, *Why labor groups genuinely believe they can unionize McDonald's one day*, WASH. POST (June 8, 2015), https://www.washingtonpost.com/news/wonk/wp/2015/06/08/why-labor-groups-genuinely-believe-they-can-unionize-mcdonalds-one-day/; *see also* Bill McMorris, *NLRB Opens Door for SEIU at McDonalds*, THE WASH. FREE BEACON (Dec. 19, 2014, 4:25PM), http://freebeacon.com/issues/nlrb-opens-door-for-seiu-at-mcdonalds/.

108. *See generally These fast facts will tell you how we're organized and what we do*, SEIU, http://www.seiu.org/cards/these-fast-facts-will-tell-you-how-were-organized/ (last accessed Dec. 1, 2015).

109. *See What is a "Neutrality Agreement" and how does it affect workers?*, NAT'L RIGHT TO WORK LEGAL DEF. FOUND., INC., http://www.nrtw.org/neutrality/na_1.htm (explaining that a "neutrality agreement" is a contract between a union and an employer under which the employer agrees to support a union's attempt to organize its workforce. Most neutrality agreements include a "card check" arrangement, in which employers allow unions to collect cards from workers saying they want a union, rather than putting the question to a secret vote.); *see also* Zev J. Eigen & David Sherwyn, *A*

If the *BFI* holding is expanded to franchisors, the unions would seek to force the franchisors to sign such agreements. The franchisors, regardless of their "control," will claim that they are not joint employers. The union, as it did with McDonald's, will encourage employees to file unfair labor practices and allege joint-employer status. The large franchisor may fight the determination. However, smaller franchisors will not have the resources and may have to accept the regional directors' determination. After joint status is adjudicated or accepted, the union will request and/or demand card-check neutrality. The franchisors will contend they cannot agree to that, for their current franchisees as they have no such right under their franchise agreements. The union could begin a corporate campaign which will feature boycotts, name-calling, threats, and other legal and ethical as well as arguably unethical or illegal acts. The franchisor may file a Racketeer Influenced and Corrupt Organizations Act ("RICO") action against the union.[110] If the franchisor does agree to a neutrality agreement, the franchisee may either sue or simply refuse to accept the terms of the neutrality agreement. Litigation over each of these issues will take years.

Even if all of these issues are resolved in the union's favor, the stores will still be separate bargaining units (maybe several could be considered one unit), and the union will still need the employees to sign cards to unionize. The union will then need to convince millions of employees, within an industry with huge turnover, that they will be better off signing cards when unionization typically benefits long-term employee units[111] over short-term employees. Moreover, the union's "fight for $15"[112] and other minimum wage initiatives will force employees to question what else they can get.

The evidence does not support the argument that unions will suddenly be successful with such a change in the joint-employer standard. Indeed, after the summer of 2006, Unite-Here secured numerous card-check neutrality

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Moral/contractual Approach to Labor Law Reform, 63 HASTINGS L.J. 695, 695–746 (2012).

110. *Cf.* Gregory B. Robertson & Kurt G. Larkin, *RICO: A New Tool for Employers Facing Union Corporate Campaigns?*, THE CORPORATE COUNSELOR (May 2009), https://www.hunton.com/files/Publication/972f4e96-7f57-4a07-b224-3d0edb9d1d86/Presentation/PublicationAttachment/9741b3f0-f4ee-4cb2-bbc7-27de4933caea/RICO_A_New_Tool_5.09.pdf (applying RICO to corporate campaigns).

111. *See generally* BENJAMIN I. SACHS, RESEARCH HANDBOOK ON THE ECONOMICS OF LABOR AND EMPLOYMENT LAW 157, (eds. Michael L. Wachter & Cynthia L. Estlund, 2012) (contrasting benefits for long-term and short-term employees).

112. FIGHT FOR $15, http://fightfor15.org/ (last visited Nov. 17, 2015); *see e.g.*, Laila Kearney, *Protesters rally for higher U.S. fast-food wages, union rights*, REUTERS (Nov. 10, 2015, 9:03PM), http://www.reuters.com/article/2015/11/11/us-usa-wages-protests-idUSKCN0SZ1KB20151111#pArpPoSD4EvYMkb5.97 (demanding a $15-per-hour minimum wage and union rights for certain workers).

agreements, and pundits predicted that union density in the hotel industry would rise.[113] Union density did not increase.[114] Moreover, this Article contends the card-check agreements led, in part, to the rise in boutique hotels that the union has been unable to organize and which led to the rise of management companies and franchisees who were and still are non-signatories to card-check contracts. There is simply no evidence that making franchisors joint-employers will help unionization.

The second benefit of extending *BFI* to franchising is that DOL, EEOC, and the plaintiffs' lawyers will be able to sue franchisors for legal violations. Moreover, Dr. Weil, in his latest paper concludes that franchisors and large franchisees have a much better level of compliance with the FLSA than smaller franchisees have.[115] The implication is clear: make all franchisors joint-employers and increase the levels of compliance. This theory may work if all franchisors embrace the joint-employer doctrine. But, will they? What if they do not?

B. The Cost of BFI *Applying to Franchising*

Franchisors will have to decide whether to embrace joint-employer status or to exercise less control. This decision will not be done without much thought and research. It is an empirical question for the company: what does it cost to be the employer? Some franchisors have company-operated stores. Such franchisors have extensive HR departments and labor counsel for company stores, but some franchisors do not have the corporate structures. Regardless, franchisors devote significantly less resources to HR and labor counsel for franchisees than firms do for their own employees. Further, extensive HR and counsel for franchisees' employees might be evidence of too much control. Companies that accept joint-employer status and want to ensure legal compliance will have to create infrastructure for their franchisees. The additional infrastructure building will result in additional costs without an accompanying revenue stream. In this case, who will pay? If the franchisor should pay, will the endeavor be worth it? If the franchisee does, instead, will the franchisee's endeavor be worth it? In regards to the consumers, how elastic is their demand? What will happen to profit-sharing, health insurance, and other ERISA plans?

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113. Richard W. Hurd, *The Origins, Effectiveness and Future of Neutrality Agreements*, CORNELL UNIVERSITY ILR SCHOOL (2008), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1305&context=articles.

114. MIA GRAY, A HOSPITABLE WORLD?: ORGANISING WORK AND WORKERS IN HOTELS AND TOURIST RESORTS 181 (eds. David Jordhus-Lier, Anders Underthun, 2015).

115. *See generally* MinWoong Ji & David Weil, *The Impact of Franchising on Labor Standards Compliance*, 68 ILR REV. 977, 991–1006 (Oct. 2015).

Will franchisors have to include franchisees' employees in such plans? If they do not, what will the costs be? Will franchisors eliminate such employee benefits? The questions can eventually be answered, but they will take years to be determined. In the meantime, what should franchisors do?

Franchisors who cannot or will not embrace joint-employer status now have a perverse incentive to 1) exercise even less control; and 2) only franchise with established franchisees and no longer work with smaller entrepreneurs. A franchisor looking to insulate itself should exercise as little control as possible. Of course, brand standards may be compromised to the dismay of consumers and operators, but legal liability will be reduced. The question is the following: who does this new joint-employer standard help? Will a franchisee's employees be better off if the franchisor is incentivized to be even further hands-off than they are now? Currently, franchisors, fearing being accused of exercising too much control, may advise, but they would never require legal compliance training, sexual harassment policies, wage and hour audits, and other practices that sophisticated HR departments provide and that franchisors provide for their own stores. Now, franchisors will provide even less guidance. Does this help society? Established businesses, with reputations at stake and deep pockets to draw upon, will work to ensure legal compliance. Fledgling franchisees will often have neither the resources nor the knowledge to fully comply. As proof, there is no better source than Dr. Weil's paper.[116] As stated, Dr. Weil found that small franchisees violate wage and hour law at a much greater rate than franchisees with more than 110 outlets (large franchisees) and franchisors.[117] Dr. Weil posits a number of reasons for this phenomenon. Specifically, Dr. Weil contends, franchisors and large franchisees because they 1) have a higher probability of being caught by the government for non-compliance; 2) have more resources because they do not pay franchisee fees or because of their size the fees are not onerous; and 3) stay more loyal to the brand and fear hurting it by not complying with the FLSA.[118]

Dr. Weil does identify the most obvious reason for his findings: small franchisees, those with 110 outlets or less, lack knowledge and resources.[119] But, he dismisses it because "mid-size" franchisees' non-compliance rates are similar to single franchisees' rates. Dr. Weil's conclusion is contestable. The fact that franchises with twelve stores have a higher non-compliance

116. *See generally id.*

117. *Id.*

118. *See generally id.*

119. *See id.* at 1002.

rate than a single owner does not undermine the effect of resources devoted to HR which affect compliance. In fact, it is the opposite. A twelve-store franchisee cannot afford extensive HR, counsel, and training. Larger employers (franchisors or franchisees) have resources, experience, and knowledge to comply with the FLSA and other labor and employment laws.

Dr. Weil and this Article have different assumptions. Dr. Weil seemingly believes that all employers seek to violate the FLSA and cheat their employees, unless they think they will be caught and have to pay damages. This Article contends that most employers would strongly prefer to comply, but it finds the law's nuances confusing and difficult. Employers with resources hire HR professionals and lawyers to analyze their practices, monitor their classifications, and ensure that rogue managers do not violate the law. Small franchisees, Dr. Weil proves, do not have the resources to do this.[120] According to Dr. Weil, the NLRB and EEOC's solution is to incentivize franchisors to hold even less control over their franchisees.[121] This Article finds that that there are consequences to this proposed solution.[122] First, franchisors will do all they can to exercise even less control so that millions of employees will work for employers that do not know how, or cannot afford, to comply with Title VII, ADEA, ADA, and the FLSA. Second, franchisors will be uncertain if they are joint employers or not, and thus, they will no longer take risks by contracting with rising entrepreneurs who cannot indemnify the franchisors. Third, and finally, entrepreneurs who lacked the capital to expand their business will no longer see franchising as a viable method.

Having employees working for fledgling employers, who lack guidance, is a not a positive for society. Will this problem be solved if franchisors only franchise with large franchisees, or, instead, do they stay out of the franchise business? Such decisions will result in more costs than benefits.

C. The Socio-Economic Impact of BFI

The primary effect of the *BFI* decision, if it remains and it leads to its likely conclusion, is that it will have a direct impact on the decision-making of franchisors. Franchising businesses and the entrepreneurs who run these businesses are among the most robust in the current U.S. economy. The International Franchise Association ("IFA") forecasts growth, in the number of franchise units, total employment, and total output, to be at their

120. *See generally* Ji & Weil, *supra* note 115.

121. *See generally* Weil, *supra* note 74.

122. *See* Press Release, Int'l Franchise Assoc., Franchise Business Index Hits Post-Recession High (Aug. 14, 2013) (on file at http://www.franchise.org/franchise-business-index-hits-post-recession-high).

highest levels seen since the great recession.[123] The IFA Report also suggests that, in 2015 alone, over 12,000 franchise establishments are projected to open; but, as the IFA Report continues, it states that "there is considerable downside risk to this forecast created by a recent ruling by the NLRB . . . If this ruling survives legal challenges, it will impose additional costs on franchisors associated with more oversight and insurance against risk."[124]

In the closing monologue in Charles Dickens' a Christmas Carol, Scrooge asked, "Are these the shadows of things that Will be or are they the shadows of things that May be?";[125] if these shadows "will be" the law, then the 150 year old world of franchising will be severely altered. For the sake of illustration, this Article offers a view of the potential change from two perspectives: first, from the viewpoint of the large franchisor and second, from the vantage point of the small entrepreneur owner–operator and hopeful franchisor.

Large franchisors like McDonald's and Burger King have billions of dollars invested in their brand, and they will have the ability to continue to operate. The two entities also have thousands of franchisees currently operating here in the United States. They will need to adapt and innovate to maintain the value of their brand equity in the market. Through costly indemnification and monitoring of current franchisees, they will seek to mitigate the risk associated with now being a joint employer. Absent the issue of unionization, they will still have myriad of other employment law compliance costs that need to be managed or immunized against. The question is not whether these practices will be costly to all franchisors. They will be costly; the real question is of who will bear the cost.

If the contracts allow it, large franchisors will seek to redistribute the costs associated with being a joint employer back where they belong: on the operating unit. Franchisees, like those at McDonald's, will face a quandary when this happens: bear the cost internally, or shift the additional cost to the consumer. Quick Service restaurants have an elasticity of demand estimate close to 1.[126] This value reveals that, for every percent increase in price, demand will decline by approximately the same percent, causing the owner/franchisee's profit to decline. Estimates suggest current

123. *Franchise Business Economic Outlook for 2015*, *supra* note 8, at 13.

124. *Id.*

125. CHARLES DICKENS, A CHRISTMAS CAROL (1843).

126. Abigail Okrent & Aylin Kumcu, Presentation of Paper: What's Cooking? Demand for Convenience Foods in the United States at the Agricultural and Applied Economics Association's 2014 Annual Meeting (July 28, 2014) http://ageconsearch.umn.edu/bitstream/170541/2/OkrentKumcu%205-28-14%20AAEA.pdf.

McDonald's earn on average six percent,[127] so it may or may not be able to absorb the cost from operating profits. However, unless the owners want to bear the full brunt of the lost profit, they will, on the margins, cut costs where they can. They can cut costs through lowering marginal hours of employment or reducing ancillary services purchased, and these cost-cutting measures will have a dampening effect on the total wages paid, local incomes, and taxes collected. These effects are unintended consequences of the *BFI* ruling, and they are too important to dismiss.

Aside from how these large franchisors manage the cost shift with current franchisees, large franchisors will also logically change their behavior as it relates to growth in new franchises. Since smaller single-unit franchisees would be less able to bear the higher costs of operations, now imputed by the cost shifts, franchisors will increasingly be open to applications for new units from only larger multi-unit franchisees. This change will, on the margin, shut out the nascent entrepreneur franchisee from the market. It may be only an unintended consequence of the NLRB, but its decision in *BFI* will lead to fewer new franchises awarded to small entrepreneurs, further concentrating the already increasing concentrated world of multi-unit franchisees.

Perhaps the more meaningful impact will be felt in a different component of the franchising space. Each year, hundreds of aspiring owner/operators develop business plans and prepare to launch a franchise. The launch process is not an easy task. According to the Franchise Performance Group, it will cost between $100,000 and $150,000 to launch a franchise system and between $500,000 and $2 million to take them from launch through the initial ramp-up to fifty units, where estimates show royalty revenues are covering costs.[128] These entrepreneurs will be launching their business into a very competitive space and must then rely on hitting that fifty-store threshold before their start-up capital runs out. These people all hope to be their own version of Ray Kroc;[129] unfortunately, most will not succeed, and evidence shows that seventy-five percent of newly formed franchises will cease to exist within twelve years.[130] This enormously high failure rate existed prior to the *BFI*

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127. *See generally* William Johnson, *What is the best advice for a young, first-time startup CEO?*, QUORA, https://www.quora.com/What-is-the-best-advice-for-a-young-first-time-startup-CEO (last visited Dec. 1, 2015).

128. Joe Mathews & Thomas Scott, *Why Do Franchises Fail?*, FRANCHISE PERFORMANCE GRP. BLOG (May 16, 2014), http://www.franchiseperformance group.com/franchising-failed-model/.

129. *The Ray Kroc Story*, MCDONALD'S CORP., http://www.mcdonalds.com/us/en/our_story/our_history/the_ray_kroc_story.html (last visited Dec. 1, 2015).

130. Scott Shane & Chester Spell, *Factors for New Franchise Success,* MIT SLOAN MGMT. REV. 44 (Apr. 15, 1998).

decision. Through its action, the NLRB has now added additional costs into an already risky business environment. Budding entrepreneurs will now face the prospect of the joint-employment doctrine.

This Article is not talking about multi-billion dollar, multi-national enterprises; to understand who will now bear this burden, one only needs to peruse the Entrepreneur Magazine list of top new franchises for 2015.[131] For example, Sweet Frog Premium Frozen Yogurt ("Sweet Frog") is number 6 on the list,[132] and after growing his business to ten units, Derek Cha decided to go the franchising route in 2012.[133] In the first year, he sold twenty-nine franchises.[134] Over three years (by 2014), there were 200 units, and most recently, there were 272 units.[135] Cha estimates that each unit will need to employ thirteen employees.[136] If, in 2012, the NLRB ruling informed Cha he may be the joint employer of 377 employees (29*13) within one year and the joint employer of 3,536 employees (272*13) over a little more than three years, he may have been intimidated out of the market. All of the people currently employed by the franchisees of Sweet Frog would have never been offered a job. All of the entrepreneurs who bought into a now very successful system would never had the chance to open and earn their profits. All of the landlords renting to Sweet Frog may still be sitting with empty storefronts. All of Sweet Frog's local, state, and federal tax revenue would be non-existent.

This outcome may be one that the NLRB had anticipated, but it is a likely external cost of its decision. Do the benefits, making McDonald's easier to unionize, outweigh the costs discussed above? These costs, which are borne by entrepreneurs; small business people; ancillary service providers; local, state, and federal governments, do not only affect McDonald's. It also affects other large franchisors. Instead, these large franchisors would irrevocably change the landscape of the entrepreneur entering the business of franchising.[137] The costs do outweigh the benefits.

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131. *See generally 2015 New Franchise Rankings*, ENTREPRENEUR MAG. (2015), http://www.entrepreneur.com/franchises/rankings/topnew-115520/2015,-1.html.

132. *Id.*

133. *2015 Franchise 500: Sweet Frog At A Glance*, ENTREPRENEUR MAGAZINE (2015), http://www.entrepreneur.com/franchises/sweetfrogpremiumfrozenyogurt/334242-0.html (last visited Nov. 17, 2015).

134. *Id.*

135. *Id.*

136. *Id.*

137. This is no anecdotal story. The list includes many other examples including but not limited to Brickhouse Cardio Club, Engineering For Kids, and Human Healthy Markets.

CONCLUSION

Applying the *BFI* holding and the DOL and the EEOC advocated control test to franchising is a disingenuous way of trying to make all franchisors liable for a franchisee's legal violations, and it makes it easier for unions to organize such employees. There is simply no basis to argue that franchisee employees are better off when their franchisors exercise even less control. The test is set up to make sure that franchisors cannot avoid joint-employer status. If, however, franchisors find a way to toe that line, it seems clear that franchisee employees and society will be worse off. Such a result is a natural result of using 16th-20th century common law to solve a 21st century problem. These governmental entities should therefore craft a 21st century solution to the problem.

To develop such a standard, this Article proposes setting a goal and trying to achieve it by examining the realities of the workplace. The goal, at a minimum, is legal compliance. As Dr. Weil proves, small franchisees, as well as franchisors, do not comply with the FLSA.[138] Thus, governmental entities need to encourage franchisors to have more control, not less. This is what the *BFI* holding seeks to do; however, it could either 1) fail because franchisors will exercise less control to avoid liability; or 2) severely compromise the franchise model. Accordingly, franchisors should have an incentive or, better yet, a requirement to comply with law without the strict liability.

All franchisors have a "brand standard" of legal compliance. It is not necessary to develop a process for such compliance in a vacuum. Instead, these entities can look to sexual harassment law with respect to vicarious liability—specifically to the application of the Faragher/Ellerth standard has been applied.[139]

A similar standard should exist for franchisors/franchisees. Franchisors must exercise reasonable care to ensure that franchisees are aware of employment laws with which they must comply. There will be no such thing as too much reasonable care, but policies and training of the franchisee will suffice. All franchisee employees must be made aware that, if they believe they have been the victim of legal violations, they should

138. *See generally* Weil, *supra* note 74

139. *See generally* Burlington Indus. v. Ellerth, 524 U.S. 742, 765 (1998); Faragher v. City of Boca Raton, 524 U.S. 775, 807 (1998). Under *Ellerth and Faragher*, employers can avoid liability for sexual harassment if they 1) exercised reasonable care to prevent and correct harassment; and 2) the employee unreasonably failed to take advantage of what the employer provided or otherwise avoid harm. In practice, courts have made it clear, employers will not be liable if they 1) have a strong anti-harassment policy; and 2) legitimately investigate such claims, fix the problem (if there is one), and discipline the harasser (if necessary).

report it to the franchisor. The franchisors will have an obligation to investigate. If they find violations, they need to make sure the franchisee corrects the problem and pays damages. A franchisee who does not cure the problem within sixty to ninety days, of being notified, will lose its franchise. A franchisor who fails to investigate or force the franchisee to cure the problem will be liable for damages.

This proposed standard is not perfect. First, it does not help unions who wish to organize franchisors with top-down organizing; this "failure" is acceptable. While the NLRA allows top-down organizing, it is bad policy to alter an entire business structure with numerous opportunities and economic positives simply on the assumption that this may help unions organize. As stated, there are enough franchisor stores and large franchisees for unions to engage in top-down organizing. Besides, the NLRA was promulgated to encourage bottom-up organizing.[140] Franchisors, especially nascent franchisors, may balk at the requirement, and franchisees may believe that the standard compromises their independence. The old axiom, that a good deal occurs when no one is truly happy, applies here in this case.

On the other hand, this Article's proposed standard solves many of the problems that concern employee advocates, and, while it does put additional obligations on franchisors, it protects the business model and allows the franchisor to impart knowledge to ensure a better workplace. As it stands, the *BFI* standard raises interesting questions. One's choice is heavily influenced by the values of the majority of franchisors and franchisees in this country. Franchisors and franchisees would like to comply with the law and would prefer that their employees are not abused. Also, litigation is long, expensive, draining, and, all-in-all, an awful process. Thus, imparting knowledge, to ensure compliance and creating methods to fix problems without litigation, is a positive development for the United States economy, employees, and society. Another theory is that the vast majority of franchisors and franchisees are bad actors who want to take advantage of employees by violating the law. Under this theory, litigation, and the overarching threat of litigation, is necessary to curtail the desires of these bad actors. If you believe the former, the proposed standard in this Article is a vast improvement. If you believe the latter, there is a much bigger problems than the joint-employer doctrine.

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140. Another potential problem is that unions could invoke an organizing tactic—mass applications—to harass franchisors. Labor organizations could encourage employees to file mass frivolous claims. The law could allow for a cause of action against those who file mass frivolous claims.

THE JOINT-EMPLOYER STANDARD AFTER *BROWNING-FERRIS II* & THE 21ST CENTURY AMERICAN DREAM

JAY FORESTER*

INTRODUCTION

On August 27, 2015, the National Labor Relations Board ("NLRB" or the "Board") issued its long-awaited *Browning-Ferris* decision[1] (the "decision" or "*Browning-Ferris II*") clarifying the "joint-employer standard"[2] under the National Labor Relations Act ("NLRA" or "Act"). The decision's majority purports to reaffirm the traditional joint-employer standard enunciated by the Third Circuit in 1982 in *NLRB v. Browning-Ferris Indus. of Pa.* ("*Browning-Ferris I*").[3] *Browning-Ferris II*'s dissenters, instead, view the decision as an unprecedented move by the Board, announcing an entirely new standard. This division is not limited to

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1. Browning-Ferris Indus., Inc., 362 N.L.R.B. No. 186, 1 (Aug. 27, 2015) [hereinafter *Browning-Ferris II*].

2. The joint-employer standard determines when a company may be held liable as an employee's "employer," though the company is not the employee's contractual employer.

3. NLRB v. Browning-Ferris Indus., Inc., 691 F.2d 1117, 1124 (3d Cir. 1981).

the decision's authors and has already begun to play out in state legislatures.[4]

Although the decision, and its significance, is far from final, it is already worthy of review. At a minimum, *Browning-Ferris II* explicitly overturns decades of NLRB precedent.[5] This Article praises the decision's majority and responds to its dissent. This Article also responds to remarks that were made at *American University Business Law Review*'s Spring 2015 Symposium ("AU Symposium"),[6] where panelists suggested that this decision would not only be bad for management but that it would also damage the "American Dream."

Browning-Ferris II will undoubtedly result in changes for affected employers, perhaps most immediately through increased legal fees. It will likely result in several parent companies sitting down at the collective bargaining table with third-party employees for the first time in decades. And, it may attract bad press for companies who still resist the notion that they, too, have a role to play at this expanded table.

In exchange, millions of NLRA-covered workers will have a better chance of receiving the full benefits of this eighty year-old law. Millions more workers will benefit from a spillover effect, whereby parent companies' expanded policies will also function to improve work conditions for the non-union workers. And, compliant employers will have a greater chance to compete on a level playing field. These changes are not only beneficial. They are essential to the American Dream in the 21st century.

I. THE ECONOMIC REALITY

The economic reality requires a functional joint-employer standard. Tellingly, in *Browning-Ferris II*, a fact at issue—whether an email from a Browning-Ferris agent directing the intermediary human resources company, Leadpoint, Inc. ("Leadpoint"), to fire an employee—was found to be sufficient evidence of control. The NLRB Regional Director ("Regional Director") argued that this email was insufficient evidence of

4. For example, a Texas law designed to defeat the decision went into effect on September 1, 2015. S.B. 652, 84th Leg., (Tex. 2015) (amending § 7 in Chapter 1156). Note also that the decision had the benefit of an array of amici briefs. *Browning-Ferris II*, 362 N.L.R.B. No. 186 at 7–8.

5. *Browning-Ferris II*, 362 N.L.R.B. at 16 ("Accordingly, we overrule *Laerco, TLI, A&M Property*, and *Airborne Express* [. . .] and other Board decisions, to the extent that they are inconsistent with our decision today.")

6. Hospitality for the Employee: Where Business, Employment, and the Hospitality Industry Intersect, American University Business Law Review Spring Symposium (Mar. 27, 2015).

"direct control."[7] Because the firing order was executed by someone other than the one communicating the instructions, the Regional Director argued that Browning-Ferris was not legally in control of the situation.

In 2015, workplaces are not only monitored remotely via e-mail and cameras; they can also be controlled directly through software that dictate a worker's schedule and tasks, hours of work performed or recorded, and pay.[8] Beyond this new technological reality, the traditional two-tiered employer-employee dynamic is now multi-layered. In 2014, a Bureau of Labor Statistics survey indicated that roughly 2.87 million workers[9] worked for a temporary agency like Leadpoint. Many millions more worked for franchised businesses. For nearly a decade, the United States Department of Labor ("DOL"), Wage and Hour Division Administrator David Weil, has focused on this "fissuring of the employment relationship."[10] Prior to his position with the DOL, Weil studied these issues as an academic and found that "[r]egardless of motivation, fissuring in employment relations dramatically complicates the regulation of workplace conditions."[11] Applied in the joint-employer context, he noted

> [s]uch clear lines of accountability have become murky and establishing the employer of record in order to assess responsibility has become more complicated. This creates significant problems for a workplace agency where foundational statutes like the FLSA assume that most employer-employee relationships are between easily identified parties. Consequently, the task of bringing regulatory pressure on the "employer" has become elusive.[12]

Recognizing these "changing patterns of industrial life" and that "the primary function and responsibility of the Board . . . is that 'of applying the

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7. *Browning-Ferris II*, 362 N.L.R.B. at 16.

8. *See, e.g.*, McDonald's USA, LLC, a joint employer, et al., NLRB Case No. 02-CA-093893 (authorizing complaints to proceed against McDonald's under joint-employer theory because of these practices).

9. *See Browning-Ferris II*, 362 N.L.R.B. at 11 ("The most recent Bureau of Labor Statistics survey from 2005 indicated that contingent workers accounted for as much as 4.1 percent of all employment, or 5.7 million workers. Employment in the temporary help services industry, a subset of contingent work, grew from 1.1 million to 2.3 million workers from 1990 to 2008. As of August 2014, the number of workers employed through temporary agencies had climbed to a new high of 2.87 million, a 2 percent share of the nation's work force. Over the same period, temporary employment also expanded into a much wider range of occupations.")

10. *See generally* David Weil, Rep. to Dep't of Labor: Wage & Hour Div., Improving Workplace Conditions Through Strategic Enforcement (May 2010), http://www.dol.gov/whd/resources/strategicenforcement.pdf.

11. *Id.* at 10 (identifying the "desire to shift labor costs and liabilities to smaller business entities or to third-party labor intermediaries, such as temporary employment agencies or labor brokers").

12. *Id.*

general provisions of the Act to the complexities of industrial life,'"[13] the NLRB found "reason enough to revisit the Board's current joint-employer standard."[14] The Board did not set out to "reshape"[15] the economic reality; the dissent itself acknowledged that we have had this complex reality for some time. Rather, the decision recognized that the NLRB has lagged behind federal courts, which have interpreted "employment" for many years under other federal labor and employment laws through a remedial, realistic, or, minimally, 21st century lens.

II. THE DECISION

Browning-Ferris II stems from a 2013 election petition by the Teamsters Union seeking to represent workers at a Browning-Ferris recycling facility in Milpitas, California. Reaffirming the "traditional" joint-employer standard from the Third Circuit in *Browning-Ferris I*[16] and relying heavily on the Supreme Court's precedent that joint-employer status under the NLRA is an issue of fact for the Board to determine,[17] the NLRB overturned the Regional Director's decision that Browning-Ferris was not a joint employer of the workers. The NLRB directed the Regional Director to permit the ballots of the approximately sixty workers in question to count. In doing so, the Board announced "[r]eserved authority to control terms and conditions of employment, even if not exercised, is clearly relevant to the joint-employment inquiry."[18] Thus, for the first time in decades, the Board said that factors exhibiting mere "indirect control," and not just factors exhibiting "direct and immediate control,"[19] could be sufficient to support a factual finding of joint employment.

Applying this "traditional" or "indirect control" standard,[20] the Board

13. *Browning-Ferris II*, 362 N.L.R.B. at 11 (citing NLRB v. J. Weingarten, Inc., 420 U.S. 251, 266 (1975)).

14. *Id.*

15. *Contra id.* at 23.

16. *See generally id.* ("Today, we restate the Board's joint-employer standard to reaffirm the standard articulated by the Third Circuit in Browning-Ferris decision. Under this standard, the Board may find that two or more statutory employers are joint employers of the same statutory employees if they 'share or codetermine those matters governing the essential terms and conditions of employment.' In determining whether a putative joint employer meets this standard, the initial inquiry is whether there is a common-law employment relationship with the employees in question. If this common-law employment relationship exists, the inquiry then turns to whether the putative joint employer possesses sufficient control over employees' essential terms and conditions of employment to permit meaningful collective bargaining.").

17. Boire v. Greyhound Corp., 376 U.S. 473, 481 (1964).

18. *Browning-Ferris II*, 362 N.L.R.B. at 2.

19. *See, e.g.*, Airborne Express Co., 338 N.L.R.B. 597, 597 n.1 (2002).

20. This distinction is immaterial for this discussion but the label depends on

found that the NLRA applied to the company who, among other factors, "indirectly"

- Required workers to be drug tested prior to hire and enforced other eligibility criteria;
- Retained the right to reject workers for "any reason";
- Ordered that specific workers be terminated;
- Determined what tasks workers completed;
- Controlled how quickly workers could perform these tasks;
- Chose where the workers would be stationed;
- Decided workers' schedules and when they were eligible for overtime; and/or
- Set the ceiling on workers' pay.[21]

The Board did not rely on any one factor in particular, but it found that "all of these forms of control—both direct and indirect—are indicative of an employer-employee relationship."[22] That is, the human resource company who merely hired, fired, and paid the workers was not the sole employer.

By contrast, the dissent would continue to require direct and immediate control.[23] Justifying its opposition, the dissent enumerated a number of specific concerns. The first three of these concerns are particularly suspect and are likely what prompted the majority to characterize the dissent as "long and hyperbolic."[24] The dissent first quipped that the majority's decision will force companies to find larger bargaining tables.[25] Second, the dissent suggested that, because employment relationships have been layered for over 200 years and since the law has not always adapted to this reality, the standard should remain unchanged and outdated.[26] Still stretching for logic, the dissent's third contention was that the Board did not have the authority to modify agency standards. Instead, it argued that

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whether one views the decision as anan extension of *Browning-Ferris I's* "traditional standard" or a novel, "indirect" standard.

21. *See Browning-Ferris II*, 362 N.L.R.B. at 18–19.

22. *Id.* at 19.

23. *Id.* at 22; *see, e.g.*, *Airborne Express*, 338 N.L.R.B. at 597 n.1.

24. *Browning-Ferris II*, 362 N.L.R.B. at 20.

25. *Id.* at 21 (Members Miscimarra and Johnson, dissenting) ("First, no bargaining table is big enough to seat all of the entities that will be potential joint employers under the majority's new standards."). Here, the dissent also makes the point that the majority does not have authority for the decision, which is addressed with the dissent's "third contention."

26. *Id.* at 22, 35 (noting the decisions the Board overturns were not challenged by courts of appeal). While this observation is noteworthy, the majority's decision was not without justification. *See supra* Part II. Furthermore, the dissent fails to explain why this lack of a challenge would warrant staying with a dormant standard.

the common law standard should apply; however, the dissent conceded that the majority purported to apply the common law as well[27] as standards set forth in the NLRA. Therefore, the concern is really that the majority applied improper interpretation, not acted without authority.

III. EMPLOYERS NOW FACE A FACT QUESTION

The dissent next criticized the decision for taking the predictability out of the law by reviving a uniquely[28] dormant legal theory. If this "kind of, sort of, maybe someday" standard—[29] as it has been called—is upheld, parent companies will need to consider the possibility that the NLRB could find that the NLRA applies to the union workers they actually control. For three decades, these companies have operated at a liability discount. Now, they may face a question of fact.

The dissent's moment of worker empathy comes in the section where the dissenters expressed the need to spare employees' confusion.[30] Even if it were true that all workers understand which entity actually "employs" them, which many likely do not, the more pressing issue is to decide what kind of *predictability* is desirable: a standard that is predictable because (a) it is so narrow that it will only apply to a parent company once every 30 years; or (b) it forces companies to consider that their intermediaries may not always, under every circumstance, be a fail proof liability shield. Choice (a) is the obvious choice of the business community, certain state legislatures, and, as explained below, the decision's dissenters. Choice (b)

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27. *Browning-Ferris II*, 362 N.L.R.B. at 14, 20 ("Today's decision is grounded firmly in the common law, while advancing the policies of the National Labor Relations Act. [. . .] The common-law definition of an employment relationship establishes the outer limits of a permissible joint-employer standard under the Act. But the Board's current joint-employer standard is significantly narrower than the common law would permit. The result is that employees covered by the Act may be deprived of their statutory right to bargain effectively over wages, hours, and working conditions, solely because they work pursuant to an arrangement involving two or more employing firms, rather than one. Such an outcome seems clearly at odds with the policies of the Act.").

28. *Browning-Ferris II*, 362 N.L.R.B. at 22–23 (explaining that other federal acts, like Title VII and the FLSA have not been applied so narrowly to require "direct" or "immediate" control).

29. Erin Horton, *NLRB Adopts New Joint Employer Test: Companies That Kind of, Sort of, Maybe Someday Could Exercise Control over Employees Can Be Joint Employers*, EMP. MATTERS BLOG (Aug. 28, 2015), http://www.employmentmattersblog.com/2015/08/nlrb-adopts-new-joint-employer-test-companies-that-kind-of-sort-of-maybe-someday-could-exercise-control-over-employees-can-be-joint-employers/.

30. *See e.g.*, *Browning-Ferris II*, 362 N.L.R.B. at 23 ("This confusion and disarray threatens to cause substantial instability in bargaining relationships, and will result in substantial burdens, expense, and liability for innumerable parties, including employee.").

is the choice required by courts and by law.

The Supreme Court has spoken clearly that "employment" is a case-by-case basis determination.[31] Accordingly, courts apply a broad interpretation of the employer-employee relationship "to identify responsible parties without obfuscation by legal fictions applicable in other contexts."[32] Thus, the Third Circuit found, in *Browning-Ferris I*,.that "the question of 'joint employer' status is a factual one and requires an examination into whether an employer who is claimed to be a 'joint employer' possessed *sufficient control* over the work of the employees to qualify as a 'joint employer' with [the actual employer]."[33] In determining that a judge's role is to assess "sufficient"—and not "direct" or "immediate"—control, the Third Circuit relied on four decades of NLRB precedent that interpreted and applied the joint-employer standard under the NLRA.

Given this established precedent, the majority's claim, that "the criticisms that our colleagues level at our joint-employer standard could be made about the concept of joint employment generally – which has been recognized under the Act for many decades and which has long been a familiar feature of labor and employment law[,]" has merit.[34] This claim is true not only for the predictability argument, but it applies to the dissent's fifth argument with equal force.

IV. MEMBERS OF THE NLRB NEED TO SEE MERIT IN COLLECTIVE BARGAINING

Fifth, to the extent the majority seeks to correct a perceived inequality of bargaining leverage resulting from complex business relationships where some entities are currently nonparticipants in bargaining, the "inequality" addressed by the majority is the wrong target, and collective bargaining is the wrong remedy.[35] The dissent continues to say that

> the inequality targeted by the new "joint- employer" test is a fixture of our economy—business entities have diverse relationships with different interests and leverage that varies in their dealings with one another. There are contractually "more powerful" business entities and "less powerful" business entities, and all pursue their own interests.[36]

Here, the two sides have a fundamental disagreement over their role on

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31. *See e.g.*, Boire v. Greyhound Corp., 376 U.S. 473, 481 (1964).

32. Dole v. Simpson, 784 F. Supp. 538, 545 (S.D. Ind. 1991).

33. NLRB v. Browning-Ferris Indus., Inc., 691 F.2d 1117, 1121 (3d Cir. 1982) (citing *Boire*, 376 U.S. at 481).

34. *Browning-Ferris II*, 362 N.L.R.B. at 23.

35. *Id.*

36. *Id.*

the NLRB. The majority stated that "the primary function and responsibility of the Board . . . is that 'of applying the general provisions of the Act to the complexities of industrial life.'"[37] While the dissenters might persuasively disagree with this function, their role as members of the NLRB should require that they, at a minimum, seek to advance the purposes of the NLRA, whatever they might be. "It is not the goal of joint-employer law to guarantee the freedom of employers to insulate themselves from their legal responsibility to workers, while maintaining control of the workplace."[38]

As the dissent continues, however, it becomes clear that the dissenters were not concerned that the decision espouses a policy, exceeding the bounds of the NLRA; instead, they were concerned that the majority's decision advances the *wrong policy*. The majority explained clearly and consistently that the Board's role was to determine what interpretation best upheld the NLRA's purpose,[39] which the Board recognized as "*encourag[ing]* the practice and procedure of collective bargaining[,]"[40] and it also cited the Supreme Court's reasoning that "[o]ne of the primary purposes of the Act is to promote the peaceful settlement of industrial disputes by subjecting labor-management controversies to the mediatory influence of negotiation."[41] In stark contrast, the dissent did not seem to have space for peaceful negotiation or settlement. The dissent did not encourage collective bargaining but found peace through silence; it found that "[r]equiring collective bargaining wherever there is some interdependence between or among employers is much more likely to thwart labor peace than advance it."[42] Although there is an inherent tension between the additional protections that employment laws afford workers and the costs these protections impose on management, both workers and management must have a voice in America.

The majority in *Browning-Ferris II* seeks to amplify workers' voice. The dissent seemed distracted from the present issues, spending several pages attempting to re-litigate other cases,[43] and it ultimately provided a better defense for the franchise industry than it does for any party present —*Browning-Ferris II* did not present a franchise relationship—or under the NLRA.

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37. *Id.* at 11.
38. *Id.* at 21.
39. *See e.g., id.* at 12.
40. *Id.* at 13.
41. *Id.* at 12–13 (citing Fireboard Corp. v. NLRB, 379 U.S. 203, 211 (1964)).
42. *Id.* at 23.
43. *Id.* at 26–32.

V. OTHER CONTEXTS

What is most clear from the decision's dissent is that there is widespread concern and disagreement about the possible implications this decision could have. While states are considering—or have passed—laws designed to countermand the decision, the Occupational Safety and Health Administration ("OSHA") is considering the possibility of a joint-employer relationship between franchisors and franchisees in regard to workplace safety maters that would follow the NLRB and its General Counsel's lead. And, there is precedent for courts to draw on the NLRA's joint-employer standard when considering the joint-employer standard under a different labor and employment law.

For example, the Third Circuit relied on *Browning-Ferris I* when considering the proper joint-employer standard to apply under the FLSA in its *Enterprise* decision.[44] At the 2015 AU Symposium, several of my co-panelists expressed concern that the potential of future cases brought, alleging joint employment under the FLSA, and not the NLRA, is the true threat. *Browning-Ferris II*, however, recognizes that the joint-employment standard, which now applies under the NLRA, is *narrower* than under the FLSA.[45] While the decision catches up to the FLSA, both laws will once again have space for questions of joint-employment status to be factually determined; however, it is unlikely that the decision will affect joint-employment interpretation under the FLSA.[46] This prediction is particularly grounded given that, outside of the Third Circuit, federal courts have been interpreting the FLSA joint-employer standard in isolation from the NLRA for decades.

Also, while the FLSA has been cited as having the broadest scope of "employment,"[47] courts rarely find that the facts are sufficient to hold a parent company liable. This notion is especially apparent in the franchise context where parent companies routinely are kept in a case through the motion to dismiss phase, *i.e.*, they have to join the initial round of talks but are then released at the summary judgment phase because the facts do not

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44. *In re* Enter. Rent-A-Car Wage & Hour Empl. Practices Litig., 683 F. 3d 462, 468 (3d Cir. 2012).

45. *See Browning-Ferris II*, 362 N.L.R.B. at 17 (explaining that the revised standard is limited to considerations of control and not broader notions of "economic realities," which are factors applied in joint-employer doctrine under both the FLSA and the Agricultural Workers Protection Act).

46. *See generally* Barfield v. N.Y.C. Health & Hosp. Corp., 537 F.3d 132, 143 (2d Cir. 2008) (describing joint employment under the FLSA as a fact intensive inquiry); Boire v. Greyhound Corp., 376 U.S. 473, 481 (1964) (describing whether company exercised sufficient control under the NLRA to be found a joint employer as a factual issue).

47. United States v. Rosenwasser, 323 U.S. 360, 363 (1945).

warrant a liability determination.[48] Despite this reality that it is very unlikely that a parent company will remain liable, the joint employment determination is still a viable legal approach under the FLSA. The same congressionally recognized rationale that justifies the joint-employer theory for the FLSA also applies to the NLRA:

> This purpose will fail of realization unless the Act has sufficiently broad coverage to eliminate in large measure from interstate commerce the competitive advantage accruing from savings in costs based upon substandard labor conditions. Otherwise the Act will be ineffective, and will penalize those who practice fair labor standards as against those who do not.[49]

The decision's dissenters and challengers should take note that labor and employment laws, including the NLRA, exist for the employers' benefit too.

VI. THE 21ST CENTURY AMERICAN DREAM

At the AU Symposium, the panel considered briefly what impact the decision could have on the American Dream. After listening to the argument that the decision threatened the American Dream because it would inhibit two young brothers' ability to start a small business early in life, I made the case for a more dynamic view of the American Dream. My version of the American Dream exists not only for my twenty-something-year-old brother to become a small-business owner early in life, but it also applies to my service-industry-employed sister who makes a living wage, which she still strives to achieve one hour at a time. It again applies to my other sister, a soon-to-be college graduate, who is repeatedly offered unpaid internships as a means to get her "foot in the door" to what *might* become a paying job and who also desires to one day earn a living wage.

In a 1987 a congressional hearing considering adjustments to the federal minimum wage, the American Dream was defined as "independence and self-reliance achieved through the fruits of one's own labor."[50] For many,

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48. *See, e.g.*, Cordova v. SCCF, Inc., No. 13CIV5665-LTS-HP, 2014 WL 3512838, at *4 (S.D.N.Y. July 16, 2014) (noting other circuits have generally held that franchisors are not employers under the FLSA). However, similar to the decision in *Olvera v. Bareburger Grp. LLC*, the court distinguished those prior cases by noting that they were all decided after the completion of discovery pursuant to summary judgment motions and the court here was deciding in the context of a motion to dismiss prior to the completion of any discovery. Because discovery was not complete and the pleadings were sufficient, it was inappropriate to dismiss the franchisor at the motions to dismiss phase). *See* Olvera v. Bareburger Grp. LLC, 73 F. Supp. 3d 201, 207 (S.D.N.Y. 2014).

49. Roland Elec. Co. v. Walling, 326 U.S. 657, 670 (1946).

50. H.R. REP. NO. 101-260, pt. 1, at 14 (1989).

this independence and self-reliance is achieved at an hourly wage. While the decision will undoubtedly increase certain costs for management, its net effect will be positive. Beyond the union workers who can apply greater financial pressure to their demands,[51] the decision will benefit non-union workers who are also jointly-employed by parent companies, whose policy changes will benefit workers without regard to union status. The decision will help this responsive employer because "the joint employer doctrine denies a competitive advantage to those who use substandard labor."[52] And, companies will begin to be more widely distinguished based on their labor records, as has occurred with companies' environmental records in recent years. To the extent that companies choose to be a resistant employer, the NLRA will now be more capable of forcing employers to be reputable in their own interest. After *Browning-Ferris II*, companies have a clear choice: respond or resist. While the initial inclination might be to resist, everyone is still better off with viable and enforceable labor and employment laws.

The 21st century American Dream recognizes that we have arrived at this economic and technological reality because of the laws that were put into place eighty years ago and the workers, as well as the innovators, that got us here. The idea that certain things have improved is not justification to reduce the legal standards and protections for any American. *Browning-Ferris II* is an important decision because it acknowledges that everyone has a voice and that we can still add more chairs to the table, essential components of the 21st century American Dream.

CONCLUSION

Browning-Ferris II is not a perfect decision. As pointed out in the dissent, it is difficult to imagine how parent companies' NLRA obligations will be limited only to those terms and conditions they are deemed to control.[53] Regardless, the decision is, on the whole, a step in the right direction.

If the decision is upheld, the NLRA has a greater likelihood of achieving its purpose, and millions of Americans stand to benefit. While there will be a financial burden imposed on certain employers, the initial costs will be absorbed, and the incentives to layer employment relationships will persist and evolve. Parent companies will still control virtually every aspect of their employment or contractual relationships. If these companies are

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51. *See Browning-Ferris II*, 362 N.L.R.B. No. 186, 28 (2015) (reaching into the parent company's "deeper pockets" and increasing costs).

52. Richard J. Burch, *A Practitioner's Guide to Joint Employer Liability Under the FLSA*, 2 HOUS. BUS. & TAX L. J. 393, 405 (2002).

53. *Browning-Ferris II*, 362 N.L.R.B. at 42

concerned with these relationships that put them at risk under the NLRA, they can terminate the relationships, can further indemnify themselves, and can even choose to be better for their workers and their brand.

ARTICLE

FATHOMING POTENTIAL IN CHINA—HOW SHIP LEASE FINANCING ARRANGEMENTS AND FREE TRADE ZONES MAY OPEN MARKETS TO NON-BANK INVESTMENT

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** In this Article, the *American University Business Law Review* editorial staff has incorporated the use of foreign characters when citing the names of laws from the People's Republic of China. The editorial staff copied the names of the laws directly from a Peking University Law School-affiliated online legal database, LawInfoChina.com, which is a United States Library of Congress-suggested web resource for Chinese laws, regulations, journal articles, and legal news. Please e-mail blree@wcl.american.edu if any of the foreign characters appear incorrectly; thank you.

INTRODUCTION

China (alternatively, the "People's Republic of China" or "PRC") is an important center for ship finance. Financial liberalization has led to a great deal of growth to its shipping sector. In 2009, the Industrial and Commercial Bank of China's ("ICBC") shipping portfolio grew to US$7.8 billion.[1] In that year alone, ICBC closed forty-five new shipping transactions totaling US$2.3 billion.[2] Inching toward market openness by lowering entry requirement for financial entities, China is improving the conditions for domestic and foreign growth within its markets. Even small governmental adjustments to China's heading have had vast effects on the giant nation's track. With vessel lease arrangements still relatively novel to China, their popularity has grown as the legal mechanics are tested and become better understood. This Article will present a legal playbook for executing both a lease and a debt financing arrangement in China. Where possible, this Article identifies opportunities through which foreign investors may enter the Chinese shipping market through these deals.

Beyond shipyards, many parties have a commercial interest in newbuilding projects.[3] The purchaser will charter out the vessel in exchange for hire payments made to the purchaser for use of the vessel. The charterers will sub-charter the vessel or will use it to move cargo in exchange for freight payments. The lending company that provided the shipyard funds to construct the vessel will collect fees and interest on the loan. Upon delivery, the purchaser will give the lending company a ship

1. Rodricks Wong, *Dealmaker of the Year Award—ICBC*, MARINE MONEY 18 (Feb. 1, 2010) https://www.marinemoney.com/sites/all/themes/marinemoney/publications/awards/2009_Dealmaker.pdf.

2. *Id.*

3. While vessel resale is a vital component of the shipping sector, this Article focuses primarily on deals for newbuilding projects or those in which shipyards construct and deliver new vessels to specifications designated by the purchaser.

mortgage over the vessel and make regular payments in exchange for the purchase price. As depicted in Figure 1 below, there are many parties attempting to benefit commercially and to transfer risk within the notoriously volatile shipping markets. This Article focuses on the financers and vessel management companies that grease the wheels of international shipping's newbuilding markets through vessel purchases and leases.

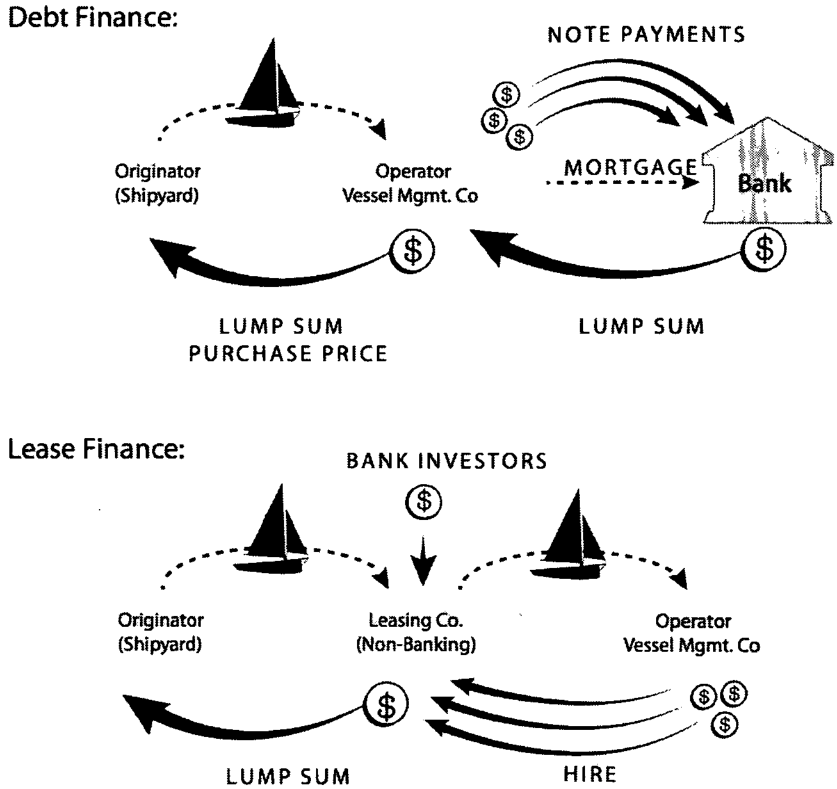

Figure 1. Showing the parties and relationships involved in each a debt finance purchase and a lease financing arrangement

While both vessel purchases and vessel leases are traditional arrangements for ship acquisition, this Article will look at advantages and disadvantages of each arrangement in the burgeoning Chinese shipping market, where the legal and regulatory regime is rapidly evolving. Finally, this Article looks at the possibility of foreign investment from the positions of both the financer and the purchasing vessel management company, and it will also consider the extent to which the China (Shanghai) Pilot Free Trade Zone is a welcoming environment for such investment.

I. WHAT IS VESSEL LEASE FINANCING, AND HOW DOES IT COMPARE TO DEBT FINANCING?

A. Debt Financing

Vessel debt financing—a loan from a bank secured by a mortgage—perhaps is the most straightforward method to acquire a vessel. A prospective shipowner will arrange with a shipyard to build a new vessel and with a bank to finance that purchase. During the construction phase, typically, the purchase will be secured by assignment of a refund guarantee issued by the shipyard's bank or by other traditional security and quasi-security mechanisms, such as share pledges and guarantees. The shipyard may require that payments be made in installments, based upon the passage of time or upon achievement of construction objectives, under the building contract. Upon completed construction, final payment will be transferred to the shipyard, and both possession and ownership of the vessel will be transferred to the purchasing shipowner with the bank as secured creditor holding a mortgage over the vessel.

Transactions of this sort are costly. Moreover, tightened Chinese credit markets make bank debt an unrealistic option for much of the sector. While achievable by the largest shipping companies, many small and medium-sized shipping companies lack access to the credit and the capital needed to arrange financing from a single bank, which is positioned to accept a mortgage from a company with little to offer as collateral besides the vessel under construction. Worldwide, stricter capital requirements imposed by Basel III[4] have caused banks to reduce exposure to the shipping sector and to replenish their capital buffers.[5] Easy money from bank loans is scarce now, causing investors and lenders alike to try new instruments to secure their investments.[6] With less bank capital available, the sector has innovated and sought funding through alternative forms, such

4. *International regulatory framework for banks (Basel III)*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/basel3.htm (last visited Nov. 14, 2015) ("Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector." As it relates to capital requirements, banks are required to hold 4.5% of risk-weighted assets in the form of their own equity, ensuring that banks have skin in the game when it comes to making decisions.).

5. *See* Andrew Quinn et al., *International Ship Finance Through Ireland*, MAPLES (Nov. 11, 2013), http://www.maplesandcalder.com/news/article/international-ship-finance-through-ireland-621/ (stating the trend has shifted since implementation of Basel III from relying upon traditional bank debt to tapping capital markets).

6. Peter T. Leach, *An End to Easy Money?*, J. OF COMMERCE (July 4, 2013, 8:30 AM), http://www.joc.com/maritime-news/ships-shipbuilding/end-easy-money_20130704.html (suggesting the end of an easy money market for shipping finance).

as debt capital markets. While bond issuance is not a new development to the industry, shipping companies have been tapping capital markets more frequently and are relying more heavily upon bond issuance as a way to fund asset acquisition.[7]

Identifying adequate security to finance a newbuilding project is problematic for vessel purchasers and their shipyards. Larger shipyards and shipping companies are in a very different position than smaller shipyards and shipping companies because they enjoy bulk-purchasing power with suppliers and have ample assets to collateralize in exchange for sufficient credit lines.[8] Small to medium-sized shipping entities and vessel-operating companies tend to be arranged as single-ship companies to minimize the risk of sister-ship arrest and to otherwise limit their potential liability owed to any judgment creditors to the single asset.[9] Thus, debt financing arrangements for newbuilding projects are primarily secured by the company's sole asset: the partly constructed asset's real value comes from its potential to do work.[10] A vessel under construction is not a vessel until it is delivered. The shipyard's rights to payment arise only upon completion; "[t]he buyer has no liability to pay 90% of the price if the ship is 90% built. It only has a liability to pay if the ship is 100% complete."[11] A ship purchaser defaulting during the construction period thus leaves its creditor with an unfulfilled order for a vessel and an incomplete

7. *See* Ben Rose, *Innovation in ship finance – tapping the capital markets*, NORTON ROSE FULBRIGHT (Jan. 2011), http://www.nortonrosefulbright.com/knowledge/publications/33057/innovation-in-ship-finance-tapping-the-capital-markets (discussing the current trend of innovation in ship finance and its reliance upon debt capital markets).

8. E-mail from Diran Majarian, Managing Dir., Amalia Tankers, to author (Apr. 19, 2015) (on file with the *American University Business Law Review*).

9. A shipowner's liability is limited to the assets it possesses. Because single-ship companies have few assets, judgment creditors may be unable to recover the full amount they are owed. Obtaining redress from the debtor's affiliated entities may prove to be extremely difficult. The equitable doctrine of veil-piercing is warranted only under extraordinary circumstances, and South Africa is the only jurisdiction that practices associated-ship arrest where assets over which the debtor holds a controlling interest may be reached by the judgment creditor. *See generally* James Dumont, *Pleading Insanity in Piercing the Corporate Veil: Supplemental Rule E's Heightened Pleading Standard Protects Polluting Shipowners in the Fourth Circuit*, 38 TUL. MAR. L.J. 665 (2014); David R. Maass, *Veiled Threats: Will the Second Cir. Hamstring Alter-Ego Claims by Applying Foreign Law?*, 38 TUL. MAR. L.J. 723 (2014); John Dyason, *S. African Mar. Law—An Overview of Some Developments*, 32 J. MAR. L. & COM. 475 (2001).

10. QIAO LIU ET AL., FINANCE IN ASIA: INSTITUTIONS, REGULATION AND POLICY 250–51 (2013).

11. Richard Henderson, *Understanding Ship Yard Securitization*, MARINE MONEY OFFSHORE (Mar. 1, 2000), https://www.marinemoneyoffshore.com/node/5880.

construction project for which it is difficult to find an alternate purchaser.

However, securing a loan to purchase an existing vessel is much easier. Here, the vessel purchaser will obtain financing through a bank and give the bank a mortgage over the asset to secure its loan. If the vessel owner defaults, the creditor must enforce the mortgage to gain possession and ownership over the asset, albeit an efficient judicial process, in commercial terms ship arrest is still an often lengthy and expensive litigious process. The risk is passed on to the purchaser in the form of higher borrowing costs. Herein, this Article will consider almost solely newbuilding projects.

In both situations—the newbuilding project financed through a non-recourse loan and a vessel purchase financed through a loan secured by a mortgage—the creditor is without possession and without ownership beyond the security interest it may have in the property under construction.

A prospective purchaser, the beneficial owner of the vessel, may have difficulty accessing bank debt to finance an outright purchase because of volatility in demand for new capacity, because of the purchaser's creditworthiness and available collateral, or because of limitations imposed upon the purchaser's own balance sheet by regulatory agencies, its own corporate governance, or existing creditors. These difficulties, along with others, have all contributed to a rise in popularity of alternative arrangements. Prospective owners unable to access bank debt may find lease financing as a viable arrangement by which it may obtain additional cargo space for its fleet.

B. Lease Financing

Lease financing arrangements are not unique to shipping markets but have been tested in contexts of heavy equipment leases and aircraft leases that are commonly arranged through a leasing company structure similar to these other equipment leasing deals. Vessel leasing falls within this general legal and economic arena of asset financing, but it still retains certain features unique to shipping.[12] Leasing arrangements provide the creditor with ownership of the vessel while releasing its right to possession. Retaining ownership puts the creditor in a much more favorable position to regain possession should the lessee default. Although it may cause the lessee to incur higher costs than under traditional mortgage financing, often, lease financing will achieve favorable results for all parties because it balances the risks more evenly than other types of vessel financing.[13]

12. Ying Li, *The Pros and Cons of Leasing in Ship Financing*, 5 WMU J. OF MAR. AFFAIRS 61, 62 (Apr. 2006).

13. *Id.*

Newbuilding projects require a great deal of capital. A vessel management company in the business of operating vessels may see its capital diluted if it is forced to raise the vessel price itself. A leasing company in the business of financing, rather than managing or operating vessels and with greater access to available credit markets—*i.e.*, a bank or a company with greater control over the transaction costs or a shipyard—is in a better position than a vessel operator to lower transaction costs and to fund the newbuild project more cheaply.[14] The lessee can devote its working capital to vessel management projects.[15] The bank earns its return through fees and interest, the shipyard earns its return through selling the vessel, and the beneficial owner earns its return through operating the vessel: chartering it and earning hire payments.

Leasing arrangements are typically easier transactions to complete—albeit more expensive—for a beneficial owner than debt financing is because the beneficial owner is not asked to step out from its wheelhouse: earning income from chartering the vessel. Instead, debt deals require the vessel operating company have greater expertise in asset management than in doing leasing deals. The vessel management company remains focused upon pairing charterers with shipping capacity to pay its lease, and the special purpose leasing company remains solely focused upon capitalization concerns to acquire ownership of new vessels. To accomplish this funding, the special purpose vehicle ("SPV") may be capitalized by its parent, by bond markets, or by equity markets.[16] In any event, the SPV must raise the full price itself to remain bankruptcy remote, meaning that the sale and purchase agreement must be a legal true sale that transfers both ownership and possession. Doing so also places the SPV in a position to securitize the asset or to sell the vessel and the leasing rights without disturbing the underlying vessel operating and charter agreements. Through sale or securitization of certain rights, beneficial ownership of charter agreements can transfer without disturbing the underlying charter party. The vessel management company can remain focused upon its specialty: matching charterers with shipping capacity.

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14. *See id.* at 67.

15. *Id.*

16. First Ship Lease Trust is a Singapore-registered company that owns a portfolio of twenty-three ships, sixteen of which are engaged in long-term lease finance arrangements, and the seven remaining ships are on shorter-term operating leases. This company is funded in part publically via the Singapore Exchange Security's main board. *See* Melissa Tan, *First Ship Lease Trust sails into the black in Q1*, THE BUSINESS TIMES (May 13, 2015, 6:53 PM), http://www.businesstimes.com.sg/companies-markets/first-ship-lease-trust-sails-into-the-black-in-q1.

In addition to making it easier to close deals due to lowered collateralization requirements, leasing arrangements can make a deal commercially viable because of tax and accounting advantages. These are non-trivial advantages available to the documented vessel owner, which subsequently leases out its vessel.[17] Both parties to the leasing arrangement can utilize these advantages to offset limitations imposed by itself, by regulators, or by creditors. Accounted for as debt, the leased vessel is not a taxable asset to the vessel operator. To the creditor, instead of lending the vessel management company funds to purchase its vessel, the leasing company owns the vessel and realizes the asset as equity on its balance sheet. Also, as an owner, the vessel operating company is entitled to claim a significant tax benefit due to depreciation of the asset over its commercial life.[18]

These advantages are related to tax deferral schemes that the parties may benefit from under leasing arrangements, but they are not available for vessel sales. The registered owner may be able to take advantage of tax credits unavailable to a less-solvent operator. Vessel management companies often operate with a tight margin and rarely turn a profit. A company without annual profits greater than the tax credit cannot benefit in the same way by owning the vessel that a more profitable company can. So, the right to offset vessel depreciation is worth more to the leasing company than it is to the less-solvent vessel management company.

A vessel management company in the business of pairing sub-charterers and operators with vessels may arrange for a long-term bareboat charter spanning the expected commercial life of the asset. Under a leasing arrangement, instead of purchasing the vessel, the beneficial owner leases the vessel, where the charterer's hire over time will cover the entire cost of the vessel and the leasing company's margin. The lessor will be an SPV set up for the purpose of owning the asset and being bankruptcy remote to protect other assets over which the company may have rights.[19] Thus, the vessel's owner will be an SPV and will be an arm of a bank, be controlled by a shipyard, or otherwise, be mostly a privately owned company, a subsidiary of a larger bank, or a leasing company positioning the SPV

17. Ying Li, *The Pros and Cons of Leasing in Ship Financing*, 5 WMU J. OF MAR. AFFAIRS 61, 63 (Apr. 2006).

18. *Id.*

19. Various entities are commonly used to isolate certain risks and legal liability to preserve the economic and legal structure needed to sustain the asset wholly apart from its originator. Risk incurred or insolvency of the originator will not affect the SPV. Likewise, risk incurred or insolvency of the SPV will not affect the originator.

lessor to receive a high credit rating.[20] To receive credit enhancement, the SPV can assign the right to be paid hire on its charter agreement directly to its creditors.

Though typically more expensive than debt financing, vessel lease financing arrangements have advantages for the lessee over traditional equity deals beyond the higher rates. Among them, the party remitting the purchase price—the lessor/leasing company—retains ownership of the asset. Because the leasing company retains ownership of the asset, it is better positioned following default than a mortgagee who must have perfected its security interest only then to foreclose and physically repossess the asset in order to exercise its security rights. Leasing may mean lower costs incurred by a trustee in bankruptcy because leased assets are easier to repossess than mortgaged assets.[21] In addition to less risk for the leasing company, the lessee can find greater certainty through a lease financing arrangement than is available through bank debt financing where, as owner of the asset, it would be exposed to market volatility.

Beyond simplifying legal processes to obtain a secure position, shipowners may find entering ship leasing arrangements to be prudent business decisions. The leasing company, as owner of the asset and obligee of the lease, can securitize and sell these rights to take advantage of market fluctuations and to manage its own portfolio by selling its ownership rights, thus leaving intact any underlying charter parties.

The leasing company can securitize its vessels and the right to collect payment on the lease arrangements. Securitization allows a company to transfer assets off the company's balance sheet and to issue to investors the right to receivables generated by the vessel under charter parties. For the leasing company to achieve such benefits, the securitized asset must be transferred to a bankruptcy-remote vehicle that has acquired ownership of the ship through a legal true and irrevocable sale, and receivables owed through the leasing company's rights to collect lease payments may be assigned to investors but may not be reached by a parent company.

Vessel lease financing arrangements also have application where a prospective owner is limited by law or by company charter to a maximum amount of equity, or where it may find itself already party to a loan that restricts further borrowing. In either situation, the vessel owning company may be unable to pursue a debt financing arrangement and find lease

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20. *See* Rodricks Wong, *Ship Leasing Takes Flight in China*, MARINE MONEY OFFSHORE (Oct. 2011), http://www.marinemoneyoffshore.com/node/6868.

21. Ying Li, *The Pros and Cons of Leasing in Ship Financing*, 5 WMU J. OF MAR. AFFAIRS 61, 64 (Apr. 2006).

financing still to be a viable arrangement by which it may obtain additional cargo space for its fleet. One of the primary reasons to participate in ship lease financing arrangements rather than through a debt financing arrangement is for ease of balance sheet management. Lease financing is a tool by which a company can control debt ratios on its balance sheet. Vessel leasing allows the company access to additional vessels and cargo capacity from a debt position.[22] The lease appears as debt rather than as equity for the party possessing the vessel. The lessor vessel management company may account for the lease as a credit asset or an account receivable. The lease arrangement puts both parties at a tax advantage over a vessel sale position. Sale-leaseback arrangements may be undertaken by entities such as shipyards to take advantage of this tax credit. The sale-leaseback arrangement may also attract shipyards in need of immediate capital to fund their next build project.

II. VESSEL FINANCE IN CHINA

A. Debt Financing Arrangements in China

With less capital available to close newbuilding deals, traditional debt financing is reserved for only the top credit risks in China—typically the largest state-owned entities. Debt financing deals in the PRC typically require a shipbuilding refund guarantee to secure the purchaser against the shipyard's failure to deliver in accordance with the contract. The shipyard's bank, or its insurer, underwrites the guarantee. However, due to the poor credit rating of many small- and mid-sized shipyards, a refund guarantee makes the transaction prohibitively expensive. Thus, the smaller privately owned entities must bear great risks or pursue innovative security schemes.

An alternative to the shipbuilding refund guarantee is the construction

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22. For additional short-term cargo demands, a ship management company may pursue an operating lease arrangement. Such leasing arrangements are uncommon in the shipping industry because a lease that is for a period shorter than the commercial life of the vessel creates a great deal of uncertainty in the volatile shipping markets, and this arrangement is better suited for a time charter than to a lease. A key difference between operating leases and time charters is that the former is subject to an amortization schedule, so while it may appear as debt for tax deferment, the lessee incurs front-loaded interest expenses. The time charter is not amortized and offers a consistent payment schedule, but it increases balance-sheet assets and liabilities. *See generally* Ying Li, *The Pros and Cons of Leasing in Ship Financing*, 5 WMU J. OF MAR. AFFAIRS 61–74 (Apr. 2006); Nancy L. Hengen, *Vessel Leasing*, *in* EQUIPMENT LEASING-LEVERAGED LEASING, § 20:1–12 (1st ed. 2010), http://www.hklaw.com/files/Publication/e6e1841f-9748-4c90-a351-e1dc3cff6c51/Presentation/PublicationAttachment/7ec88f4d-4abe-48f4-bf4a-958a0664c217/54404.pdf.

mortgage.[23] The Maritime Law of China ("PRC Maritime Law") recognizes the right of a creditor to hold a mortgage interest over a vessel under construction.[24] Pursuant to Article 14 of the PRC Maritime Law, for the mortgage to give the creditor a secured interest, the shipbuilding contract must be registered with the Maritime Safety Administration of China, or else the creditor holds an unsecured interest over the construction project. The purchaser and the shipyard must meet citizenship requirements similar to those U.S. requirements for coastwise trade under the Jones Act.[25] The relevant ship registration procedures are described in the Ship Registration Regulations of China 1994 ("SRRC 1994"). For the ship to be registered in China, it is required that either 1) the ship be owned by a PRC citizen with its principle place of business located in China; or 2) the ship be owned by a legal person established under laws of PRC, with its principal place of business in China, and may involve foreign investment, requiring at least 50 percent capital contribution from Chinese investors.[26]

The Guaranty Law of the PRC ("PRC Guaranty Law"), by way of Articles 41–43, outlines the procedure a creditor must follow to charge its security interest through a mortgage.[27] The mortgage contract is not effective until the registration is complete.[28] The authority to deal with the

23. The construction mortgage approach is not straightforward. As previously described, the approach to securing its rights requires a creditor to comply with provisions from the PRC Maritime Law, the PRC Registration of Ships Regulations, the PRC Guaranty Law, the PRC Registration of Mortgages by Notaries Public Procedures, and the PRC Securities Law.

24. (中华人民共和国海商法) [PRC Maritime Law] (promulgated by Order No. 64 of the President of the PRC, Nov. 7, 1992, effective July 1, 1993) 1992 STANDING COMM. NAT'L PEOPLE'S CONG. art. 14 (China), http://english.mofcom.gov.cn/aarticle/lawsdata/chineselaw/200211/20021100050726.html ("Mortgage may be established on a ship under construction. In registering the mortgage of a ship under construction, the building contract of the ship shall as well be submitted to the ship registration authorities.").

25. 46 U.S.C. § 50501 (2006) ("A corporation, partnership, or association is deemed to be a citizen of the United States only if the controlling interest is owned by citizens of the United States. However, if the corporation, partnership or association is operating a vessel in the coastwise trade, at least 75 percent of the interest must be owned by citizens of the United States.").

26. (中华人民共和国船舶登记条例) [PRC Registration of Ships Regulations] (promulgated by Decree No. 155 of the State Council, June 2, 1994, effective Jan. 1, 1995), art. 2 (China), http://www.asianlii.org/cn/legis/cen/laws/rgtros490/.

27. (中华人民共和国担保法) [PRC Guaranty Law] (promulgated by Order No. 50 of the President of the PRC, June 30, 1995, effective Oct. 1, 1995) 1995 STANDING COMM. NAT'L PEOPLE'S CONG. arts. 41–43 (China), http://www.asianlii.org/cgi-bin/disp.pl/cn/legis/cen/laws/gl132/gl132.html?stem=0&synonyms=0&query=mortgage.

28. *Id.* art. 41.

mortgage registration is the same body that deals with registering the asset.[29] An unregistered mortgage is worthless in effect, so the creditor must follow the registration procedures to secure its position. A party registering its mortgage is secured from the date of execution, but a party failing to register its mortgage remains unsecured and may not defend claims raised by third parties.[30] Article 43 of the PRC Guaranty Law must be read in conjunction with the Registration of Mortgages by Notaries Public Procedures, 2002 ("PRC Mortgage Law") to ensure that the scope of "other property" includes property beyond that specified in the PRC Security Law.[31]

While a creditor's substantive right to charge a construction mortgage over a vessel under construction exists pursuant to the Maritime Law of China, the Property Law of the People's Republic of China 2007 ("PRC Property Law") also reaffirms the right to secure a shipbuilding project with a construction mortgage. In a priority contest, a mortgage made pursuant to the PRC Property Law primes a mortgage entered into under the Maritime Law of China because

> [t]his Law is enacted in accordance with the Constitution for the purpose of upholding the basic economic system of the State, maintaining the order of the socialist market economy, defining the attribution of things, giving play to the usefulness of things and protecting the property right of obligees.[32]

The PRC Property Law derives its authority directly from the Chinese Constitution out of a basic interest for upholding economic order, while the PRC Maritime Law arose from an interest in regulating, promoting, and developing maritime transport relations and securing the rights of parties concerned.[33]

Under the PRC Property Law, Article 180 lists vessels as "property which the debtor or the third party is entitled to dispose of may be

29. *Id.* art. 42(4).

30. *Id.* art. 43.

31. (公证机构办理抵押登记办法) [PRC Registration of Mortgages by Notaries Public Procedures] (promulgated by Ministry of Justice Order No. 68, Feb. 20, 2002, effective Feb. 20, 2002), art. 3(4) (China), http://www.chinalawedu.com/news/23223/23228/22541.htm (citing Arts. 37, 42 of the PRC Security Law).

32. (中华人民共和国物权法) [PRC Property Law] (promulgated by Order No. 62 of the President of the PRC, Mar. 16, 2007, effective Oct. 1, 2007) 2007 NAT'L PEOPLE'S CONG. art. 1 (China), http://www.china.org.cn/china/LegislationsForm2001-2010/2011-02/11/content_21897791.htm.

33. *Compare id.*, *with* [PRC Maritime Law] (promulgated by Order No. 64 of the President of the PRC, Nov. 7, 1992, effective July 1, 1993) 1992 STANDING COMM. NAT'L PEOPLE'S CONG. art. 1.

mortgaged."[34] Alternatively, a vessel under construction may be construed as "production equipment, raw and semi-finished materials, semi-finished products and finished products," and falling within the purview of Article 180(4).[35]

Under a bank debt financing arrangement, the purchaser both owns and possesses the vessel subject to their creditor's security interest. A registered construction mortgage allows a creditor to secure rights to a vessel and gives the lender executable rights over the property in case of the purchaser's default. To enforce its rights, the creditor bank must understand and apply the PRC laws regarding default, foreclosure, and repossession of the property in order for the creditor bank to enforce its rights secured by the mortgage.

B. Lease Financing Arrangements in China

1. Lease Financing in China—Now a Viable Option, Soon a Popular One

Debt financing arrangements remain almost exclusively available to state-owned entities, and the smaller privately owned shipping companies benefit from innovative risk-allocating arrangements such as lease financing. Despite China's global importance to import and export markets and its growing shipping sector, small- and medium-sized Chinese shipowners are considered "un-bankable" by state-owned banks, so these companies benefit from alternative forms of ship acquisition arrangements like lease financing.[36] Leasing agreements allow prospective purchasers to avoid certain commercial and legal complications—such as obtaining a shipbuilding refund guarantee—incumbent with newbuilding projects.

A vessel leasing arrangement provides for a more streamlined legal approach to debt financed acquisition of vessels, and it puts less strain upon vessel managers to negotiate legally complex financing arrangements with banks and instead can devote greater resources to pairing charters with appropriate vessels.

Since first being permitted in 2007, a significant amount of vessel leasing deals have been arranged in the Chinese shipping sector. For example, Minsheng Financial Leasing Co. ("Minsheng"), which is rapidly becoming one of the most important lease financing companies in China's

34. [PRC Property Law], art. 180(5).

35. *Id.* art. 180(4).

36. Rodricks Wong, *The Changing Topography of Ship Finance in China*, MARINE MONEY OFFSHORE (Oct. 2011), http://www.marinemoneyoffshore.com/node/3889.

domestic market, entered into an agreement with Shanghai Guodian Shipping Co. Ltd, a subsidiary of Fujian Guohang Ocean Shipping Co. Ltd. to deliver eighteen Panamax bulk carriers under a financial leasing arrangement.[37] Rongsheng Heavy Industries Group Holdings Ltd., a Chinese heavy industries group and shipbuilder, announced that the first of the Minsheng-commissioned Panomax bulkers were delivered after three years on October 28, 2011.[38] Before taking delivery, Minsheng placed a bullish order for ten additional Panomax vessels in 2010 and, subsequently, sought Chinese candidates for lease financing.[39] ICBC is still one of the largest Chinese vessel leasing companies, offering an array of solutions applicable to the shipping sector including financial leasing for new equipment; operating leasing for new equipment; sale and leaseback financing; international synthetic leasing; and trust lease and securitizing.[40]

Leasing companies can be funded by capital markets. Shanghai-based Sinochem owns a subsidiary—Far East Horizon—that provides financial leasing services supporting major Chinese industries. The China Securities Regulatory Commission in 2011 permitted the Chinese-owned subsidiary to access global equity by listing publicly in Hong Kong.[41]

Chinese banks are becoming shipowners by creating leasing arms that fund newbuild projects and maintain ownership over the assets. The leasing arm can permit ship managers to charter the vessel out, putting the bank-owned asset to work and receiving the benefit through contracts for hire rather than through complicated procedures for mortgage. Maintaining ownership of the asset the banks minimize judicial intervention required to repossess the vessel. Leasing companies may be an arm of a bank, and thus, they are positioned to obtain favorable credit ratings or credit enhancement. Alternatively, leasing companies may be an arm of a shipyard or shipbuilding company, taking advantage of favorable pricing

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37. *A Cooperation Agreement Inked Among CCS, Fujian Guohang Group, and Minsheng Financial Leasing Co.*, CHINA CLASSIFICATION SOC'Y (Sept. 5, 2008), http://www.ccs.org.cn/ccsewwms2007/displayNews.do?id=91&displayLanguage=null.

38. *China: RHI Christens First Panamax Bulk Carrier Ordered by Minsheng Financial Leasing,* WORLD MARITIME NEWS (Oct. 30, 2011), http://worldmaritime news.com/archives/36919/china-rhi-christens-first-panamax-bulk-carrier-ordered-by-m insheng-financial-leasing/.

39. Neil Connor, *Minsheng Seeks Leasing Clients for Latest Orders*, TRADE WINDS NEWS (May 27, 2010), http://www.tradewindsnews.com/weekly/202545/ minsheng-seeks-leasing-clients-for-latest-orders.

40. *Equipment Finance*, ICBC LEASING SOLUTIONS (last visited Sept. 9, 2015), http://www.icbcleasing.com/en/03-%20Services/3-1-Business%20field/3-1-3-Equipme nt%20finance.html.

41. *Chinese finance leasing firm debuts in Hong Kong,* CHINA L. & PRAC. (Apr. 4, 2011), 2011 WLNR 8601079.

over the asset and collapsing its profit margin with the shipbuilder's margin.

In China, leasing companies must be licensed in order to engage in vessel leasing arrangements. In 2007, the China Banking Regulatory Commission ("CBRC") began granting non-bank financial entities licenses to lease ships.[42] In 2009, leasing companies registered under the CBRC Scheme offer finance leasing solutions across industries reaching RMB 20 billion (US$2.9 billion) in volume.[43] By 2011, seventeen bank-affiliated financial leasing companies had been issued licenses and were supervised by the CBRC; however, these seventeen leasing companies were not limited to the shipping sector but instead included licenses to lease aviation equipment, heavy machinery, medical equipment, and the like.[44]

Leasing's popularity has brought innovative leasing arrangements including a cross-border vessel finance lease through an SPV established in the Tianjin Free Trade Zone, acting as the vessel's owner to contract for construction with a Korean shipyard and a Marshall Islands bareboat charterer.[45] The Chinese leasing company that arranged the deal will own the vessel and lease it to a Chinese operator, but the parties benefit from accessing the most advanced shipyards in Korea and by flying the Marshall Islands flag, a favorable shipping jurisdiction. The possibility of cross-border deals is among the most exciting innovations to Chinese vessel finance, which has long been state-sponsored and off-limits to citizens.

The leasing company may be an arm of a bank, and thus positioned to obtain high credit ratings or credit enhancement. The CBRC Scheme contains strict requirements ensuring that transactions between related parties proceed with no more favorable terms than those between non-related parties undertaking similar transactions.[46] The leasing company may be an arm of a shipyard or a shipbuilding company, and thus it can take advantage of favorable pricing over the asset and collapse its margin with the shipbuilder's margin. Shipyards or builders will likely obtain licensing for finance leasing from the Chinese Ministry of Commerce ("MOFCOM") to avoid the strict requirements of the CBRC Scheme requiring favorable terms for transactions between related parties.[47]

42. Rodricks Wong, *Ship Leasing Takes Flight in China*, MARINE MONEY OFFSHORE (Oct. 2011), http://www.marinemoneyoffshore.com/node/6868.

43. *Id.*

44. *Id.*

45. *Id.* at 6.

46. Jean-Marc Deschandol & Charles Desmeules, *Finance Leasing with Chinese Characteristics*, CHINA L. & PRAC. (July 1, 2007), 2007 WLNR 28161582.

47. *See infra* Part II.B.2 (defining MOFCOM and the CRBC Scheme).

Notably, there are two types of leases typically arranged for assets such as ships, aircraft, and heavy equipment: finance leases and operating leases. Finance leases are arranged for the commercial life of the asset, proceed with a transfer of ownership from the lessor to the lessee, and conclude with a lessee's option to purchase the asset at fair market value. The finance lease lasts for the span of the asset's functional life. Operating leases are short term, and the same asset may be leased out once again after a lease is concluded. Operating leases may solve immediate capacity shortfalls or be used to bridge other issues caused by uncertainty. Insofar as this Article is concerned with leases, it is concerned primarily with finance leases.

2. Two Competing Schemes for PRC Financial Leasing Companies

There are two competing schemes in the PRC under which companies may register to conduct finance leasing transactions. The CBRC issued the "Measures for the Administration of Lease Financing Companies," effective on March 1, 2007, was revised by Order [2014] No.3 of the CBRC, and it entered effect on March 13, 2014. Herein, it will be referred to as the "CRBC Scheme." The Chinese Ministry of Commerce issued the "Measures for the Administration of Foreign-capital Lease Industry," which became effective on March 5, 2005, referred to herein as the "MOFCOM Scheme."[48]

The CBRC Scheme targets large financial entities, requiring its principal investors to hold at least fifty percent of the company's registered capital on hand. Conversely, the MOFCOM Scheme is more investor-friendly and is better suited for manufacturers and privately funded financial leasing companies, but it still requires at least US$5 million in assets and three years experience in lease financing.[49] Under the MOFCOM Scheme, small- to mid-sized non-bank leasing companies may engage in vessel leasing operations more easily without a CBRC license. Neither the CBRB Scheme nor the MOFCOM Scheme place any cap on foreign investor shareholdings in a finance leasing company.

The two schemes differ in the types of foreign investment vehicles each scheme permits, and each scheme has different capital requirements for the

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48. (外商投资租赁业管理办法) [PRC Measures for the Administration of Foreign-Capital Lease Industry] (promulgated by the Ministry of Commerce, Jan. 21, 2005, effective Mar. 5, 2005), art. 6(2) (China), http://www.asianlii.org/cgi-bin/disp.pl/cn/legis/cen/laws/mftaofli611/mftaofli611.html?stem=0&synonyms=0&query=Foreign-Capital%20Lease%20Industry.

49. Jean-Marc Deschandol & Charles Desmeules, *Finance Leasing with Chinese Characteristics*, CHINA L. & PRAC. (July 1, 2007), 2007 WLNR 28161582.

leasing company. Both schemes are alike in that neither places a cap on foreign investment.

As mentioned, the two schemes have drastically different capital requirements. Likely structured to control few assets, a vessel management company seeking to undertake a lease financing enterprise is better suited for the MOFCOM Scheme's lower capital requirements.[50] While there is nothing in the CBRC Scheme to make investors concerned that vessels are not an asset suitable for lease financing under the scheme, the MOFCOM Scheme specifically names "vessels" as a type of property that may be leased under the scheme.[51] Attractive to companies seeking to manage their balance sheets, sale-leaseback arrangements are specifically permitted under both the CBRC Scheme[52] and the MOFCOM Scheme.[53]

With no cap to limit foreign investor shareholdings,[54] foreign investors can take part in either scheme. However, the MOFCOM Scheme applies only to foreign-capital enterprises that establish a limited liability company or a joint-stock limited company within China, and it must take the form of a Chinese-foreign equity joint venture, a Chinese-foreign contractual joint venture, or a solely foreign-capital enterprise.[55] Certain foreign entities

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50. *Compare* [PRC Measures for the Administration of Foreign-Capital Lease Industry], art. 7 (noting that the Scheme's capital requirement is at least US$5 million in assets or capital), *with* (金融租赁公司管理办法) [PRC Measures for the Administration of Financial Leasing Companies] (promulgated by the China Banking Regulatory Commission, Mar. 13, 2014, effective Mar. 13, 2014), arts. 9(3), 10(2), 11(2) (China), http://www1.lawinfochina.com/display.aspx?id=17474&lib=law (noting that the Scheme's capital requirement is at least RMB80 billion (approximately US$12.9), RMB5 billion (approximately US$806 million), or RMB10 billion (approximately US$1.6 billion)).

51. [PRC Measures for the Administration of Foreign-Capital Lease Industry], art. 6(2).

52. *See* [PRC Measures for the Administration of Lease Financing Companies], art. 5 ("For the purposes of these Measures, the term 'sale-leaseback' means a form of lease financing wherein the lessee sells [property] to the lessor" and executes an agreement with the lessor to lease back the same property from the lessor. The lessee and the supplier are the same party.).

53. *See* [PRC Measures for the Administration of Foreign-Capital Lease Industry], art. 5 ("The foreign-capital financial leasing company may undertake its financial leasing business by adopting the various forms of direct lease, sublease, leaseback, leveraged lease, trust lease and joint lease.").

54. There is a caveat that Promoter requirements must be satisfied. *See infra* nn.64–71.

55. *See* [PRC Measures for the Admin. of Foreign-Capital Lease Industry], arts. 2–3 ("These Measures shall apply to the foreign-capital companies, enterprises and other economic organizations (hereinafter referred to as the foreign investors) that establish foreign-capital enterprises within the territory of China in the forms of Chinese-foreign equity joint venture, Chinese-foreign contractual joint venture and solely foreign-capital enterprise to conduct leasing business or financial leasing business. Article 3:

may utilize the CBRC Scheme as well. While banks are specifically prohibited from becoming lease financing companies under the CBRC Scheme,[56] commercial banks may be the major investor in a lease financing company and may be registered in China or abroad.[57] The CBRC Scheme also permits the major investor to be a leasing company registered in China or abroad,[58] or a large domestic manufacturer of products suitable for leasing.[59] Thus, the CBRC Scheme is attractive to domestic or foreign banks, to domestic or foreign companies already in the business of lease financing, and to domestic manufacturers of products suitable for lease financing arrangements, such as state-owned shipyards seeking to invest in a lease financing arm.

Entities with foreign equity interest exceeding fifty percent of total capital are prohibited from registering vessels on the PRC registry.[60] These entities can utilize either the CBRC Scheme or the MOFCOM Scheme to circumvent this restriction by having the registered vessel owner be a leasing company with more than fifty percent of its registered capital in the PRC.[61] While both schemes are still in effect, it appears that the PRC has chosen to develop the CBRC Scheme over the MOFCOM scheme by providing recent revisions to the measures and by issuing guiding documentation to clarity or extend the legal purview of the scheme.

3. Lease Financing under the CBRC's Revised Scheme—The 2014 Measures

The CBRC's pilot project began in 2007.[62] By its end in September 2013, twenty-three lease financing companies had been established on China's mainland, and these companies held assets totaling RMB95.6

The foreign-capital lease industry may take the form of a limited liability company or a joint-stock limited company. A foreign-capital enterprise undertaking leasing business is a foreign-capital leasing company. A foreign capital enterprise undertaking financial leasing business is a foreign-capital financial leasing company.").

56. [PRC Measures for the Administration of Lease Financing Companies], art. 2.

57. *Id.* art. 9.

58. *Id.* art. 9(2).

59. *Id.* art. 9(3).

60. (中华人民共和国船舶登记条例) [PRC Registration of Ships Regulations] (promulgated by Decree No. 155 of the State Council, June 2, 1994, effective Jan. 1, 1995), art. 2(2) (China), http://www.asianlii.org/cn/legis/cen/laws/rgtros490/.

61. Jean-Marc Deschandol & Charles Desmeules, *Finance Leasing with Chinese Characteristics*, CHINA L. & PRAC. (July 1, 2007), 2007 WLNR 28161582.

62. [PRC Measures Administering Finance Leasing Companies] (promulgated by the China Banking Regulatory Commission, Jan. 23, 2007, effective Mar. 1, 2007) [EXPIRED] (China), http://www.asianlii.org/cn/legis/cen/laws/maflc413/.

billion (approximately US$15.3 billion) and earned profits of RMB1.18 billion (approximately US$189.3 million).[63] Newly revised measures replaced the 2007 measures and marked a more flexible regulatory scheme open to project-based special purpose vehicles commonly relied upon in the shipping industry.[64]

Lease financing companies are non-bank financial entities primarily engaged in financial leasing as their core business.[65] Only fixed assets are eligible as leased items for financial leasing,[66] and for assets that require ownership to meet certain registration requirements, the lease financing company must register using the appropriate procedures.[67] Sale-leaseback arrangements—where the lessee and the supplier are one and the same party—are explicitly permitted,[68] but the leasing company shall not accept for leaseback an asset subject to any mortgage.[69] In order to establish a lease financing company, the company, established in compliance with the PRC Company Law[70] must apply to the CBRC. An eligible applicant must have, *inter alia*, minimum registered capital of RMB100 million, or its equivalent, and fifty percent of the company's employees must have a minimum of three years' experience working in financial or financial leasing businesses.[71]

Lease financing companies must have an eligible promoter in order to gain CBRC approval,[72] and the promoter shall contribute at least thirty percent of the total capital for the proposed lease financing company.[73] Eligible promoters may be a commercial bank registered within or outside

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63. Xin Zhang & Miller Wang, *Opinion: Aircraft and ship lease financing opens up*, CHINA L. & PRAC. (Apr. 24, 2014), 2014 WLNR 16482976.

64. *See id.*

65. (金融租赁公司管理办法) [PRC Measures for the Administration of Financial Leasing Companies] (promulgated by the China Banking Regulatory Commission, Mar. 13, 2014, effective Mar. 13, 2014), art. 2 (China), http://www1.lawinfochina.com/display.aspx?id=17474&lib=law (stating that the term "lease financing company" must be indicated in the company's name and no entity may include such words in its name unless approved by the CBRC).

66. *Id.* art. 4.

67. *Id.* art. 33.

68. *Id.* art. 5.

69. *Id.* art. 34.

70. [PRC Company Law] (promulgated by Order No. 42 of the President of the PRC, Oct. 27, 2005, effective Mar. 1, 2014) 2013 STANDING COMM. NAT'L PEOPLE'S CONG., http://www1.lawinfochina.com/Display.aspx?lib=law&Cgid=60597.

71. *Id.* arts. 7(3)–(4).

72. *Id.* art. 7(2).

73. *Id.* art. 12.

of China,[74] be a large enterprise registered within China,[75] or be a lease financing company registered outside of China with total assets of not less than RMB10 billion in freely convertible currency, and it pledges in its application not to transfer its equity holdings in the CBRC lease financing company for five years.[76] Foreign financial entities other than lease financing companies eligible under Article 11 of the 2014 Measures shall qualify to be a promoter of a CBRC lease financing company if it has, *inter alia*, not less than US$1 billion or its equivalent in total assets or freely convertible currency and if it pledges not to transfer its equity holdings in the CBRC lease financing company for five years.[77] Whoever the promoter may be, the promoter must agree to provide liquidity to the financial leasing company in the event of payment difficulties (insolvency) and to promptly replenish any of the financial leasing company's eroding capital due to operating losses.[78]

In several ways, the 2014 Measures are open to foreign investment. The 2014 Measures may accommodate foreign direct investment, as they contain no provision restricting the seventy percent non-promoter capital being contributed from foreign investors. If the promoter is a foreign entity under Article 11 or 14 of the 2014 Measures, then, subject to CBRC approval, the CBRC lease financing company could be entirely foreign owned. Subject to CBRC approval, a registered lease financing company may transact its business in either RMB or in a foreign currency.[79] It may engage in the business of fixed-return securities investment.[80] The lease financing company may engage in overseas borrowing.[81] Subject to CBRC approval, a registered lease financing company may issue bonds in either RMB or in foreign currency,[82] and it may securitize its assets.[83] However, fixed-return securities investment shall not exceed 20 percent of the leasing company's net capital.[84]

In July 2014, the CBRC promulgated the Interim Provisions on the Administration of Specialized Subsidiaries of Financial Leasing Companies

74. *Id.* art. 9.
75. *Id.* art. 10.
76. *Id.* arts. 11(2), (7).
77. *Id.* arts. 14(3), (6).
78. *Id.* art. 16.
79. *Id.* art. 26.
80. *Id.* art. 26(3).
81. *Id.* art. 26(8).
82. *Id.* art. 27(1).
83. *Id.* art. 27(3).
84. *Id.* art. 46.

("Interim Provisions") in order to supplement and clarify certain aspects of the CBRC Scheme.[85] Through the Interim Provisions, the CBRC Scheme specifically permits financial leasing companies to establish overseas subsidiaries for specific fields that include vessel leasing.[86] Financial leasing companies can directly establish specialized subsidiaries domestically, overseas, and within Mainland FTZs and bonded areas.[87] By setting up specialized subsidiaries, a mature financial leasing company can leverage its advantages by experimenting with new or riskier ventures separate from the parent.[88] The promoter of the overseas subsidiary shall be a financial leasing company established under the CBRC Scheme.[89] In order to establish an overseas subsidiary, the financial leasing company must demonstrate that it has a genuine business development need and that it maintains clear overseas development strategies.[90] The leasing company must also demonstrate that it has internal management and risk control capabilities suitable for overseas business development.[91]

As with all aspects of the CBRC Scheme, the CBRC examines and interprets the application conditions. Once established, the overseas subsidiary must report to the CBRC its place of registration, its registered overseas capital, the currency of the capital injected, and other reporting formalities.[92] Subsidiaries established in China's Special Administrative Regions are considered overseas specialized subsidiaries for purposes of the Interim Provisions.[93] Under special circumstances, foreign companies may invest in domestic specialized subsidiaries established under the Interim Provisions, but the parties must establish there is a need for foreign investors; the domestic financial leasing company shall control at least 51

85. *See generally* (中国银行业监督管理委员会办公厅关于印发金融租赁公司专业子公司管理暂行规定的通知) [PRC Interim Provisions on the Administration of Specialized Subsidiaries of Financial Leasing Companies] (promulgated by Yin Jian Ban Fa No. 198 of the China Banking Regulatory Commission, July 11, 2014, effective July 11, 2014) (China), http://www.lawinfochina.com/display.aspx?id=17567&lib=law&SearchKeyword=&SearchCKeyword=.

86. *Id.* art. 2.

87. *Id.*

88. Shu Wang & Jun Zhu, *CBRC Issues Interim Provisions on the Admin. of Specialized Subsidiaries of Fin. Leasing Companies*, 8 HAN KUN LAW OFFICES—CHINA PRACTICE GLOBAL VISION 1, 7–13 (Aug. 27, 2014), http://www.lexology.com/library/detail.aspx?g=ece62802-f46f-4759-874e-52685ae547c8.

89. *Id.* at 10–11.

90. [PRC Interim Provisions on the Administration of Specialize Subsidiaries of Financial Leasing Companies], art. 11(1).

91. *Id.* art. 11(2).

92. *Id.* art. 15.

93. *Id.* art. 33.

percent of the domestic subsidiary; and the foreign investors must satisfy all the conditions to be a promoter under the CBRC Scheme.[94]

III. SECURITIZATION IN THE SHIPPING SECTOR

A. Securitizing Newbuilding Projects and Lease Financing Agreements

Securitization is attractive to shipyards looking for off-balance sheet financing for construction projects, and it is attractive to lease financing companies. Securitization allows the originator to realize assets up front and shift liabilities off its own balance sheet by selling the credit risk to investors.

Securitization is attractive to shipbuilders as an alternative method to finance newbuilding projects that otherwise would rely upon the buyer's installment payments or upon the shipyard's own balance sheet, putting a heavy strain on the shipyard's own resources and access to cheap credit.[95]

Under a buyer's installment ship financing plan, the primary source of construction capital is the shipyard's own balance sheet as the shipyard must first pay the costs of construction to meet a progress goal, and the buyer pays the shipyard only after (and not before) portions of construction have been completed, replenishing the shipyard's ability to pay the continuing costs of construction. The problem that securitization solves is the shipyard's inability to get ahead of the buyer's installment payments—instead, the shipyard sells in one lump sum the right to receive the buyer's installment payments before any installments are actually collected.

Sale of the rights to collect the buyer's installment payments can be outright and final. Because the sale is final rather than contingent upon performance, the credit risk shifts to the investor, and the shipyard holds no liability on its own balance sheet. Instead, the shipyard can realize gains from the deal before it completes the newbuilding project and, in this way, achieve off-balance sheet financing for construction.[96]

Selling upfront the right to collect a buyer's future payments, investors

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94. *Id.* art. 5; *see supra* nn.65–72 and accompanying text for discussion of the requirements to become a promoter under the CBRC Scheme.

95. Richard Henderson, *Understanding Ship Yard Securitization*, MARINE MONEY OFFSHORE (Mar. 1, 2000), https://www.marinemoneyoffshore.com/node/5880 (explaining that when payments are paid after work is completed, the shipbuilder's balance sheet is the builder's principle source of finance. Securitization allows the shipbuilder to free up its own balance sheet for other purposes.).

96. *Id.* (stating that the shipbuilder is selling the right to receive installment payments from the buyer before they are due).

will discount the shipyard's right to collect over time, and the shipyard will collect a lower total payment for the vessel under construction through securitization than it would have had it collected installments directly from the buyer.[97] However, the shipyard will be paid in advance and can use its clean balance sheet to begin the next project or to close another deal—leverage.[98]

Similarly, securitization is also attractive to leasing companies engaged in vessel lease financing agreements for the commercial life of a vessel because it is a mechanism to generate the capital required to pay for the deal outright, freeing up the leasing company's own balance sheet for additional deals. In order to raise upfront the capital necessary for the leasing company to first purchase a vessel that it will lease out, the leasing company can securitize the right for investors to receive regular future proceeds, such as hire payments, paid upon the vessel lease financing agreement.

B. Securitization in China

While securitization has been used widely in Western shipping markets, securitization in China is relatively new and untested, but increasingly popular under two distinct securitization schemes. Securitization in China relies upon the special purpose trust, which is a contractual arrangement created by the trust contract pursuant to statutory authority. The special purpose trust is not an independent legal entity. By law, the trust property is not property belonging to the estate of the trustee, and by contract, the originator entrusts credit assets to the special purpose trust. While new regulations in 2014 aspire to add clarity to and interest in the PRC, such securitization schemes may establish uncertain rights for investors in cross-border securitization deals because of how Western investors are likely to view legal isolation of the entity issuing securities, which "from a constitutional point of view it is a case of sending a boy to do a man's job."[99]

The CBRC Scheme launched in 2005 pursuant to a pair of CBRC and People's Bank of China ("PBOC") regulations permitting banks and non-bank financial entities to entrust loan receivables to a trust company for administration as trustee of those assets.[100] CBRC requires licensing and

97. *See id.*

98. *See id.*

99. Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS 1, 9 (Feb. 11, 2015), http://www.dentons.com/~/media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

100. (金融机构信贷资产证券化试点监督管理办法) [PRC Measures for the

approval for every step along the way. The banks and non-bank financial entities must be licensed by the CBRC.[101] The loan receivables must constitute "credit assets" under CBRC guidelines.[102] The trust must be licensed by the CBRC,[103] and any securities the trustee may issue requires specific approval both by the CBRC[104] and by the PBOC.[105]

As of February 2015, the CBRC Scheme has been used to establish eighty-five domestic securitization transactions in China since the program launched in 2005—sixty-eight of those transactions were concluded since 2012.[106]

Under the CBRC Scheme, the sponsor, who originates the receivable credit assets, enters into a trust contract with the trustee, establishing a special purpose trust.[107] Pursuant to the PRC Trust Law, the sponsor entrusts credit assets by contract, and the trustee issues securities.[108]

In addition to the CBRC Scheme, the PRC saw fit to establish another

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Supervision and Administration of Pilot Projects of Credit Asset Securitization of Financial Institutions] (promulgated by Decree No. 3 of the China Banking Regulatory Commission, Nov. 7, 2005, effective Dec. 1, 2005), arts. 3–4 (China), http://www.asianlii.org/cn/legis/cen/laws/mftsaaotpsocaofi1179/ [hereinafter "PRC Measures for the Supervision and Administration of Pilot Projects"]; (信贷资产证券化试点管理办法) [PRC Administrative Measures for Pilot Securitization of Credit Assets] (promulgated by the People's Bank of China and the China Banking Regulatory Commission, Apr. 20, 2005, effective Apr. 20, 2005), art. 2 (China), http://www.lawinfochina.com/display.aspx?id=4122&lib=law&SearchKeyword=CREDIT%20ASSETS&SearchCKeyword=.

101. [PRC Measures for the Supervision and Administration of Pilot Projects], art. 2.

102. *Id.* art. 3.

103. *Id.* art. 7.

104. *Id.* art. 5.

105. [PRC Administrative Measures for Pilot Securitization of Credit Assets], art. 10.

106. Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS 1, 1–2 (Feb. 11, 2015), http://www.dentons.com/~/media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

107. [PRC Administrative Measures for Pilot Securitization of Credit Assets], arts. 20, 21.

108. (中华人民共和国信托法) [PRC Trust Law] (promulgated by Order No. 50 of the President of the PRC, Apr. 28, 2011, effective Oct. 1, 2011) 2001 STANDING COMM. NAT'L PEOPLE'S CONG. arts. 6–13 (China), http://www.asianlii.org/cgi-bin/disp.pl/cn/legis/cen/laws/tl126/tl126.html?stem=0&synonyms=0&query=Trust%20Law%20of%20the%20people%27s%20republic%20of%20china; Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS 1, 2 (Feb. 11, 2015), http://www.dentons.com/~/media/PDFs/Insights/2015/February/Securitization_in_China.pdf. (noting that at least two classes of securities are created—a senior class of securities is issued to investors and a subordinate class of securities is held by the sponsor).

securitization mechanism under the China Securities Regulatory Commission ("CSRC Scheme"). The CSRC Scheme is well suited for the shipping industry because the underlying assets must be specific and be able to generate independent and predictable cash flow.[109] Thus, a lease financing company wishing to securitize the regular proceeds generated by hire payments in accordance with underlying lease financing agreements, and a shipyard wishing to securitize proceeds generated by buyers' installment payments will find these are suitable underlying assets for securitization by the CSRC Scheme.[110]

Under the CSRC Scheme, investors entrust funds to securities companies[111] pursuant to a fund contract.[112] The fund manager uses the entrusted funds to purchase assets, and the manager issues asset-backed securities to a maximum of 200 investors.[113] The asset-backed securities evidence the purchaser's beneficial interest in the underlying assets, and the securities can be traded and purchased by qualified foreign and domestic investors alike on stock exchanges such as the Shanghai and Shenzhen exchanges and over-the-counter marketplaces approved by the CSRC.[114]

The 2014 CSRC regulations are established upon the PRC Securities Investment Funds Law,[115] which incorporates the PRC Trust Law.[116] Under the CSRC Scheme, Article 5 asserts that assets entrusted into the scheme are legally isolated. However, there is reason to question how courts, as well as foreign investors, will interpret the status of assets entrusted into the CSRC Scheme, which is premised upon a set of

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109. [PRC Administrative Provisions on the Asset Securitization Business of Securities Companies and Subsidiaries of Fund Management Companies] (promulgated by the China Securities Regulatory Commission, Nov. 19, 2014, effective Nov. 19, 2014), art. 3 (China) [hereinafter "PRC Administrative Provisions on Asset Securitization"] (on file with the *American University Business Law Review*).

110. *Id.* art. 3 (including specifically "account receivables [and] creditors' right under lease").

111. (中华人民共和国证券投资基金法(2012修订)) [PRC Securities Investment Fund Law] (promulgated by Order No. 71 of the President of the PRC, Dec. 28, 2012, effective June 1, 2013) 2012 STANDING COMM. NAT'L PEOPLE'S CONG. art. 2 (China), http://www1.lawinfochina.com/display.aspx?id=12559&lib=law; Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS 1, 3–4 (Feb. 11, 2015), http://www.dentons.com/~/media/PDFs/Insights/2015/February/Securitization_in_China.pdf.

112. [PRC Securities Investment Fund Law], art. 3.

113. [PRC Administrative Provisions on Asset Securitization], art. 38.

114. *Id.*

115. *Id.* art. 1. (incorporating [PRC Securities Investment Fund Law]).

116. [PRC Securities Investment Fund Law], art. 2 (incorporating the [PRC Trust Law]).

administrative regulations not constituting statutory law.[117] While the regulations assert that assets are isolated from their originator's estate for insolvency purposes, the statutory law is less clear.[118]

Assets become legally isolated upon a legal true sale when the previous owner has discharged both ownership and possession of the assets. Translations of the PRC Trust Law contemplate entrustment as a discharge of possession, but they do not clearly and undisputedly discharge ownership.[119] While courts in the PRC have interpreted the PRC Trust Law to provide legal isolation to assets entrusted under Article 2, it is less certain whether Western investors will find assets to be isolated from the estate in bankruptcy when those assets have been discharged for purposes of possession but not for ownership.[120]

While securitization is a helpful and popular device used in the Western shipping markets, the two schemes available for investment in China do not provide the certainty and wide accessibility necessary for securitization to be useful to PRC shipping markets. Amendments to the PRC Trust Law, clarifying that both ownership and possession indeed transfer with entrustment and providing that trusts establish separate and identifiable legal entities rather than a set of contractual rights, would be major steps toward increasing the viability of securitization in PRC shipping markets for shipyards and for vessel lease financing companies. Furthermore, subjecting every step to approval by the requisite commission adds uncertainty to the process that would better be removed.

IV. OPPORTUNITY FOR FOREIGN INVESTMENT IN THE FREE TRADE ZONES

By a major decision of the central government, the PRC established certain geographic FTZs in order to accelerate the national transformation of government functions and actively explore innovative administrative models to promote and facilitate trade and investment in China.[121] The

117. Jefferey H. Chen & Liu Haiping, *Securitization in China – overview and issues*, DENTONS 1, 7 (Feb. 11, 2015), http://www.dentons.com/~/media/PDFs/Insights/2015/February/Securitization_in_China.pdf..

118. *Id.* at 4–5 (comparing Article 5 of the [PRC Provisions on the Asset Securitization Business of Securities Companies and Subsidiaries of Fund Management Companies] with Article 2 of the [PRC Trust Law]).

119. *Id.*

120. *See id.* (explaining that Chinese law does not explicitly disambiguate the concept of ownership from the concept of possession when viewed in the context of trusts).

121. [General Plan for the China (Shanghai) Pilot Free Trade Zone] (promulgated by Guo Fa [2013] No.38 of the State Council on Sept. 18, 2013) art. 1 (China) [hereinafter "General Plan for China"].

FTZs were designed to attract and develop foreign leasing companies and were established to facilitate industries such as international shipping and shipping finance and international vessel management.[122] While Tianjin—and, more recently, its FTZ—has long been an attractive forum for single-ship companies, special purpose vehicles, and novel leasing ventures, the CBRC Scheme has given rise to strong competition from the Shenzhen Wianhai Economic Zone and the Shanghai Pilot FTZ, where financial leasing is a stated priority.[123]

Under the CBRC Scheme, unlike the general policy throughout China where all business actions are prohibited except for those the government has occasioned to specifically permit, the Shanghai FTZ operates on the more practical "negative list" approach, wherein business and foreign investment actions are permitted unless specifically restricted by the government.[124] Foreign investment into the leasing industry is regulated in order to promote healthy development and to minimize business risk.[125] The PRC's MOFCOM procedures regulating and administering foreign investment into the PRC leasing industry specifically permit foreign investment into China's ship-leasing industry because the regulations govern leased property for transportation such as vessels and motor vessels.[126] MOFCOM examines and administers foreign investment into the leasing industry,[127] which should be made through limited liability companies or limited through share purchase.[128]

Under the MOFCOM Scheme, foreign investors must have assets

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122. *Id.* arts. 5-6.

123. Xin Zhang & Miller Wang, *Opinion: Aircraft and ship lease financing opens up*, CHINA L. & PRAC. (Apr. 24, 2014), 2014 WLNR 16482976.

124. *See Update on Incentives for Companies to enter the Shanghai FTZ – The Jury is still out*, RHK LEGAL CORPORATE ADVISORS (Oct. 13, 2014), http://www.rhklegal.cn/news/updates/2676.html; *see also* Rick Beaumont, *Avenues to Foreign Investment in China's Shipping Industry—Have lease financing arrangements and the Free Trade Zones opened markets for foreign non-bank investment?*, BEPRESS (2015), http://works.bepress.com/rick_beaumont/3/ (available for download).

125. (外商投资租赁业管理办法) [PRC Measures for the Administration of Foreign-Capital Lease Industry] (promulgated by the Ministry of Commerce, Jan. 21, 2005, effective Mar. 5, 2005), art. 1 (China), http://www.asianlii.org/cgi-bin/disp.pl/cn/legis/cen/laws/mftaofli611/mftaofli611.html?stem=0&synonyms=0&query=Foreign-Capital%20Lease%20Industry.

126. *Id.* art. 6(2) (listing specifically transport facilities as leased property covered by the provisions).

127. *Id.* art. 4 (stating that all foreign-capital leasing companies fall within the jurisdictions of the PRC and that the MOFCOM is the entity charged with regulating the foreign-capital leasing industry).

128. *Id.* art. 3 (listing the types of companies of which the foreign-capital lease industry may take a form).

grossing at least US$5 million in order to enter a foreign-invested leasing company. But under the PRC General Scheme for the Shanghai FTZ, there is no minimum registered capital requirement for stand-alone single ship SPVs that have been established by financial leasing companies located in the FTZ.[129] Foreign-invested companies may participate in several different forms of lease financing such as direct leasing, subleasing, and trust leasing (*i.e.*, securitization).[130] It is suspected that financial leasing companies registered under the CBRC Scheme may establish SPVs in the Shanghai FTZ; however, the industry awaits more detailed announcements from the CBRC regarding non-bank financial entities operating in the FTZ.[131]

Ship-leasing companies operating in the PRC can lease vessels to foreign-owned companies. In fact, the PRC has encouraged exportation of leased ships as a means of encouraging development of local harbors, the vessel construction industry, and the financial leasing industry.[132] In 2010, the PRC State Administration of Taxation offered a one-year export tax refund to those leasing companies that are registered in Tianjin and licensed to conduct financial leasing.[133] Tianjin-based leasing companies engaged in financial leasing arrangements—those in which the terms are for the commercial life of the vessel and by which the lessee is transferred ownership at the expiration of the term—may also apply for export valued-added tax refunds.[134] In the Shanghai FTZ, a pilot export tax refund is available as a project subsidiary to finance leasing companies incorporated in the FTZ.[135] An import-level value-added tax exemption is available

129. *Changes to the Financial Services Market in Shanghai FTZ*, SHANGHAI FTZ SERIES 3 (Nov. 2013); *A milestone for China's new wave of economic reform – Shanghai Pilot Free Trade Zone*, ERNST & YOUNG: CHINA TAX & INVESTMENT NEWS, 1, 4 (Sept. 30, 2013), www.ey.com/Publication/vwLUAssets/CTIN2013005_en/$FILE/EY-CTIN2013005-en.pdf (on file with the *American University Business Law Review*).

130. [PRC Measures for the Administration of Foreign-Capital Lease Industry], arts. 4–5 (listing also leasebacks, leveraged leases, and joint leases as possible methods of participation).

131. *Changes to the Financial Services Market in Shanghai FTZ*, SHANGHAI FTZ SERIES 3 (Nov. 2013); *A milestone for China's new wave of economic reform – Shanghai Pilot Free Trade Zone*, ERNST & YOUNG: CHINA TAX & INVESTMENT NEWS, 1, 3 (Sept. 30, 2013), www.ey.com/Publication/vwLUAssets/CTIN2013005_en/$FILE/EY-CTIN2013005-en.pdf.

132. David Yu & Clare Lu, *Breaking the ice of post-VAT reform*, CHINA L. & PRAC. (June 17, 2010), 2010 WLNR 13941360 (explaining that multiple PRC agencies, including Customs, Taxation, and General Administration of Customs, came together to form this regulation that would encourage participation in development of this type).

133. *Id.*

134. *Id.*

135. *Changes to the Financial Services Market in Shanghai FTZ*, SHANGHAI FTZ

specifically for aircraft finance leasing companies for overseas purchases, but the Value-Added Tax ("VAT") exemption has yet to be extended to other sectors.[136]

Financial leasing was an activity removed from the restricted category of MOFCOM's 2011 guidance catalogue for foreign investors, and thus the activity is now permitted for foreign investors to partake.[137] Minsheng's leasing arm—China's "most ambitious lessor"—is based in the Tianjin FTZ.[138] Financial leasing companies have been permitted in the Shanghai Pilot Free Trade Zone as well. Foreign-invested banks may qualify to set up enterprises in the Shanghai FTZ.[139] Qualifying non-bank and private capital entities may set up finance leasing companies in the Shanghai FTZ.[140] Cross-border financing entities may be established in the Shanghai FTZ for purposes of offshore vessel financing.[141] While these individual entities and activities are permitted in the Shanghai FTZ, it is yet to be seen whether a foreign-invested entity may establish a finance leasing company for purposes of ship-leasing and whether that foreign-invested entity would be subject to the same CBRC regulations and licensing requirements.

China's FTZs are incubators for transformation. MOFCOM approval is no longer needed to establish foreign representative offices in FTZs.[142] This is a positive step toward streamlining foreign investment and removing uncertainty from an opaque administrative process subject to its own internal approval. Now, all the foreign entity must do is follow a set of published registration procedures. Similar steps to promote certainty

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SERIES 3 (Nov. 2013); *A milestone for China's new wave of economic reform – Shanghai Pilot Free Trade Zone*, ERNST & YOUNG: CHINA TAX & INVESTMENT NEWS, 1, 6 (Sept. 30, 2013), www.ey.com/Publication/vwLUAssets/CTIN2013005_en/$FILE/EY-CTIN2013005-en.pdf.

136. *Id.* ("Aircraft with a loading capacity of 25 tons or above purchased by Project Subsidiaries from overseas and leased to domestic airlines can be exempted from import-level VAT.").

137. *See Catalogue for the Guidance of Foreign Inv. Indus. (Amended in 2011)*, PRC MINISTRY OF COMMERCE (Feb. 21, 2012), http://english.mofcom.gov.cn/article/policyrelease/aaa/201203/20120308027837.shtml.

138. Neil Connor, *Minsheng seeks leasing clients for latest orders*, TRADEWINDS (May 27, 2010), http://www.tradewindsnews.com/weekly/202545/minsheng-seeks-leasing-clients-for-latest-orders#.

139. *Circular on China Banking Regulatory Commission on Issues Concerning Banking Supervision in China (Shanghai) Free Trade Zone*, SHFTZ art. 3 (Sept. 28, 2013), http://en.china-shftz.gov.cn/Government-affairs/Laws/Banking/191.shtml.

140. *Id.* arts. 2, 4.

141. *Id.* art. 5.

142. Laetitia Tjoa et al., *Foreign Representative Office Procedures Consolidated*, CHINA L. & PRAC. (July 1, 2004), 2004 WLNR 23450455.

will attract foreign investment and should be adopted more widely. Currently, every step toward establishing a leasing company under the CBRC Scheme is subject to CBRC approval.[143] The PRC should continue to step in the direction of certainty and establish procedures that will continue to open markets to foreign non-bank investment.

143. *See supra* nn.92–94, 100–105.

COMMENT

THE RULE OF LENITY AND THE ENFORCEMENT OF THE FEDERAL SECURITIES LAWS

ANNA CURRIER*

In 1984, the Supreme Court of the United States ruled in Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc. *("*Chevron*") that courts owe deference to an executive agency's interpretation of a statute. On November 10, 2014, the Supreme Court in* Whitman v. United States, *a criminal insider trading case, denied a petition for writ of certiorari. In a statement accompanying the denial of certiorari, Justice Scalia questioned whether a federal court owed deference to an executive agency's interpretation of a statute that has both criminal and administrative applications. The crux of Justice Scalia's concern is that the Securities and Exchange Commission (the "Commission" or "SEC"), through its rulemaking authority, is usurping the role of Congress by defining criminal conduct. Specifically, Justice Scalia reiterated his belief that the rule of lenity requires that any ambiguity arising from the applicable law in a criminal case must be resolved in favor of the defendant and that* Chevron *deference must yield to lenity where a statute has both criminal and administrative application.*

This Comment will examine the impact on the enforcement of the federal securities laws by the Commission and the Department of Justice ("DOJ") and whether Chevron *deference should be required to give way to the rule of lenity where a Commission rule or statute has both criminal and administrative application, specifically Section 10(b), Rule 10b-5, Rule 10b5-1, and Rule 10b5-2. This Comment will also consider how the application of the rule of lenity will affect the national market system and the public investors.*

* I would like to thank my family and Alan Lieberman for their continued support and guidance during this process.

INTRODUCTION

Since the Supreme Court's landmark decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.* ("*Chevron*"), it has been settled law that courts owe deference to an executive agency's interpretation of a "statutory scheme it is entrusted to administer . . . ."[1] The principle, of whether statutory construction will continue to apply in cases involving the enforcement of the federal securities laws, is now in question.

Included in Justice Scalia's concurrence in *Whitman* was an invitation of sorts, expressing his favorable disposition toward granting certiorari in a case that presented the Supreme Court with the opportunity to decide

1. *See* Chevron U.S.A., Inc. v. Nat. Res. Def. Council Inc., 467 U.S. 837, 844 (1984).

whether lenity trumps deference where a rule or statute has both administrative and criminal application.[2] The implication of Justice Scalia's concurrence for the enforcement of the federal securities laws are unprecedented in their scope and impact.[3]

In *Whitman v. United States*, Whitman had been convicted of insider trading as a secondary tippee,[4] and the Second Circuit affirmed his conviction.[5] The Second Circuit followed this rationale in *United States v. Royer*, which held that a defendant commits insider trading in violation of Section 10(b) when he trades "while in knowing possession of nonpublic information material to those trades."[6] *Royer* was based in part on the Court's reading of the Commission's interpretation of Rule 10b5-1[7], which defines insider trading as a manipulative and deceptive device[8] and adopts an awareness standard for insider-trading liability under Section 10(b).[9]

In December 2014, the Second Circuit ("Court") decided another criminal insider trading case: *United States v. Newman*.[10] In *Newman*, the

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2. *See* Whitman v. United States, 135 S. Ct. 352, 352, 354 (2014) ("A court owes no deference to the prosecution's interpretation of a criminal law . . . . Whitman does not seek review on the issue of deference . . . [s]o I agree with the Court that we should deny the petition. But when a petition properly presenting the question comes before us, I will be receptive to granting it.").

3. *See generally* Matthew T. Martens et al., *Scalia's Deference Argument Could Have Dramatic Effects*, LAW360 (Nov. 18, 2014, 11:57 AM), http://www.law360.com/articles/597223/scalia-s-deference-argument-could-have-dramatic-effects (reporting that Justice Scalia's question on whether courts should defer to agency interpretations of laws subject to criminal and civil enforcement "implicitly invited litigants to mount challenges" to the judicial practice of deference).

4. United States v. Whitman, 904 F. Supp. 2d 363, 365 (S.D.N.Y. 2012) ("Specifically, the counts charged that Mr. Whitman traded or agreed to trade on material inside information that he received from tippees who had, in turn, obtained the information from inside employees . . . . ").

5. United States v. Whitman, 555 F. App'x. 98, 107 (2d Cir. 2014) (finding no error in the jury instruction on appeal and affirming Whitman's conviction).

6. *Id.* (quoting United States v. Royer, 549 F.3d 886, 899 (2d Cir. 2008)).

7. *Royer*, 549 F.3d at 899 (deferring to the Commission adoption of a knowledge requirement in Rule 10b5-1).

8. 17 C.F.R. § 240.10b5-1(a) (2011) ("The 'manipulative and deceptive devices' prohibited by Section 10(b) of the [Securities Exchange] Act (15 U.S.C. § 78j) and §240.10b-5 . . . include . . . the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholder of that issuer, or to any other person who is the source of the material nonpublic information.").

9. *See id.* § 240.10b5-1(b) (stating that a purchase or sale of security is "on the basis of" material nonpublic information if the person making the purchase or sale was "aware" of the material nonpublic information when the sale was made).

10. *See* United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014) (establishing that appellants Newman and Chiasson were appealing from judgments of conviction

U.S. Attorney's Office for the Southern District of New York ("Government") argued that it was sufficient to prove a violation under Rule 10b5-2 by showing that a tippee had traded on material, nonpublic information with knowledge that the information was tipped in breach of a fiduciary duty.[11] The Second Circuit rejected this formulation and, appearing to implicitly adopt Justice Scalia's approach, the Court embraced a standard that imposed a heavier burden on the Government. This heavier burden was exemplified by the Court's holding that a breach of fiduciary duty is only committed if there is a personal benefit to the tipper, and the Government must prove beyond a reasonable doubt that the tippee had knowledge of both the fiduciary duty and the personal benefit.[12] The Second Circuit in *Newman* defined personal benefit with specificity; the Court held that the Government would need to prove a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature," and the Government must bring evidence of "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]."[13] *Newman* relied in part on the Supreme Court's decision in *Dirks v. SEC*, a civil insider trading case decided before the Commission had promulgated Rules 10b5-1 and 10b5-2.[14]

On July 30, 2015, the Government filed a petition for writ of certiorari with the Supreme Court.[15] In the petition, the Government argued that *Newman's* holding sharply contrasted with *Dirks* because the former opinion articulated a heightened personal benefit requirement that rejected *Dirks'* previous definition of personal benefit, a benefit that was explained by the Second Circuit as one that could be "inferred from a personal relationship between the tipper and the tippee."[16]

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based on violations of Section 10(b) and Rules 10b5-1 and 10b5-2).

11. *Id.* at 447 (stating that the Government felt it only needed to prove "[t]hat the 'defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality'").

12. *Id.* at 450.

13. *Id.*

14. *See generally* Dirks v. SEC, 463 U.S. 646 (1983) (decided seventeen years before Rules 10b5-1 and 10b5-2 were adopted (17 C.F.R. § 240.10b5-1 (2011)) (originally enacted Aug. 24, 2000); 17 C.F.R. § 240.10b5–2 (2011) (originally enacted Aug. 24, 2000).

15. United States v. Newman, 773 F.3d 438 (2d. Cir. 2014), *cert. denied*, 84 U.S.L.W. 3170 (U.S. Oct. 5, 2015) (No. 15-137).

16. Petition for a Writ of Certiorari, United States v. Newman, (U.S. July 30, 2015) (No. 15-137), http://www.justice.gov/sites/default/files/osg/briefs/2015/08/13/newman_cert_petition.pdf (citing United States v. Newman, 773 F.3d at 452).

This Comment will discuss *Newman*'s potential impact on the enforcement of federal securities laws. Specifically, it examines whether subordinating deference to the rule of lenity, combined with a federal court's denial of deference to the Commission in insider trading prosecutions brought under Rule 10b-5 as recently seen in *Newman*, signals an important change in the enforcement of the federal securities laws in criminal proceedings.

Section I will review the Commission's rulemaking and enforcement authority. First, this Section will review the adoption of the Securities Act of 1934, specifically Section 10(b), and the Commission's subsequent promulgation of Rule 10b-5, Rule 10b5-1, and Rule 10b5-2, which interpret Section 10(b). Second, it will review the case law that implemented Congress' intent that the Commission and DOJ cooperate and enforce the anti-fraud provisions of the federal securities laws. Third, it will discuss the application and importance of *Chevron* deference to the Commission's enforcement of the federal securities laws. Fourth, it will examine the pertinent and relevant case history, demonstrating the federal courts deference (or lack thereof) to the Commission's interpretation of Rule 10b-5 for insider trading liability.

The tension between *Chevron* deference and the rule of lenity is best understood in the development of the law of insider trading. Section II will analyze how applying the rule of lenity to the Commission's interpretation of Rule 10b-5 in both civil and criminal cases will affect the Commission's enforcement power for insider trading cases and, ultimately, the investing public.

In Section III, this Comment will recommend that federal courts should apply the rule of lenity in criminal prosecutions for insider trading. This Comment will conclude by setting the boundaries for Commission deference in criminal prosecution cases concerning insider-trading liability under Rule 10b-5.

I. THE SECURITIES LAWS AND THE COMMISSION'S RULEMAKING AUTHORITY

A. The Commission's Adoption of Rules Implementing Section 10(b)

In 1933 and 1934, following the market crash of the Great Depression,[17] Congress enacted the Securities Act of 1933[18] (the "Securities Act") and

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17. *See generally* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 407-10 (1990) (describing how the market crash of 1929 led to enactment of the Securities Exchange Act).

18. 15 U.S.C. § 77a (2015).

the Securities Exchange Act of 1934[19] (the "Exchange Act"). These laws were enacted to address and prevent an array of abuses of the public markets.[20] The principal anti-fraud provision of the Exchange Act is Section 10(b). Congress determined that the best antidote to securities fraud was full material disclosure of information to the investing public in connection with the purchase or sale of securities, and it created Section 10(b) as the catchall anti-fraud provision.[21] Congress delegated rule-making authority to the Commission to implement the provisions of Section 10(b).[22] In fulfilling this congressional mandate, the Commission adopted Rule 10b-5,[23] Rule 10b5-1,[24] and Rule 10b5-2.[25] Rule 10b-5 prohibits the employment of fraudulent or deceitful devices in connection with the purchase or sale of securities.[26] Rule 10b5-1, adopted nearly six decades after Rule 10b-5,

> defines when a purchase or sale of securities constitutes trading 'on the basis of' material nonpublic information in insider trading cases brought under . . . Rule 10b-5 . . . if the person making the purchase or sale of securities was aware of the material nonpublic information when the person made the purchase or sale.[27]

Rule 10b5-2, adopted in the same year as Rule 10b5-1, prohibits "the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence."[28]

Rule 10b-5, adopted in 1942,[29] was intended to provide investors an even

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19. *Id.* § 78a (2015).

20. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) ("[The Acts] . . . have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued periodically thereafter.").

21. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) ("[Rule 10(b)] was described . . . as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'").

22. *See* 15 U.S.C. § 78j(b) (2015) ("[I]t shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").

23. 17 C.F.R. § 240.10b-5 (2011).

24. *Id.* § 240.10b5-1.

25. *Id.* § 240.10b5-2.

26. *Id.* § 240.10b-5 (barring any person from employing any "device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security").

27. *Id.* § 240.10b5-1.

28. *Id.* § 240.10b5-2 ("misappropriation theory").

29. *See* Press Release, SEC, No. 3230 (May 21, 1942) (announcing that the

playing field for trading in the public market.[30] To provide clarity to a rule that invited varying court interpretation,[31] the Commission promulgated Rules 10b5-1 and 10b5-2 in 2000.[32] The rules seek to prevent insiders from benefitting from their positions of power by trading on confidential inside information.[33] A Rule 10b-5 violation occurs when trading relies upon information that would reasonably be expected to affect the market price.[34]

B. The Commission's Enforcement Power and Rulemaking Authority

The Commission's Enforcement Division ("Enforcement Division") investigates and prosecutes those who violate the federal securities laws.[35] The Enforcement Division has broad power to manage investigations of potential violations of the securities laws through statutory authority.[36] The Penny Stock Reform Act of 1990 ("Reform Act") significantly enhanced the enforcement remedies the Commission could seek in federal court and administrative proceedings.[37] The Act gave administrative law judges power to impose civil penalties through administrative proceedings.[38]

Commission had adopted a rule (Rule 10b-5) prohibiting fraud by any person in connection with the purchase of securities).

30. *See* SEC v. Tex. Gulf Sulphur, Inc., 401 F.2d 833, 848 (2d Cir. 1968) (explaining that Rule 10b-5 is based in the policy that all investors trading in the marketplace should have equal access to information).

31. *See generally* SEC v. Zandford, 535 U.S. 813, 813–14 (2002) (holding that Section 10(b) should be construed "flexibly" and that the Commission's broad reading of the statute should be entitled deference).

32. *See supra* note 15.

33. Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1922 (2007).

34. *Compare* Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965) (explaining importance of disclosures under Rule 10b-5 being limited to situations that are "extraordinary in nature" and also "which are reasonably certain to have a substantial effect on the market price if the security is disclosed"), *with Tex. Gulf Sulphur, Inc.*, 401 F.2d at 848 (2d Cir. 1968) (holding that an insider may not always be excluded from trading in his own company because he is more familiar with it than outsiders).

35. *Division of Enforcement*, SEC, http://www.sec.gov/enforce#.VQ7zMWTF_Ck. (last modified Apr. 15, 2015).

36. 15 U.S.C. § 78u(a) (2015).

37. *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP & FIN. L. 367, 392–93 (2008) (explaining that the Reform Act formulated a "tiered" penalty framework that was used to adopt an appropriate penalty for the circumstances of specific cases).

38. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 202(a), 104 Stat. 931, 937 (1990).

The endemic greed and looting of corporate assets and fraudulent financial reporting that caused the collapse of Enron and WorldCom led to the enactment of the Sarbanes-Oxley Act in 2002 ("Sarbanes-Oxley").[39] Under Sarbanes-Oxley, the Commission was able to obtain director and officer bars in administrative proceedings,[40] a remedy the Commission could previously only obtain in federal court.[41] Congress addressed the 2008 financial crisis with the passage of the Dodd-Frank Act ("Dodd-Frank"), which enhanced the Commission's enforcement power and rulemaking authority.[42] As with the Reform Act and Sarbanes-Oxley, Dodd-Frank expanded the Commission's penalty options, specifically the ability to impose civil penalties in administrative cease-and-desist proceedings brought under the Securities Act and the Exchange Act: penalties the Commission could previously only obtain in federal court.[43] As a result of this enhanced power, the Commission has opted to file more of its enforcement actions as administrative proceedings, particularly in insider trading actions.[44]

The Commission has not only been endowed with greater regulatory powers through legislation, but it has also been influenced by its Commissioners. Chairwoman Mary Jo White has encouraged the Commission to enforce the federal securities laws in accordance with a "broken windows policy"—a policy that seeks to pursue all types of federal securities violations no matter their severity.[45] By expanding the Commission's reach, Chairwoman White's enforcement program created a

39. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 705(b), 116 Stat. 745, 799–800 (2002) ("Sarbanes-Oxley Act") (requiring the office of the Comptroller General to submit a report to Congress indicating whether the financial industry had assisted public companies with fraudulent reporting; regulatory and statutory recommendations were also to be included in the report).

40. *Id.* § 1105(a)(f) (granting the Commission authority to proscribe any person who violates Section10(b) or any "rules or regulations thereunder" from serving as an officer or director).

41. *See* Atkins, *supra* note 37, at 395 (explaining that officer and director bars were previously only enforced in civil actions after showing of unfitness).

42. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1802 (2010) (hereinafter "Dodd-Frank Act").

43. *Id.* § 929P.

44. *See* Sarah N. Lynch, *U.S. SEC to File Some Insider-Trading Cases in its In-house Court*, REUTERS (June 11, 2014, 4:09 PM), http://www.reuters.com/article/2014/06/11/sec-insidertrading-idUSL2N0OS1AT20140611 (reporting on Division of Enforcement Director Andrew Ceresney's comments that the SEC intends to bring more insider trading cases in the administrative forum).

45. Mary Jo White, Chairwoman, SEC, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539872100 ("[M]inor violations that are overlooked or ignored can feed bigger ones . . . .").

system where every market participant is subject to scrutiny.[46]

C. Parallel Enforcement of the Federal Securities Laws by the Commission and DOJ

As a civil agency, the SEC's Enforcement Division brings civil suits in both federal court and administrative forums.[47] The Commission exercises its discretion in determining whether to prosecute violations in federal court or in an administrative proceeding.[48] The principal anti-fraud provisions of the federal securities laws have both civil and criminal applications, and "Congress has expressly authorized the SEC to share information with the [DOJ] to facilitate the investigation and prosecution of crimes."[49] The Commission and the DOJ cooperate in prosecuting fraud in the securities markets, and the two agencies often conduct concurrent investigations and prosecutions.[50] The DOJ frequently utilizes Sections 1341, 1343, and 1348 of Title 18 to prosecute violations of federal securities laws.[51] As with Rule 10b-5, these criminal statutes prohibit "a scheme or artifice to defraud."[52] The DOJ can also use Section 371 of Title 18 to charge conspiracies in violation of securities fraud.[53]

1. The Commission's and DOJ's Different Burdens

In *Steadman v. SEC*, the Supreme Court held that Congress intended the Commission to use a preponderance standard in its proceedings.[54] A

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46. *See id.* (instructing that market participants will be aware of the Commission's increased presence through the Commission's work with other regulatory agencies, pursue "deficient gatekeepers," and actively seeking and prosecuting "broken windows" in the federal securities markets).

47. *How Investigations Work*, SEC, http://www.sec.gov/News/Article/Detail/Article/1356125787012#.VPDnELPF_Ck (last modified July 15, 2013).

48. *Id.* (recommending which forum the Commission should bring its enforcement action in).

49. United States v. Stringer, 535 F.3d 929, 939 (9th Cir. 2008).

50. *Division of Enforcement Manual*, SEC 1, 83 (June 4, 2015), http://www.sec.gov/divisions/enforce/enforcementmanual.pdf ("Parallel civil and criminal proceedings are not uncommon. In furtherance of the SEC's mission . . . the staff is encouraged to work cooperatively with criminal authorities, to share information, and to coordinate their investigations.").

51. 18 U.S.C. §§ 1341, 1343, 1348 (2014).

52. *Id.*

53. *See, e.g.*, United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014) (explaining that the District Court found Newman guilty "on charges of securities fraud in violation of Section 10(b) [. . .] Rules 10b-5, and 10b5-2 [. . .] and conspiracy to commit securities fraud in violation of 18 U.S.C. § 371"); *see also* United States v. Newman, No. 12 CR 121(RJS), 2013 WL 1943342 (S.D.N.Y. May 9, 2013).

54. *See* Steadman v. SEC, 450 U.S. 91, 104 (1981) ("The Commission's consistent practice, which is in harmony with § 7(c) and its legislative history, is persuasive

preponderance standard, seen as the "[l]ightest burden of proof to modern law,"[55] has traditionally been imposed in civil proceedings.[56] In criminal actions where the rule of lenity is applied, elements of securities fraud must be proven by the government beyond a reasonable doubt.[57] The DOJ, by having to show that the defendant acted "willfully" in committing a violation of a federal securities law, is required to prove a heightened mental state under a higher evidentiary burden.[58] Despite the two agencies' different burdens of proof, their investigations of federal securities law violations frequently intersect.[59] The securities laws also allow the Commission to share the evidence it accumulates while conducting its civil investigations with United States Attorneys for the purpose of facilitating a criminal investigation.[60] In *United States v. Stringer*, the Ninth Circuit approved the Commission's role in sharing information with the DOJ to facilitate the DOJ's own investigation and prosecution of crimes.[61] The Commission and the DOJ also liberally share investigation materials. For example, Form SEC 1662 is sent to all witnesses who are subpoenaed to

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authority that Congress intended that Commission disciplinary proceedings, subject to § 7 of the APA, be governed by a preponderance-of-the-evidence standard.").

55. Russell G. Ryan, *The SEC's Low Burden of Proof*, WALL ST. J. (July 14, 2013, 5:24 PM), http://www.wsj.com/articles/SB10001424127887323297504578582213820533922.

56. *See* Annotation, *Instructions Defining Term "Preponderance or Weight of Evidence"*, 93 A.L.R. 155 (1934) ("There is no doctrine of the law settled more firmly than the rule which authorizes issues of fact in civil cases to be determined in accordance with the preponderance or weight of the evidence.").

57. *See United States Attorneys' Manual 9-27.300 Selecting Charges—Charging Most Serious Offense*, DOJ (Dec. 2014), http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/27mcrm.htm#9-27.300 ("[An attorney for the government] should not include in an information or recommend in an indictment charges that he/she cannot reasonably expect to prove beyond a reasonable doubt by legally sufficient evidence at trial.").

58. *Compare* 15 U.S.C. § 78ff(a) (2015) (stating that any person who "willfully violates any provision of this chapter [including 15 U.S.C. § 78j] or any rule or regulation thereunder . . . shall upon conviction be . . . imprisoned not more than 20 years . . . . "), *with* 17 C.F.R. § 240.10b5-1 (2011) (stating that a purchase or sale of security is "on the basis of" material nonpublic information if the person making the purchase or sale was "aware" of the material nonpublic information when the sale was made).

59. *See Division of Enforcement Manual*, *supra* note 50 (explaining that parallel criminal and civil proceedings are common and that the Commission should share investigation materials and coordinate investigations "when appropriate").

60. *See* 15 U.S.C. § 77t(b) (allowing the Commission to convey evidence concerning violations of the securities laws to the Attorney General).

61. United States v. Stringer, 535 F.3d 929, 933 (9th Cir. 2008) (asserting that the government's practice of sharing information with the DOJ was not unconstitutional and that the government is free to conduct "simultaneous criminal and civil investigations . . . ").

testify before the Commission,[62] and it informs the subpoenaed witness that any information obtained may be used in a criminal proceeding.[63]

Where both the DOJ and the Commission have filed concurrent actions, it is not unusual for the DOJ to request a stay of the civil proceeding to limit the criminal defendant's discovery opportunities.[64] The DOJ's objective in requesting a motion to stay is to protect its witnesses from exposure to broad civil discovery.[65] Under Rule 26 of the Federal Rules of Civil Procedure, a party must provide to the opposing party the name, address, and telephone number of each witness they intend to use, as well as identify each exhibit the party plans to use at trial.[66]

D. Chevron Deference

In 1984, the Supreme Court decided a milestone administrative law case, *Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.*, where it held that a court owes deference to an executive agency's interpretation of a statute.[67] The Supreme Court enunciated its analysis that must be applied when reviewing such an interpretation. Specifically, if Congress has unambiguously spoken on the issue, both the court and the agency must "give effect to the unambiguously expressed intent of Congress."[68] The Supreme Court went on to state that, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the

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62. *Division of Enforcement Manual*, *supra* note 50, at 43 (explaining that when requesting documents or information, the SEC lawyers must provide the witness with the 1662 form); *see also Stringer*, 535 F.3d at 934 (stating that Form 1662 is "[a] form sent to all witnesses subpoenaed to testify before the SEC").

63. *Supplemental Information for Persons Requested to Supply Information Pursuant to a Commission Subpoena* § B(5), SEC, http://www.sec.gov/about/forms/sec1662.pdf.

64. *See* Walter P. Loughlin, *Parallel Civil and Criminal Proceedings*, 22 THE PRACTICAL LITIGATOR 19, 22–23 (Mar. 2011), http://www.klgates.com/files/Publication/780dc44c-a3af-4b60-8efe-bb6b913fed75/Presentation/PublicationAttachment/bddd1cf9-2f07-4d57-b38c-bcf3142e589b/Loughlin_PracticalLitigator_March2011.pdf ("A parallel civil and criminal case can be an avenue for civil discovery that is not available in the criminal case, a fact which often prompts a prosecution application for a stay of the civil case so as to protect its witnesses from exposure to civil discovery.").

65. *Id.*; *see also* SEC v. Saad, 229 F.R.D. 90, 92 (S.D.N.Y. 2005) (denying the Government's motion to stay the civil case pending resolution of the criminal action. Judge Rakoff rejected concerns that defendants would use civil discovery to "special advantage," noting that the DOJ elected to coordinate the filing of its indictment with the SEC's civil action).

66. FED. R. CIV. P. 26(a)(3)(A)(i), (iii).

67. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 844 (1984) ("[The Court has] long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to agency interpretations.").

68. *Id.* at 842–43.

agency's answer is based on a permissible construction of the statute."[69] It stressed that legislative regulations should be given deference unless they are "arbitrary, capricious, or manifestly contrary to the statute."[70] Although this was not the first case that imposed agency deference,[71] it was the first case to expressly approve agencies' power to fill in gaps in statutory language, giving executive agencies power to use regulations to define statutory liability when intended.[72]

The *Chevron* holding required judicial deference to agency regulations that are not unreasonable,[73] a holding that conflicts with the rule of lenity.[74] The Supreme Court addressed this tension initially in *Crandon v. United States*, a civil suit based on a criminal statute.[75] It resolved the statutory ambiguity using the rule of lenity and held that "legislatures, not courts, define criminal liability."[76] Five years later, the Supreme Court appeared to change direction in *Babbitt v. Sweet Home Chapter, Communities for Great Ore*, a civil case brought under an Environmental Protection Agency statute capable of both civil and criminal applications.[77] In *Babbitt*, the Supreme Court stated that it has "never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations . . . ."[78]

Most recently, in *Leocal v. Ashcroft*, the Supreme Court reversed a

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69. *Id.* at 843.

70. *Id.* at 844.

71. *See* NLRB v. Seven-Up Bottling Co., 344 U.S. 344, 346 (1953) (holding that the National Labor Relations Board holds discretionary authority in effectuating the policies of the Labor Relations Act based on its insight "gained from experience").

72. *See Chevron*, 467 U.S. at 843–44 ("If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation.").

73. *See id.* at 844 (holding that agency rule promulgations should be given deference unless they are "arbitrary" or defy what the statute was intended to address).

74. *See* Whitman v. United States, 135 S. Ct. 352, 353 (2014) (expressing that, pursuant to the rule of lenity, ambiguity in criminal laws should be resolved in favor of the defendant); *see also* Elliot Greenfield, *A Lenity Exception to* Chevron *Deference*, 58 BAYLOR L. REV. 1, 10 (2006) (articulating that judicial interpretation of ambiguous legislation concerning criminal liability should be done narrowly in the defendant's favor).

75. Petitioners were all former employees of Boeing Company. Before all petitioners left Boeing to accept jobs with the federal government, Boeing made to each person a payment to mitigate the salary loss expected to occur. The United States filed a civil complaint under 18 U.S.C. § 209(a), a criminal statute. *See generally* Crandon v. United States, 494 U.S. 152 (1990).

76. *Id.* at 158 (citing Liparota v. United States, 471 U.S. 419, 427 (1985)).

77. Babbitt v. Sweet Home Chapter, Cmtys. for a Great Or., 515 U.S. 687, 736 n.9 (1995) (explaining elements of the knowledge requirements required for criminal and civil penalties under the Endangered Species Act).

78. *Id.* at 704 n.18.

ruling brought under a statute capable of both civil and criminal enforcement, applying the rule of lenity. It held that any statutory ambiguity had to be interpreted in the petitioner's favor to ensure consistent interpretation.[79] As *Crandon, Leocal*, and *Babbitt* illustrate, the Supreme Court has inconsistently applied the rule of lenity.[80] However, unlike the rule of lenity, the Supreme Court has consistently applied the Commission's rules in both civil and criminal cases, holding in *SEC v. Zandford* that the Commission's interpretation of Section 10(b) was entitled to deference.[81]

It is not always clear when *Chevron* should actually apply.[82] *Chevron* deference allows executive agencies to construe statutory language and to clarify a law, power that can infringe upon the courts' role. As Justice Marshall famously said, "It is emphatically the province and duty of the judicial department to say what the law is."[83] *Chevron's* portrayal of administrative agencies as experts bestows upon these agencies the power to articulate new policy by devising schemes through promulgating their own rules.[84]

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79. Leocal v. Ashcroft, 543 U.S. 1, 11 n.8 (2004) (explaining that, even though the statute was being considered in Leocal's case in the civil context of deportation, it was a statute that had both criminal and civil applications, so the rule of lenity needed to be applied to ensure consistency).

80. *See supra* notes 75–79 (stating that *Crandon* read a statute capable of both criminal and civil enforcement in favor of the defendant using the rule of lenity. *Babbitt* did not implement the rule of lenity when interpreting a statute capable of both criminal enforcement and instead deferred to the administrative regulation. *Leocal* held that the rule of lenity needed to apply to a statute in both its criminal and non-criminal contexts to ensure consistency.).

81. SEC v. Zandford, 535 U.S. 813, 819–20 (2002) (holding that Section 10(b) has always been interpreted flexibly and that the SEC's consistent and broad interpretation of Section 10(b) should be entitled to deference because it is reasonable).

82. Patricia G. Chapman, *Has the* Chevron *Doctrine Run Out of Gas? Senza Ripieni Use of* Chevron *Deference or the Rule of Lenity*, 19 MISS. C. L. REV. 115, 117 (1998) ("[N]o consistent 'deference' guidelines have been articulated by the Supreme Court for other courts that must review agency interpretive activities.").

83. Marbury v. Madison, 5 U.S. 137, 177 (1803).

84. *See* Sanford N. Greenberg, *Who Says It's A Crime?:* Chevron *Deference To Agency Interpretations Of Regulatory Statutes That Create Criminal Liability*, 58 U. PITT. L. REV. 1, 9 (1996) (clarifying the principle of *Chevron* that courts should defer to administrators, and that administrator's expertise "gives executive agencies the power to resolve ambiguous policy objectives in legislation").

E. Federal Court's Adoption of Deference to Rule 10b-5 in Insider Trading Cases

1. The Classical Theory of Insider Trading: Disclose or Abstain

A discussion of deference to the Commission's rules begins with In re *Cady, Roberts & Co.* ("*Cady Roberts*"), an administrative proceeding that established the Commission's standard of corporate insiders having a duty to disclose material information[85] or, alternatively, abstain from trading.[86] One of the first cases to adopt the Commission's reasoning in *Cady Roberts* was *SEC v. Texas Gulf Sulphur, Inc.* ("*Texas Gulf*").[87] In *Texas Gulf*, the Second Circuit held that any person in possession of material nonpublic information—not just officers and directors—must either disclose it to the investing public or abstain from trading on the material nonpublic information.[88]

Nineteen years after *Cady Roberts* was decided, in *Chiarella v. United States*, the Supreme Court endorsed the Commission's holding in *Cady Roberts*.[89] Although the Court held that insider trading liability under Rule 10b-5 "[was] premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to the transaction,"[90] there was no such duty between Chiarella and the shareholders of the companies in whose stock he traded because the shareholders had not placed their trust and confidence in Chiarella.[91] When both *Texas Gulf* and *Chiarella* were decided, Rule 10b-5 was the only Commission Rule promulgated under Section 10(b) that reached insider trading.[92]

In 2008, eight years after the Commission had promulgated Rules 10b5-1 and 10b5-2,[93] the Second Circuit decided *United States v. Royer*.[94] In *Royer*, a criminal case, the Court held that a defendant commits insider trading in violation of Section 10(b) when he trades "'while in knowing possession of nonpublic information material to those trades."[95] *Royer*'s

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85. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

86. *Id.*

87. SEC v. Tex. Gulf Sulphur, Inc., 401 F.2d 833 (2d Cir. 1968).

88. *Id.* at 848.

89. Chiarella v. United States, 445 U.S. 222, 226–27 (1980).

90. *Id.* at 230.

91. *Id.* at 232–33 ("No duty could arise from [Chiarella's] relationship with the sellers of the target company's securities, for [Chiarella] had no prior dealings with them . . . [h]e was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

92. *See supra* note 15.

93. *Id.* § 240.10b5-1, 240.10b5-2.

94. *See generally* United States v. Royer, 549 F.3d 886 (2d Cir. 2008).

95. *Id.* at 899.

holding was based in part on deference to Rule 10b5-1, which defines insider trading as a manipulative and deceptive device within the meaning of Section 10(b) and incorporates an awareness standard for insider trading liability under Section 10(b).[96]

2. *The Misappropriation Theory of Insider Trading*

"Rule 10b5-2 addresses misappropriation of "material nonpublic information . . . in breach of a duty of trust or confidence."[97] Rule 10b5-2 delineates the circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory.[98]

Three years after the Supreme Court, in *Chiarella*, held that a corporate outsider did not owe a fiduciary duty to a company's shareholders[99] and seventeen years before the Commission promulgated Rule 10b5-2, the Court decided *Dirks*.[100] In *Dirks*, the Court held that a tippee inherits the duty of the insider not to trade on material nonpublic information "[o]nly when the insider [tipper] has breached his fiduciary duty to the shareholders by disclosing the information and the tippee knows or should know that there has been a breach."[101] A breach is determined by whether a financial "benefit" has been obtained.[102] In *Dirks*, the Court did not defer to the Commission's interpretation of Rule 10b-5.[103]

United States v. O'Hagan, decided in 1997, explicitly addressed the misappropriation theory and held that a person can be liable for insider trading under Rule 10b-5 ""[w]hen he misappropriates confidential

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96. *See id.* ("[T]he SEC . . . enacted Rule 10b5–1, adopting a knowing possession standard, and that determination is itself entitled to deference."); *see also* United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) (holding that the "knowing" possession standard promulgated by the Commission is entitled to consideration and comports with the disclose or abstain rule from *Chiarella*).

97. 17 C.F.R. § 240.10b5-2(a).

98. *Id.* § 240.10b5-2(b) ("For purposes of this section, a 'duty of trust or confidence' exists . . . : (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history . . . of sharing confidences . . . ; or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling [. . . .]").

99. Chiarella v. United States, 445 U.S. 222, 232–33 (holding that, as a corporate outsider, Chiarella did not owe a fiduciary duty to the target company's shareholders because they did not place their "trust and confidence" in him).

100. *See supra* note 15.

101. Dirks v. SEC, 463 U.S. 646, 647 (1983).

102. *Id.* at 663.

103. *Id.* at 647 (explaining that the SEC's position "rests on the erroneous theory that the antifraud provisions require equal information among all traders. A duty to disclose arises from the relationship between parties and not merely from one's ability to acquire information because of his position in the market.").

information for securities trading purposes, in breach of a duty owed to the source of the information."[104]

II. *NEWMAN'S* IMPLICIT ADOPTION OF LENITY AND WHAT IT PORTENDS FOR THE COMMISSION

A. Adopting Lenity in DOJ's Criminal Proceedings

In a criminal insider trading case, deference to the Commission's interpretation of Rule 10b-5 conflicts with the rule of lenity.[105] The rule of lenity requires that 1) defendants be put on notice about the elements that constitute a crime and that 2) legislatures, not courts, should define criminal activity.[106] Therefore, a significant result of deference to agency interpretation is that new crimes can be defined by executive agencies,[107] a power that traditionally rests solely with the legislative branch.[108]

1. The Legislative Power to Define Crimes

As a civil agency, the Commission cannot bring criminal prosecutions.[109] However, when *Chevron* deference is given to an executive agency's interpretation of a law that is capable of both civil and criminal enforcement, there is an insinuation of a civil agency's rulemaking into criminal proceedings that raises due process issues. Specifically, it raises the concern "that laws which regulate persons or entities in society must give fair notice of conduct that is forbidden or required."[110] The due

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104. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

105. Whitman v. United States, 135 S. Ct. 352, 353 (2014) (explaining the fundamental notion of lenity is to resolve a statutory ambiguity in favor of the defendant).

106. United States v. Bass, 404 U.S. 336, 348 (1971) (asserting that the rule of lenity is necessary to give "fair warning" to defendants concerning criminal liability, and because criminal liability can result in loss of freedom and "condemnation of the community," it should be defined by the legislature).

107. *See Whitman*, 135 U.S. at 353 (contending that deference to an executive agency's rule promulgation of a statute contemplating criminal liability allows that agency to ultimately define crime).

108. *Id.* ("[L]egislatures not executive officers define crimes [. . . .] Undoubtedly Congress may make it a crime to violate a regulation, but it is quite a different matter for Congress to give agencies—let alone for us to presume that Congress gave agencies—power to resolve ambiguities in criminal legislation.").

109. *See Division of Enforcement*, *supra* note 35 (clarifying that the Division of Enforcement "conducts investigations into possible violations of the federal securities laws and prosecutes the Commission's civil suits in the federal courts as well as its administrative proceedings"); *see also Division of Enforcement Manual*, *supra* note 50, at 104 (explaining that the Commission cannot bring criminal enforcement actions).

110. FCC v. Fox Television Stations, Inc., 132 S. Ct. 2307, 2317 (2012).

process clause of the Fifth Amendment requires this notice.[111] Such a constitutional principal is at odds with what Justice Stevens articulated in *Chevron* when he reasoned that Congress could delegate to executive agencies the power to interpret statutory language when authorized and could promulgate rules that implement policy decisions.[112] Agencies possess the power to create policy; however, when these agencies administer regulations that carry criminal sanctions, the agencies' actions remove the legislative branch's power to impose punishment rules. The legislative branch, and not the executive agencies, should be defining crimes and ordaining the associated punishments.[113]

Chevron deference is not unconstitutional, and the specificity with which executive agencies interpret statutory language that contemplates both criminal and civil enforcement is important.[114] However, there is a line between interpreting an ambiguity and creating a new crime, and a common argument for deferring to an agency's promulgation of a rule, its expertise on the issue at hand, falls flat when that expertise is used to determine what conduct merits criminal punishment.[115] Executive agencies carry out executive functions; because the executive branch does not give executive agencies the power to "[assess] the societal mores underlying criminal law [. . . .] The policies supporting special treatment for all criminal rules outweigh any remaining vitality of the *Chevron* policies. *Chevron* thus has no place in the review of administrative crimes."[116]

The application of the rule of lenity will benefit defendants of criminal insider trading prosecutions brought under Rule 10b-5; therefore, a uniform basis for criminal liability under Rule 10b-5 could help resolve the current federal circuit split on what behavior constitutes criminal liability.[117]

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111. *See id.* (citing United States v. Williams, 553 U.S. 285, 304 (2008)).

112. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 865 (1984).

113. *See* United States v. Wiltberger, 18 U.S. 76, 95 (1820).

114. *See* Greenberg, *supra* note 84, at 17 (conceding that courts expect agencies to fill in gaps because it is unrealistic to assume Congress can predict every possible "ramification" of a law).

115. Mark D. Alexander, Note, *Increased Judicial Scrutiny for the Administrative Crime*, 77 CORNELL L. REV. 612, 622 (1992) ("The expertise theory of administrative agencies is problematic when used to resolve any value judgment, but is particularly difficult when the determination of societal mores is at issue. Agencies have no expertise to determine what conduct deserves the criminal penalty.").

116. *Id.* at 646.

117. *Compare* United States v. Newman, 773 F.3d 438, 447–48, 452 (2d. Cir. 2014) (holding that the personal benefit standard requires "proof of a meaningfully close personal relationship" between the tipper and tippee that results in an "objective" and "consequential" exchange with "potential" economic value), *with* United States v. Salman, 792 F.3d 1087, 1093-94 (9th Cir. 2015) (holding that a personal benefit is satisfied pursuant to *Dirks* when an insider discloses nonpublic material information to

Furthermore, achieving clarity and consistency in the elements of a criminal insider trading case brought under Rule 10b-5 will satisfy the fair notice requirement of due process.[118] Although the Second Circuit in *Newman* did not explicitly discuss *Chevron* or the rule of lenity, the balancing of those two competing notions is complicit in the Second Circuit's holding that liability should only be imposed under Rule 10b5-2 if the government proves the tipper breached a fiduciary duty by receiving a personal benefit that went beyond mere friendship and that the tippee knew about the breach of the fiduciary duty.[119] This standard expanded the language initially articulated in *Dirks*, a case decided before the promulgation of Rule 10b5-2 or *Chevron*.[120]

2. *Judicial Adoption of the Rule of Lenity*

The Supreme Court has analyzed the tension between the *Chevron* deference and the rule of lenity since the *Chevron* decision in 1984.[121] *Crandon v. United States*, decided in 1990, was a civil suit based on 18 U.S.C. § 209(a), which criminalizes payment by a private party—and receipt by a government employee—of "[s]upplemental compensation for the employee's government service."[122] Concerning the meaning of the statute, the Supreme Court held that, because the "[g]overning standard is set forth in a criminal statute, it is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage."[123] The Supreme Court ultimately interpreted the statute's ambiguity in favor of the petitioners.[124]

Justice Scalia's concurrence in *Crandon* addressed the notion of deference to the government's interpretation of a criminal statute:

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a "relative or friend").

118. *See* FCC v. Fox Television Stations Inc., 132 S. Ct. 2307, 2317 (2012) (explaining that the Due Process clause requires clarity in executive agency regulations).

119. *Newman*, 773 F.3d at 447–48, 452.

120. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983) (explaining that, when an insider discloses material inside information, it is only a breach of fiduciary duty when that insider receives some sort of personal benefit or gain).

121. *See* Greenfield, *supra* note 74, at 38–40 ("Although the Supreme Court has not yet decided how a conflict between Chevron deference and the rule of lenity should be resolved, it has briefly discussed the issue in [Crandon v. United States, 494 U.S. 152 (1990) and Babbitt v. Sweet Home Chapter, Cmtys. for a Great Or., 515 U.S. 687 (1995)].").

122. Crandon v. United States, 494 U.S. 152, 154 (1990).

123. *Id.* at 158.

124. *Id.* at 168 ("To the extent that any ambiguity over the temporal scope of [the statute] remains, it should be resolved in the petitioners' favor unless and until Congress plainly states that its intent has been misconstrued.").

> The law in question, a criminal statute, is not administered by any agency but by the courts. [. . .] The Justice Department, of course, has a very specific responsibility to determine for itself what this statute means, in order to decide when to prosecute; but we have never thought that the interpretation of those charged with prosecuting criminal statutes is entitled to deference.[125]

Justice Scalia wrote another dissent, five years later, in *Babbitt. Babbitt* was an environmental law case where the Supreme Court affirmed the Secretary of the Interior's promulgation of a rule defining "harm" under the Endangered Species Act of 1973, a law that had both criminal and civil applications.[126] The Supreme Court did not apply the rule of lenity, stating that it had "never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations whenever the governing statute authorizes criminal enforcement."[127] In *Whitman*, Justice Scalia recalled that the Supreme Court in *Babbitt* deferred "with scarcely any explanation, to an agency's interpretation of a law that carried criminal penalties."[128] Justice Scalia expressed his continued disagreement with this outcome, as it controverted previous federal court decisions which held that if a law was capable of both criminal and civil enforcement then the rule of lenity should apply in both the criminal and civil proceedings.[129]

In 2004, in *Leocal*, the petitioner, a lawful permanent resident of the United States, violated Florida law when he was convicted of driving under the influence of alcohol ("DUI") and of causing serious bodily injury in an accident.[130] An Immigration Judge and the Board of Immigration Appeals classified the conviction under 18 U.S.C. § 16 and ordered the petitioner to be deported.[131] The Supreme Court reversed the conviction.[132] Although the pertinent statute was used in a noncriminal context (for deportation), the statute had both criminal and civil applications.[133] This dual application permitted the Court to apply the rule of lenity and interpret any statutory

125. *Id.* at 177 (Scalia, J., concurring).

126. *See* Babbitt v. Sweet Home Chapter of Cmtys. for a Great Or., 515 U.S. 687, 696 n.9 (1995) (clarifying that the Secretary of the Interior's definition of the harm under 50 C.F.R. § 17.3 (1994) "is limited to 'act[s] which actually kil[l] or injur[e] wildlife'" and that one must knowingly violate the Endangered Species Act to be subject to criminal or severe civil liability).

127. *Babbitt*, 515 U.S. at 704, n.18.

128. Whitman v. United States, 135 S. Ct. 352, 353 (2014).

129. *See id.* at 353–54 (contending that the *Babbitt* Court's refusal to apply lenity goes against case precedent that clearly states if a law is capable of both civil and criminal applications, the rule of lenity "governs its interpretation in in both settings").

130. Leocal v. Ashcroft, 543 U.S. 1, 3 (2004).

131. *Id.*

132. *Id.* at 13.

133. *Id.* at 11 n.8.

ambiguity in Leocal's favor to ensure consistent interpretation.[134]

B. Applying the Rule of Lenity in the Commission's Civil Proceedings

The cases presented in the previous section, unlike *Newman*, were civil cases, yet the Supreme Court applied the rule of lenity in both *Crandon* and *Leocal* because the statutes at issue were capable of both criminal and civil applications. Applying the rule of lenity to civil enforcement actions potentially will impede the SEC's robust enforcement initiatives under the Commission's Chairwoman, Mary Jo White.[135] Chairwoman White has been vocal in advocating a "broken windows" approach to enforcement, holding that no violation is too small to pursue.[136]

However, SEC Commissioner Michael Piwowar has expressed skepticism about the broken windows enforcement policy, suggesting that its zero-tolerance policy ultimately harms the Commission's regulatory role.[137] Commissioner Piwowar noted that by adopting a broken windows approach to enforcement actions, the Commission's mission becomes diluted; "If you create an environment in which regulatory compliance is the most important objective for market participants, then we will have lost sight of the underlying purpose for having regulation in the first place."[138]

The Commission's administrative power further increased with the 2010 implementation of Dodd-Frank, granting the Commission power to impose civil penalties. These were penalties the Commission could previously seek only in federal court: in administrative cease-and-desist proceedings brought under violations of the Securities Act and the Securities Exchange Act.[139] Dodd-Frank also expanded the reach of the Commission by allowing it to bring administrative actions against any unregistered

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134. *See id.* (holding that Leocal's DUI could not be found to be a crime of violence under section 16, under the principle that any ambiguity in the statute must be resolved in Leocal's favor).

135. *SEC Biography: Chair Mary Jo White*, SEC, http://www.sec.gov/about/commissioner/white.htm#.VQ8aV2TF_Ck (last updated July 23, 2013).

136. *See* White, *supra* note 45 ("[M]inor violations that are overlooked or ignored can feed bigger ones, and, perhaps more importantly, can foster a culture where laws are increasingly treated as toothless guidelines. And so, I believe it is important to pursue even the smallest infractions. Retail investors, in particular, need to be protected from unscrupulous advisers and brokers, whatever their size and the size of the violation that victimizes the investor.").

137. *See* Michael S. Piwowar, Commissioner, SEC, Remarks to the Securities Enforcement Forum 2014 (Oct. 14, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543156675 (explaining that the Commission's mission is to have a strong capital market, not solely to achieve regulatory compliance).

138. *Id.*

139. Dodd-Frank Act, Pub. L. No. 111-203, § 929P(a), 124 Stat. 1802, 1862 (2010).

individual.[140] With these increased powers, administrative proceedings have become the Commission's forum of choice for insider trading actions.[141]

The Commission has distinct advantages in its administrative forum.[142] Along with being tried by a Commission-appointed administrative law judge,[143] administrative proceedings differ in important ways from those of a federal court: 1) the proceedings are limited in their discovery process, most notably in that a defendant cannot conduct discovery depositions; 2) the out of court investigation testimony of the Commission is freely admitted; and 3) there is no right to a trial by jury in an administrative proceeding.[144]

Dodd-Frank expands the Commission's administrative enforcement power through Section 929P(a), which enables the Commission to obtain virtually everything it could obtain through federal court proceedings through internal administrative proceedings.[145] These increased enforcement powers, along with the implicit adoption of lenity in *Newman*, may prompt the Commission to move its insider trading cases to the administrative forum.[146] In an administrative proceeding, federal courts

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140. *Id.*

141. *See* Sarah N. Lynch, *U.S. SEC to file some insider-trading cases in its in-house court*, REUTERS (June 11, 2014, 4:09 PM), http://www.reuters.com/article/2014/06/11/Commission-insidertrading-idUSL2N0OS1AT20140611.

142. *See* Andrew Ceresney, Director, SEC Division of Enforcement, Remarks to the American Bar Association's Business Law Section Fall Meeting (Nov. 14, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543515297#.VQ3AEmTF_Ck ("First, administrative actions produce prompt decisions. [. . .] Second, administrative proceedings have the benefit of specialized factfinders [*sic*]. [. . .] Third, the rules governing administrative hearings provide that ALJs should consider relevant evidence. In practice, what this means is that ALJs are guided by, but not obligated to strictly apply, the Federal Rules of Evidence.").

143. *See* 15 U.S.C. § 78d-1(a) (2015) ("The [SEC] shall have the authority to delegate . . . any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge . . . including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter.").

144. *See* Alan M. Lieberman, *Fast Track Justice: Is the SEC Exercising 'Unchecked and Unbalanced Power'?"*, 20 WESTLAW J. SECS. LITIG. & REGULATION 1, 1-4 (Sept. 18, 2014) http://www.blankrome.com/siteFiles/WLJ_SCL_2010_Commentary_Lieberman.pdf (explaining several ways in which the Commission has 'advantages in the administrative forum).

145. Jed S. Rakoff, U.S. District Judge, U.S. District Court for the Southern District of New York, Keynote Address at the PLI Securities Regulation Institute: Is the Commission Becoming a Law Unto Itself? (Nov. 5, 2014) at 5, http://media.jrn.com/documents/secaddress.pdf.

146. *See id.* at 7, 9–10 (explaining that, given the expansion of administrative powers by Dodd-Frank and the Commission's hope to avoid defeat in federal courts, the Commission may begin bringing cases in administrative proceedings).

give an administrative law judge's decision deference, so an administrative judge effectively makes the law.[147] If the rule of lenity applied to both criminal prosecutions and civil administrative proceedings, the Commission would lose a key advantage of bringing enforcement actions in its administrative forum because courts would no longer give these administrative actions *Chevron* deference.[148]

C. Limiting the Rule of Lenity to DOJ's Criminal Proceedings

In *Newman*, as in any criminal case, the Government needed to prove each element of the offense beyond a reasonable doubt.[149] Furthermore, the Government was obligated to prove that the defendant committed the violations "willfully," a more advanced mental state than the awareness standard the Commission must meet in civil cases brought under Rule 10b5-1.[150] The application of both *Chevron* deference and the rule of lenity requires a statutory ambiguity to be applied. The statutory ambiguities identified by the Second Circuit in *Newman* were resolved in favor of Newman, and the Court implicitly applied the rule of lenity in two ways. First, it resolved the statutory ambiguity regarding the tippee's mental requirement of knowledge, and it explicitly held that the tippee must have knowledge of both the tipper's breach of fiduciary duty and the tipper's personal benefit.[151] Second, the Court went further than *Dirks* and resolved the ambiguity of what a personal benefit actually is,[152] a standard first articulated in *Dirks*.[153] The Court held in *Newman* that mere friendship

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147. *Id.* at 10.

148. *See id.* (explaining that an administrative law judge's ruling on an "undecided issue of statutory interpretation of the securities law is, just like rules enacted by the Commission, entitled to 'Chevron' deference").

149. *See supra* notes 54–57 (noting the Commission, as a civil agency, is held by the courts to a preponderance of the evidence standard of proof, whereas DOJ is held to a beyond a reasonable doubt standard).

150. *See supra* note 59.

151. *Compare* United States v. Newman, 773 F.3d 438, 450 (2d. Cir. 2014) (holding explicitly that a tippee's insider trading liability is predicated on the tippee's knowledge of both the tipper's breach of fiduciary duty and the tipper's receipt of a personal benefit), *with* Dirks v. SEC, 463 U.S. 646, 660-62 (1983) (holding that liability shall be imposed when the tippee knows there has been a breach of fiduciary duty. The tippee's knowledge of the tipper's personal benefit is implicit because whether a tipper has breached his fiduciary duty hinges on whether he will personally benefit from the tip.).

152. *Newman*, 773 F.3d at 452 (articulating a specific personal benefit standard, namely a relationship that is significant and results in a "consequential" exchange with "potential" economic value).

153. *Dirks*, 463 U.S. at 663 ("[T]he initial inquiry is whether there has been a breach of duty by the insider [. . . .] *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational

between the tipper and the tippee is not enough to establish a personal benefit.[154]

It is only necessary to apply the rule of lenity to a criminal proceeding for insider trading violations. If all of the insider trading violation elements articulated in *Newman* are proven, then the conviction would subsume the preponderance of the evidence standard the Commission would be required to prove in a civil proceeding: a proceeding that would have likely been stayed pending the outcome of the criminal proceeding.[155] However, if the government cannot prove the elements beyond a reasonable doubt in a criminal proceeding, a district court judge or an administrative law judge could then appropriately apply *Chevron* deference to the Commission's rule promulgations. The Commission would need to prove each element by a preponderance of the evidence standard in a civil proceeding.[156]

Andrew Ceresney, Director of the SEC Enforcement Division, has publicly stated that *Newman* is not likely to inhibit the Commission's pursuit of insider trading cases.[157] However, *Newman* has affected administrative proceedings as well as district court decisions. In February 2015, Administrative Law Judge Jason Patil ordered the Commission to show that the respondent in an administrative proceeding had received a significant personal benefit that went beyond mere friendship in exchange for tipping a trader with material inside information.[158] In the Southern District of New York, myriad defendants cited the *Newman* ruling in various applications for review in criminal proceedings brought by DOJ.[159]

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benefit that will translate into future earnings.").

154. *Newman*, 773 F.3d at 452 (holding that if the Government were allowed to meet its burden by proving two people by the mere fact of friendship, the requirement would be a "nullity").

155. *See* Loughlin, *supra* note 64, at 22–23 (explaining that DOJ frequently requests a stay in the civil proceedings to protects its witnesses from broad civil discovery).

156. *See* Steadman v. SEC, 450 U.S. 91, 103 (1981) (holding that Congress intended that the Commission's proceedings should be governed by a preponderance of the evidence standard subject to § 7 of the Administrative Procedure Act).

157. Stephanie Russell-Kraft, *SEC's Ceresney Isn't Sweating 2nd Circ.'s Newman Ruling*, LAW360 (Feb. 10, 2015, 6:10 PM), http://www.law360.com/articles/620472/sec-s-ceresney-isn-t-sweating-2nd-circ-s-newman-ruling (reporting that Mr. Ceresney's statement at a Practicing Law Institute event that *Newman* is not likely to change the Commission's approach to insider trading cases involving tippee liability because the Commission is subject to a lower burden of proof and has the ability to bring actions in other forums).

158. *In re* Gregory T. Bolan, Jr. and Joseph C. Ruggieri, Admin. Proc. 3-16178, Administrative Proceedings Rulings Release No. 2309 (Feb. 12, 2015), http://www.sec.gov/alj/aljorders/2015/ap-2309.pdf.

159. Max Stendahl, *Bharara Foes Pounce on Newman Ruling in SDNY*, LAW360 (Feb. 13, 2015, 4:42 PM), http://www.law360.com/articles/620971/bharara-foes-

Attorney for the Southern District of New York, Preet Bharara, raised concerns about the impact of *Newman* in his petition for a rehearing en banc following the *Newman* ruling,[160] as well as the Commission's subsequent amicus brief in support of the petition.[161] The petition for rehearing contended that *Newman* "[b]reaks with Supreme Court and Second Circuit precedent, conflicts with the decisions of other circuits, and threatens the effective enforcement of the securities laws . . . [by] engender[ing] confusion among market participants, parties, judges, and juries."[162] The petition noted that *Newman*'s definition of personal benefit is inconsistent with the Supreme Court's holding in *Dirks*.[163] As for the impact on investors, the petition noted that *Newman*'s holding put in jeopardy the Commission's ability to continue its robust enforcement of insider trading violations, a bulwark of its primary mission of protecting investors.[164]

The Second Circuit denied the petition for rehearing en banc on April 3, 2015.[165] On July 30, 2015, the Government filed a petition for writ of certiorari in the Supreme Court.[166] The petition presented and asked the Court to resolve a narrow issue: whether insider trading liability under the misappropriation theory requires that the personal benefit the tipper receives be a product of a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[167] In the petition, the Government argued that the *Newman* holding departed from *Dirks* because it imposed a heightened personal benefit requirement that

pounce-on-newman-ruling-in-sdny.

160. Petition of the United States for Rehearing and Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837) [hereinafter United States Petition Rehearing En Banc].

161. Commission's Motion for Leave to File an Amicus Curiae Brief Supporting the Petition of the United States for Rehearing or Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837).

162. United States Petition for Rehearing and Rehearing En Banc, *supra* note 160, at 1–2.

163. *Id.* at 13–14 (explaining that the Second Circuit used the personal benefit language from *Dirks* but "upended" it in a way that was "inconsistent with *Dirks*").

164. *Id.* at 23 (explaining as an example that *Newman*'s heightened personal benefit standard could permit tippers to reveal material inside information to a tippee and avoid liability "because the tipper "'did not expect any pecuniary or 'similar' value in return").

165. United States v. Newman, Order No. 13-1837(L), 13–1917(Con), 2015 WL 1954058, at *1 (2d. Cir. Apr. 3, 2015).

166. Petition for a Writ of Certiorari, United States v. Newman, (U.S. July 30, 2015) (No. 15-137), http://www.justice.gov/sites/default/files/osg/briefs/2015/08/13/newman_cert_petition.pdf

167. *Id.*

rejected *Dirks*' holding that a personal benefit could be "inferred simply by a personal relationship between the tipper and the tippee."[168] On October 5, 2015, the petition for certiorari was denied by the Supreme Court.[169]

In *United States v. Salman*, Judge Rakoff, sitting by designation, eschewed the Second Circuit's holding in *Newman*. Instead, Judge Rakoff referred to *Dirks*, holding that proof of a personal benefit only requires "proof that the insider disclosed material nonpublic information with the intent to benefit a trading relative or friend . . . . "[170] Judge Rakoff, citing *Dirks*,' held that a personal relationship between the tipper and the tippee satisfies the personal benefit element.[171] Specifically, the Ninth Circuit held that a breach of fiduciary duty (and thus the tipper's personal benefit) can be established when an insider discloses confidential information to someone with whom the insider has a personal relationship; no enhanced "tangible benefit" articulated by *Newman* is necessary to establish liability.[172]

Due process requires that defendants be given fair notice as to what conduct could result in criminal liability.[173] While varying court opinions interpreting Rule 10b-5, Rule 10b5-1, and Rule 10b5-2 are appropriate in the civil arena,[174] criminal liability needs to be defined with more specificity to avoid "[r]andomly sacrificing individuals on the altar of investor confidence."[175] In *Newman*, the Second Circuit ultimately used language that resolved the ambiguity in Rule 10b-5 in favor of the defendant.[176] Although the Second Circuit did not explicitly invoke the

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168. *Id.* at 452.

169. United States v. Newman, 773 F.3d 438 (2d. Cir. 2014), *cert. denied*, 136 S.Ct. 242 (U.S. Oct. 5, 2015) (No. 15-137).

170. United States v. Salman, 792 F.3d 1087, 1094 (9th Cir. 2015).

171. *Id.* at 1093 (declining to apply *Newman*'s personal benefit standard and holding instead that a personal benefit is satisfied pursuant to *Dirks* when an insider discloses nonpublic material information to a "relative or friend").

172. *Id.* ("[The Defendant] argues that because there is no evidence that [the tipper] received any such tangible benefit in exchange for the inside information, or that [the Defendant] knew of any such benefit, the Government failed to carry its burden. To the extent *Newman* can be read to go so far, we decline to follow it.").

173. *See* Bach Hang, *The SEC's Criminal Rulemaking in Rule 10b5-2: Incarceration Should Be Made of Sterner Stuff*, 41 WASHBURN L.J. 629, 653 (2002) (explaining that due process requires defendants to be on notice of what behavior constitutes as criminal and could therefore lead to imprisonment).

174. *Id.* (arguing that developing the misappropriation theory on individualized facts may be appropriate in the civil arena but determining criminal liability on an "ill-defined" definition can have negative repercussions).

175. *Id.*

176. United States v. Newman, 773 F.3d 438, 452 (2d. Cir. 2014) (rejecting the Government's argument and holding that the tippee's knowledge of both the breach of fiduciary duty and of the personal benefit is necessary to impose criminal liability).

rule of lenity, *Chevron* deference, or mention *Whitman* in its holding, the Second Circuit's reasoning reconciles each of these principles implicitly in its language and ruling in favor of Newman.[177] This implicit judicial adoption of the rule of lenity in a criminal proceeding rejects the Commission's interpretation of insider trading rules. *Newman*, by defining criminal liability with clear and specific language, performs its judicial function of interpreting Congress' language in Section 10(b) of the Exchange Act.[178] Ultimately, this clear language protects investors and bolsters their confidence in participating in a federal securities market that does not impose arbitrary standards for criminal liability.

D. *The Circuit's Differing Interpretations of* Dirks *and the Supreme Court's Denial of Certiorari*

In *Newman*, the Second Circuit went beyond the "trading relative or friend" language used by the *Dirks* court[179] and defined personal benefit with specificity.[180] *Salman*, in contrast, held that since the defendant had received an insider trading tip from someone considered a "relative or friend," that was sufficient to establish liability.[181] Newman argued in his brief in opposition to certiorari that *Newman*'s holding remains consistent with *Dirks*.[182] Newman further argued that the Second Circuit appropriately used *Dirks*' language to articulate a more detailed standard of tipper liability that defines when a tipper's disclosure results in a significant personal benefit.[183] The Second Circuit's language in *Newman* articulates a

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177. *See id.* at 447–48, 452 (resolving the ambiguity regarding the knowledge requirement of the tippee and what a personal benefit actually is by holding 1) that the tippee must know about both the tipper's breach of fiduciary duty and his personal benefit, and 2) that the personal benefit requires proof of "a meaningfully close personal relationship" that results in an exchange with potential pecuniary value).

178. National Conference of State Legislatures, *Separation of Powers—An Overview*, http://www.ncsl.org/research/about-state-legislatures/separation-of-powers-an-overview.aspx (last visited Sept. 17, 2015) (explaining that the judicial branch's role is to interpret the laws passed by Congress).

179. Dirks v. SEC, 463 U.S. 646, 664 (1983).

180. *See Newman*, 773 F.3d at 452 (articulating a heightened personal benefit standard requiring a relationship that goes beyond mere friendship and that results in an exchange with potential economic value).

181. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).

182. *See* Brief for Todd Newman in Opposition at 21, United States v. Newman 773 F.3d 438 (2d. Cir. 2014) (No. 15-137) (explaining that the Second Circuit acknowledged and used the relevant personal benefit language first articulated in *Dirks* when defining liability in *Newman*).

183. *See Newman*, 773 F.3d at 452 (noting that, in circumstances where there is a close personal relationship between the tippee and the tipper that is meaningful, significant, and goes beyond "mere friendship," a reasonable inference of a personal

specific standard that market participants will know has potential criminal implications.[184]

The petition presented a narrow issue for the Supreme Court to consider: whether *Newman*'s personal benefit holding contravened *Dirks*.[185] The broader issue of *Chevron* deference was not raised in the Government's petition for certiorari. On October 5, 2015, the petition for certiorari was denied.[186] As is customary, the Supreme Court did not articulate a reason for this denial.[187] It is possible the Supreme Court will take the opportunity to decide whether the rule of lenity trumps *Chevron* deference when a more explicit presentation of the issue comes along. Justice Scalia, in his accompanying statement in *Whitman*, has already sent a strong signal inviting a case that squarely presents the *Chevron* issue.[188]

III. RECONCILING THE RULE OF LENITY WITH THE COMMISSION'S ENFORCEMENT POWER

Lenity is a historical rule of criminal law that is based on due process principles of notice and the legislature's right to define crimes.[189] The issue of whether the rule of lenity is required to be applied in the Commission's enforcement proceedings evokes a fundamental structure of the United States: the separation of powers.[190] The legislative branch enacts the laws; the executive branch enforces the laws enacted by the legislative branch; and the judicial branch interprets the laws enacted by the legislative branch and the rules promulgated by the executive branch.[191] Justice Scalia made

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benefit to the tipper is created).

184. *Id.* (contending that Newman's heightened personal benefit standard puts market participants on notice about whether they partake in a personal relationship that could "trigger an inference" of a personal benefit).

185. Petition for a Writ of Certiorari, United States v. Newman, (U.S. July 30, 2015) (No. 15-137), http://www.justice.gov/sites/default/files/osg/briefs/2015/08/13/newman_cert_petition.pdf

186. United States v. Newman, 773 F.3d 438 (2d. Cir. 2014), *cert. denied*, 136 S.Ct. 242 (U.S. Oct. 5, 2015) (No. 15-137).

187. *Id.*

188. *See* Whitman v. United States, 135 S. Ct. 352, 354 (2014) ("But when a petition properly presenting the question [of deference to the Commission] comes before us, I will be receptive to granting it.").

189. *See* United States v. Bass, 404 U.S. 336, 348 (1971) (explaining that the rule of lenity is founded on two policies that have long been part of the Court's tradition: first, defendants have a right to fair notice about what the law is, and second, that legislatures should ultimately define crime).

190. *See* Greenfield, *supra* note 74, at 12 ("The rule that penal laws are to be construed strictly . . . is founded . . . on the plain principle that the power of punishment is vested in the legislative, not in the judicial department. It is the legislature, not the Court, which is to define a crime, and ordain its punishment.").

191. *See* National Conference of State Legislatures, *supra* note 178.

clear, in his statement accompanying the Court's denial of certiorari in *Whitman*, that the executive branch has usurped the function of the legislative branch through its rulemaking authority and has enabled this usurpation by applying *Chevron* deference in criminal cases.[192]

The Commission's "mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation" is vital to ensuring a strong national market.[193] However, as part of the executive branch, the Commission is not empowered to define crimes.[194] Using the rule of lenity in criminal prosecutions under Rule 10b-5, the promulgation of a rule of significant importance and of routine use could create a fair system that respects due process as well as the Commission's expertise and mission of protecting investors. Applying the rule of lenity to every law that contemplates both criminal and administrative enforcement would have widespread ramifications, as many of the Commission's laws contemplate both civil and criminal liability.[195]

Arguably, "[a court should not] interpose its own construction when the Commission's expertise is more adept at dealing with the complex nature of mutual fund structures, market transactions, and unique or novel forms of fraud."[196] The Commission is adept at dealing with the complex nature of the securities market, but the enforcement of criminal laws has never been a power delegated to the Commission. The rule of lenity is a standard of interpretation that should be used only when criminal penalties are at stake.[197]

To balance these conflicting interests, lenity should be applied in criminal proceedings only. This recommendation has proved feasible when using *Newman* as the framework. It is only necessary to apply the rule of lenity to a criminal proceeding for insider trading violations brought by the DOJ; if the government could obtain a conviction by proving beyond a reasonable doubt all of the insider trading violation elements articulated by

192. *See* Whitman v. United States, 135 U.S. 342, 353 (2014) (contending that legislatures rather than executive officers should articulate crimes and that judicial deference to executive rule promulgations where criminal liability is at stake allows the executive agency (rather than the legislature) to define criminal conduct).

193. Atkins, *supra* note 37, at 369.

194. *Whitman*, 135 U.S. at 353.

195. Martens, *Scalia's Deference Argument Could Have Dramatic Effects*, *supra* note 3 (stating that adoption of Justice Scalia's lenity argument in *Whitman* could extend to claims brought under the Securities Act, the Investment Company Act, the Investment Advisors Act, and the Foreign Corrupt Practices Act).

196. Matthew P. Wynne, *Rule 10b-5(b) Enforcement Actions in Light of Janus: Making the Case for Agency Deference*, 81 FORDHAM L. REV. 2111, 2148 (2013).

197. *See* Greenfield, *supra* note 74, at 60 ("The Chevron presumption, which opts for a blanket rule of deference over a case-by-case determination of whether Congress intended a particular result, is inappropriate where criminal penalties are at issue.").

Newman, then that conviction would subsume the preponderance of the evidence standard the Commission is required to prove in a civil proceeding.[198] However, if the Government could not prove the elements beyond a reasonable doubt, *Chevron* deference could then be appropriately applied to the Commission's rule promulgations in a civil proceeding, and the Commission will be bound to prove each and every element by a preponderance of the evidence standard.[199] Adopting the rule of lenity, rather than deferring to the Commission under *Chevron* in insider trading prosecutions, is ultimately a way to preserve a defendant's due process rights while still ensuring that the Commission's administrative powers are not stripped from the agency.

CONCLUSION

Justice Scalia's voiced disapproval of applying *Chevron* deference in a criminal context, in conjunction with the Second Circuit's holding in *Newman*, represents a judicial shift away from administrative deference when criminal liability is at stake under Rule 10b-5. The rule of lenity is appropriate only in criminal proceedings brought under Rule 10b-5. Due process principles need to be upheld by the defendant's right to be informed of what constitutes criminal liability, and it is not within the Commission's power to define criminal liability. It is important to allow the Commission to maintain its mission of protecting investors by allowing *Chevron* deference to the Commission's interpretation of Rule 10b-5 only in civil proceedings when civil penalties are at stake. Ultimately, investors will benefit from more narrowly drawn rules, defining criminal conduct and allowing for more uniformity in judicial interpretation of the Commission's rules.

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198. *See* Loughlin, *supra* note 64, at 22–23 (explaining that DOJ prosecution frequently requests a stay of civil proceedings for discovery purposes).

199. *See* Steadman v. SEC, 450 U.S. 91, 103 (1981) (concluding that Congress intended the preponderance standard to apply in civil proceedings directed by the Commission).

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FRIENDS WITH BENEFITS: ANALYZING THE IMPLICATIONS OF *UNITED STATES V. NEWMAN* FOR THE FUTURE OF INSIDER TRADING

TEBSY PAUL*

In the 2014 case United States v. Newman, *a federal appeals court vacated convictions of insider trading and dismissed the indictments against two former hedge fund traders, Todd Newman and Anthony Chiasson. In overturning their convictions, the United States Court of Appeals for the Second Circuit ("Court") held that the U.S. Attorney's Office for the Southern District of New York ("Government") failed to prove that the corporate insiders received a significant benefit for tipping downstream tippees, who were several levels removed from the corporate insiders. The Court also held that the Government failed to show that the defendants had any knowledge of the alleged benefits that the insiders supposedly received. The Court reasoned that the benefit conferred to the tippees must be "of some consequence" so that it is no longer sufficient to show just friendship as a form of benefit. After the ruling, the Government sought a rehearing en banc and argued that the ruling departs from United States Supreme Court and Second Circuit precedent and that it threatens the effective enforcement of securities law, specifically in cases involving remote tippees and tippers. Following the denial for a rehearing by the Second Circuit, the Government filed a petition for writ of certiorari to the Supreme Court which was also denied on October 5, 2015.*

This Comment argues that the Court's decision in Newman, *requiring a tangible personal benefit, is proper because the decision clarified the*

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requirements necessary to sustain a conviction for remote tippee liability in insider trading cases. The Court's decision correctly curbed the government's ability to bring insider trading cases by limiting the Securities and Exchange Commission's ("SEC") broad interpretation of existing securities law. The SEC's broad interpretation has damaged the overall efficiency of the market by limiting the incentives of market participants to obtain information and make informed trading decisions. Furthermore, this Comment will recommend the need for Congress to enact create laws directly criminalizing insider trading behavior.

INTRODUCTION

In the recent decision by the United States Court of Appeals for the Second Circuit ("Second Circuit" or "Court"), *United States. v. Newman,*[1] the Court reviewed its standard for prosecuting "downstream" or "remote" tippees under Section 10(b) of the Securities Exchange Act and Securities and Exchange Commission's ("SEC") Rule 10b-5.[2] In *Newman*, the Court vacated the conviction of two "remote tippee"[3] hedge fund managers[4] and

1. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

2. Andrew C. Whitman, *The Supreme Court Should Overturn U.S. v. Newman and Recognize a New Type of Insider Trading Liability*, AM. CRIM. L. REV. (Jan. 20, 2015), http://www.americancriminallawreview.com/aclr-online/supreme-court-should-overturn-us-v-newman-and-recognize-new-type-insider-trading-liability/.

3. *See Newman*, 773 F.3d at 446 ((explaining the relationship between a "tipper" ("the insider or misappropriator in possession of material nonpublic information") and a "tippee" (the outsider to whom the tipper discloses such material information, "who

concluded that "the government must show that someone who received inside information and then traded on it . . . knew that the source received a benefit for providing the tip."[5] This decision is particularly troublesome for the Government because the Court redefined what constitutes a personal benefit, holding that "the mere fact of a friendship" is not enough to justify a charge of insider trading.[6] In *Newman*, the Court concluded that the career advice and friendship the defendants received or maintained, and thereafter traded on, did not amount to a "personal benefit" that represented a potential gain of a "pecuniary or similarly valuable nature."[7] This new heightened standard of proof will make it harder for the Government to successfully prosecute future insider trading cases involving remote tippers and tippees.

On January 22, 2015, U.S. Attorney Preet Bharara announced that he would ask for an *en banc* hearing by the Second Circuit Court of Appeals to review the Court's landmark ruling in *United States v. Newman*,[8]

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then trades on the basis of the information before it is publicly disclosed")).

4. *See id.* at 455.

5. Peter J. Henning, *Fallout Builds from Ruling on Insider Trading*, N.Y. TIMES (Jan. 20, 2015, 12:32 PM), http://dealbook.nytimes.com/2015/01/20/fallout-from-insider-trading-ruling/?_r=0.

6. *See* Alison Frankel, *In Insider Trading Appeal, Justice Department Makes Big Concession*, REUTERS (Jan. 26, 2015), http://blogs.reuters.com/alison-frankel/2015/01/26/in-insider-trading-appeal-justice-department-makes-big-concession/ (explaining that a tipster must have a meaningfully-close personal relationship with the initial recipient of confidential information or else stand to receive a pecuniary benefit from the disclosure).

7. *See generally* Daniel P. Chung & Avi Weitzman, *United States v. Newman: Second Circuit Ruling Portends Choppier Waters for Insider Trading Charges Against Downstream Tippees*, GIBSON DUNN: PUBLICATIONS (Dec. 15, 2014), http://www.gibsondunn.com/publications/pages/US-v-Newman—Second-Circuit-Ruling-Portends-Choppier-Waters—Insider-Trading-Charges-Against-Downstream-Tippees.aspx (suggesting that *Newman* would now "re-invigorate" the original meaning of the *Dirks* benefit test, making it harder for the Justice Department and the SEC to prevail where evidence of a pecuniary benefit to the tipper is not readily provable).

8. *Newman*, 773 F.3d at 438, *reh'g en banc denied*, United States v. Newman, 2015 U.S. App. LEXIS 5788 (2d Cir. Apr. 3, 2015); *see also* Roger Parloff, *Top Manhattan Prosecutor Will Challenge Landmark Insider Trading Case*, FORTUNE (Jan. 23, 2015, 2:06 PM), http://fortune.com/2015/01/23/top-manhattan-prosecutor-will-challenge-landmark-insider-trading-case/; Stephanie Russell-Kraft, *SEC Backs Bharara in 2nd Circ. Insider Trading Appeal*, LAW360 (Jan. 26, 2015, 6:27 PM), http://www.law360.com/articles/615237/sec-backs-bharara-in-2nd-circ-insider-trading-appeal (noting the SEC's support of the government's motion for an *en banc* hearing. Based on its belief that the Second Circuit's holding was incorrect, the SEC filed an amicus brief explaining that "[t]he panel's narrowed definition of personal benefit and lack of clarity about the evidence required for establishing such benefit could negatively affect the SEC's ability to bring insider trading actions. Any such weakening of the SEC's ability to effectively police and deter insider trading could

although the request was denied on April 3, 2015. While the Government considers the Second Circuit's decision in *Newman* to be troublesome,[9] the defense counsel promptly declared the decision a "resounding victory for the rule of law."[10] The *Newman* decision has already received considerable commentary. Some have expressed full-fledged support, calling the Second Circuit's decision a well-deserved lesson for the Government, particularly after Bharara's weak crusades against insider trading.[11] Others have condemned the decision, believing that it "shield[s]from accountability Wall Street's corrupt culture."[12]

Prior to the SEC's creation in 1934, the public had little confidence in the federal government's ability to regulate the securities market.[13] Prompted by the stock market crash of 1929 and the Great Depression, it was first imperative to rebuild the public's faith in the capital markets in order to restore the country's economy.[14] Insider trading regulation began with the implementation of the Securities Act of 1933 ("Securities Act"), which mandated "full and fair disclosure." The enactment of the Securities Exchange Act of 1934 ("Securities Exchange Act") followed, and it codified laws for the "disclosure and disgorgement of insider trading profits."

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undermine investor confidence in the fairness and integrity of the securities markets.").

9. *See* Henning, *supra* note 5 (stating that prosecutors believe that the *Newman* ruling will tie their hands in pursuing Wall Street crime).

10. *See* Ben Protess & Matthew Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, N.Y. TIMES (Dec. 10, 2014, 10:19 AM), http://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions/ (demonstrating defense counsel's relief of the Second Circuit's decision).

11. *An Outside the Law Prosecutor*, WALL ST. J. (Dec. 10, 2014, 8:18 PM), http://www.wsj.com/articles/an-outside-the-law-prosecutor-1418260680 (noting Bharara's attempt to "expand the definition of insider trading to whatever he could sell to a jury" as well as exploiting both "public anger against the finance industry as well as the ambiguity in the legal definition of insider trading" when prosecuting insider trading cases).

12. *See* William K. Black, *The Second Circuit Makes Sophisticated Insider Trading the Perfect Crime*, NEW ECON. PERSP. (Dec. 11, 2014), http://neweconomicperspectives.org/2014/12/second-circuit-makes-sophisticated-insider-trading-perfect-crime.html (noting that the Second Circuit's decision leads to the perfect crime because it is guaranteed to make elite traders who trade on inside information wealthy and providing a roadmap allowing those elite traders to arrange the scheme with total impunity from criminal laws).

13. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, http://www.sec.gov/about/whatwedo.shtml#.VLlV0CvF—M (last updated June 10, 2013).

14. *See also id.* (suggesting that once Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, both federal and state prosecutors had "more ammunition to convict inside traders by requiring mandatory disclosure and fair treatment of investors").

In the 1960s, under its authority granted by Section 10(b) of the Securities Exchange Act ("Section 10(b)"), the SEC and federal courts applied the antifraud principle of SEC Rule 10b-5 to insider trading cases.[15] The application of Rule 10b-5 effectively allowed the SEC to prosecute securities fraud through administrative actions and federal lawsuits.[16] Today, the profitable business of illegal insider trading has developed to include cases that are in all types of sectors, like the banking, technology, and pharmaceutical sectors.[17]

Part I of this Comment provides background on insider trading law by highlighting relevant statutory and case law that have shaped United States' securities law. Part II addresses the potential fallout for the Government's future insider trading cases based on the Second Circuit's decision in *Newman*. Part III concludes by recommending that Congress draft and implement laws that directly target the current insider trading legal regime to mitigate the illegal profits reaped by insider traders.

I. THE EVOLUTION OF INSIDER TRADING

Throughout the years, the Government has applied various securities laws in an effort to combat insider trading. The Securities Act was applied to insider trading to provide investors with a "full and fair disclosure of character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in sale thereof."[18] The Securities Exchange

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15. 15 U.S.C. § 78a (2012) (making it unlawful for any person through the means of interstate commerce to scheme or defraud or make any untrue statement of a material fact in connection with the purchase or sale of any security); *see* 17 C.F.R. 240.10b-5 (2015); *see also* Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 269 (2003), http://www.ebaughlaw.com/uploads/1/1/9/4/11948411/tjbl_article.pdf (stating that the principal tools used by the SEC and private plaintiffs to prosecute insider trading are Section 10(b) of the Securities Exchange Act and Rule 10b-5).

16. *See* Ebaugh, *supra* note 15, at 269.

17. *See* Chris Matthews, *How Profitable is Insider Trading, Anyway?*, FORTUNE (Oct. 20, 2014, 1:25 PM), http://fortune.com/2014/10/20/insider-trading-profits/ (suggesting insider trading is "insanely" profitable by demonstrating that the median investor betting $200,000 on the basis of an illegal tip can reap $72,000 on that trade-amounting to a thirty-five percent gain with a turnaround period of just twenty-one days); *see also Preet Bharara: Insider Trading Is "Rampant" on Wall Street*, FRONTLINE (Jan. 7, 2014, 9:41 PM), http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/to-catch-a-trader/preet-bharara-insider-trading-is-rampant-on-wall-street/ (explaining how Bharara suggests that the hedge fund business is not the only business that insider trading is exploiting).

18. 15 U.S.C. § 77a (2013); *see* SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (10th Cir. 1937) (reiterating that the purpose of the Securities Act is to provide full and fair disclosure for investors).

Act strengthened the Securities Act's prohibitions of fraud in the sale of securities.[19] Other statutory provisions that govern insider trading include the Insider Trading Sanctions Act of 1984[20] ("ITSA") and the Insider Trading and Securities Fraud Enforcement Act of 1988.[21]

Under SEC Rule 10b5-1, an insider trading violation occurs when there is a purchase or sale of a security on the basis of information that is material, nonpublic, and traded in breach of fiduciary duty.[22] SEC Rule 10b-5 specifies that only untrue statements or omissions of material fact are actionable.[23] "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider [the information] important in deciding how to vote."[24] The "disclose or abstain rule" is premised on case law decided under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5's theory of equal access to information.[25] The "disclose or

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19. *See* Parloff *supra* note 8. *See generally* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 484–85 (1989) (holding that both the Securities Act of 1933 and the Securities Exchange Act of 1934 should be construed harmoniously because they "constitute interrelated components of federal regulatory scheme governing transactions in securities").

20. *See* Thomas C. Newkirk, Assoc. Dir., Div. of Enforcement, Speech at Jesus College 16th Int'l Symposium on Economic Crime: Insider Trading – A U.S. Perspective (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm (stating that ITSA served as a deterrent after the Commission determined that injunctions and disgorgements were inadequate deterrents. "The Act provides penalties up to three times the profit gained or the loss avoided by the insider trading."); *see also* Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1166 (1997) (suggesting that "using ITSA as an effective weapon, the SEC became increasingly vigorous in enforcing insider trading prohibitions" and the Insider Trading and Securities Fraud Enforcement Act "bolstered the civil and criminal remedies available for Rule 10b-5 violations").

21. Newkirk, *supra* note 20 (stating that the Insider Trading and Securities Fraud Enforcement Act expanded the Commission's ability to request testimony and production of documents from foreign security authorities so the Commission could obtain information to assist foreign regulators).

22. 17 C.F.R. § 240.10b5-1 (2015).

23. *Id.* § 240.10b-5(b) (2015); *see also* WILLIAM WANG & MARC STEINBERG, INSIDER TRADING 109 (3d ed. 2010) (explaining that there are two kinds of material information: (1) information about the issuer's internal affairs, such as its earnings and profits, or (2) information such as knowledge about a forthcoming tender offer for the stock). *See generally* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 34 (2d ed. 2007).

24. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (noting that this standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote).

25. *Compare* Cady, Roberts & Co., 40 SEC 907 (1961) (extending the "disclose or abstain" rule beyond classical insiders and deciding that a "corporate insider" (anyone that had access to nonpublic information) must abstain from trading in the shares of his

abstain rule" states that "when a public issuer or one of its insiders is in possession of undisclosed material information, the issuer or insider must either disclose the material information before trading in the issuer's securities or abstain from trading in the issuer's securities."

In insider trading cases, the government must establish that the person traded with the requisite scienter[26] while in possession of "nonpublic" information. The distinction between public and nonpublic material operates along a spectrum. At one end is information disclosed by a company through official channels of communication, such as those the SEC mandates;[27] at the other end are cases involving information leaked to the media, Internet, or individuals who have an interest in obtaining the information.[28] Courts have established two theories to determine whether the information is considered public or not. Under the first theory, before insiders can act upon material information, the information must be disclosed by the original source in a manner sufficient to insure its availability to the investing public. In *SEC v. Texas Gulf Sulphur Co.*, the SEC brought an action against the defendants alleging violations of Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78, and Rule 10b-5.[29] Texas Gulf Sulphur ("TGS") officials discovered evidence of a major ore deposit,[30] and shortly after, company officials planned to publicly announce the findings in a major press conference.[31] In the days leading up to the

corporation unless he has first disclosed all material inside information known to him), *with* United States v. Chiarella, 445 U.S. 222, 226-30 (1980) (shifting back to the requirement that a *relationship* giving access to nonpublic information exist, when determining who is an insider).

26. *See* Aaron v. SEC, 446 U.S. 680, 702 (1980) (defining "scienter" as the defendant's mental state embracing an intent to deceive, manipulate, or defraud); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that "a private cause of action for damages will not lie under [Section] 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' – i.e. intent to deceive, manipulate, or defraud").

27. *See* Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U.J.L. & BUS. 151, 170-74 (2011) (discussing the different theories of insider trading and the distinction between public and nonpublic information).

28. *See id.*

29. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (holding that not only are directors or management officers of corporation "insiders" within meaning of rule of SEC, so as to be precluded from dealing in stock of corporation, but the rule is also applicable to one possessing information. Thus, anyone "in possession of material inside information" is an "insider" and must "either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect corporate confidence, or he chooses not to do so, must abstain from trading in or recommending securities concerned while such inside information remains undisclosed.").

30. *See id.* at 843.

31. *See id.* at 844-46.

formal statement announcing the discovery of ore deposits, TGS insiders bought stock or stock options in the company.[32] Others tipped off outsiders who, in turn, also bought stock in the company.[33] Upon discovering the scheme, the SEC sued TGS and argued that the company's press release about the discovery was "materially false and misleading" and that TGS officers and employees knew this information was false.[34] The Second Circuit held that where a formal announcement to the media is revealed, all insider activity must await dissemination of the promised official announcement.[35]

Under the second theory, information is public when trading causes the information to be integrated into the price of the particular stock. In *United States v. Libera*, the Supreme Court found the defendants guilty of conspiracy and securities fraud for insider trading.[36] The Government argued that the defendants executed trades in stock based on information in advance copies of *Business Week*.[37] The defendants' convictions were based on the misappropriation theory, which stated that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and [SEC] Rule 10b-5."[38] Although the defendants argued that the advance copies of *Business Week*—containing the information which they used to execute their trades—was based on public information, the Second Circuit disagreed. The Second Circuit held that information may be considered public for Section 10(b) purposes—even though there had been no public announcement and only a small number of people know of it—if trading has caused the information to be fully impounded into the price of the particular stock.[39]

To ensure a fair market, the "disclose or abstain" rule states that if information is not public, one must either disclose the information before trading on the information or abstain from trading if the information is not released to the public. In accordance with application of the "disclose or

32. *See id.* at 842, 847.

33. *See id.* at 844.

34. *See id.* at 858.

35. *See id.* at 854 (holding that, at a minimum, the defendant should have waited "until the news could reasonably have been expected to appear over the media of widest circulation").

36. *See* United States v. Libera, 989 F.2d 596, 602 (2d Cir. 1993).

37. *See id.* at 598.

38. *See id.* at 599.

39. *Id.* at 601 (agreeing with appellants and stating that information may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people knew about it).

abstain" rule, there must be a determination of whether a fiduciary relationship exists between the inside trader and those with whom he or she is about to trade.[40] Whether an individual has violated a fiduciary duty depends on the nature of the fiduciary relationship that the government is asserting. There are three traditional theories of insider trading liability that this Comment will discuss: the "classical" theory, the "tipper-tippee" theory, and the "misappropriation" theory. These theories all cover different types of fiduciary duties, each with different types of relationships and obligations. Accordingly, when applying these theories, the government has the burden of proving that a person trading on a tip knew or should have known that there was a breach of a duty based on the source of the information.[41]

A. Analyzing the Second Circuit's Interpretation of Personal Benefits following Dirks v. SEC

In the seminal Supreme Court case, *Dirks v. SEC*, the Supreme Court held that a prosecutor could charge tippees with insider trading liability if he or she met two conditions: 1) if the tip recipient had reason to believe that when the information was divulged, it was in violation of another's fiduciary duty; and 2) if the recipient personally gained from acting upon the information.[42] In *Dirks*, the petitioner worked as a securities analyst at an insurance company. An insider at an investment company urged the petitioner to investigate the investment company after the insider received information that the company was engaging in fraud.[43] The petitioner confirmed the fraud by interviewing other corporate employees.[44] In the course of the investigation, neither the petitioner nor his firm traded any

40. *E.g.*, Dirks v. SEC, 463 U.S. 646, 654 (1983) (noting that the duty to disclose does not arise from the mere possession of nonpublic market information, rather it arises from the existence of a fiduciary relationship); *see also* Chiarella v. United States, 445 U.S. 222, 232-33 (1980) (holding that no duty to disclose could arise since petitioner was not an agent, fiduciary, or person in whom the sellers had placed their trust and confidence).

41. *Dirks*, 463 U.S. at 660 ("A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know there has been a breach.").

42. *See id.* (noting that the Supreme Court was not suggesting that all tippees were free to trade on material nonpublic information but that a tippee's duty to disclose or abstain must be derived from the insider's duty).

43. *See id.* at 649.

44. *See id.* (noting that Dirks interviewed several officers and employees of the corporation and the senior management denied any wrongdoing but that certain corporation employees corroborated the charges of fraud).

stock from the company; however, the petitioner did discuss his findings with a number of clients who in turn sold their holdings.[45] As a result, the company's stock fell, causing the New York Stock Exchange to halt trading.[46]

The SEC found that the petitioner had aided and abetted violations of United States' securities laws, and it censured him.[47] The Supreme Court reversed the SEC's judgment and reaffirmed its decision in *Chiarella v. United States*, holding that a duty to disclose "arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[48] The Supreme Court also held that, because the tippers were only motivated by a desire to expose the fraud, there was no personal benefit to the tippers and thus no derivative liability for the petitioner-tippee.[49] In *Dirks*, the Supreme Court found that the petitioner had no fiduciary duty to the shareholders or officers of the investment company nor was there expectation by the petitioner's source of information that he would keep the information confidential.[50] Furthermore, because the petitioner did not misappropriate or illegally obtain the information, the Supreme Court found that there was no actionable violation.[51]

Since *Dirks*, the Second Circuit has interpreted the *Dirks* "personal benefit test" differently. In *United States v. Rajaratnam* and *United States v. Whitman*, the Second Circuit interpreted *Dirks* to require that the Government prove a tippee's knowledge of a benefit to the tipper who violated a fiduciary duty.[52] However, in *United States v. Jiau* and *United*

45. *See id.*

46. *See id.* at 650.

47. *See id.* at 650–52.

48. *See id.* at 657–58 (citing Chiarella v. United States, 445 U.S. 222, 235 (1980), which rejected the SEC's position that anyone who knowingly receives nonpublic, material information from an insider has a fiduciary duty to disclose before trading).

49. *See Dirks*, 463 U.S. at 663–67 (requiring courts to focus on an objective criterion, "i.e. whether the insider receives a direct or indirect personal benefit from disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings").

50. *See id.* at 665.

51. *See id.*

52. *See* United States v. Rajaratnam, 719 F.3d 139, 158 n. 23 (2d Cir. 2013) (holding that "when an unlawful tip occurs, the tippee is . . . liable if he knows or should know that the information was received from one who breached a fiduciary duty and the tippee traders or tips for personal benefit with the requisite scienter"); United States v. Whitman, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2012) (holding that to be criminally liable for insider trading, a secondary tippee must have a general understanding that the inside information was obtained from an insider who breached a duty of confidentiality in exchange for some personal benefit and that the tippee must

States v. Libera, the Second Circuit interpreted *Dirks* to require that the Government principally prove that the tipper received some benefit but that the Government did not have to prove that the tippee had knowledge of that benefit.[53] The Second Circuit's decision in *Newman* offers a different interpretation of *Dirks* and brings clarity to an otherwise vague interpretation of establishing personal benefits. Prior to the *Newman* decision, the legal community has described the personal benefit element for tipper/tippee liability as "broadly defined."[54]

B. Comparing Tippee Liability through the Classical and Misappropriation Theories

In *Newman*, the Second Circuit and prosecutors assessed the Defendant's liability through different theories of liability, and after the Second Circuit put forth its decision, New York judges began to follow suit.[55] With this large-scale response, the Department of Justice ("DOJ") quickly sought to curb *Newman*'s effect by arguing that the decision only applied to "classical" insider trading cases and not to cases brought under the "misappropriation" theory.[56] However, the elements of tipping liability are the same regardless of whether the tipper's duty arose under the classical or

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have a specific intent to defraud the company to which the information relates).

53. *See* United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013) (holding that "[t]he existence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]' may be sufficient to justify an inference of personal benefit." (citing *Dirks*, 463 U.S. at 664)); United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) (implying that the breach of a fiduciary duty in return for some benefit was required to establish liability; it is not necessary to establish that the tipper must specifically know that their breach of a fiduciary duty will lead to trading.).

54. *See United States v. Newman: Second Circuit Clarifies Its "Delphic" Interpretation of Insider Trading Laws in Landmark Ruling*, NIXON PEABODY LLP (Dec. 11, 2014), http://www.nixonpeabody.com/files/172497_GIWC_Alert_11DEC2014.pdf (suggesting that the Second Circuit's decision in *Newman* "brings case law back in line with the Supreme Court's decision in *Dirks v. SEC*, which noted that not all disclosures of confidential information exposes the tipper to securities laws violation").

55. *See e.g.*, United States v. Conradt, No. 12-cr-887, 2015 U.S. Dist. LEXIS 16263, at *2–4 (S.D.N.Y. Jan. 22, 2015) (noting that the presiding judge rejected the government's argument that any reference to the misappropriation theory in *Newman* was dicta and that prior Second Circuit decisions have held that the misappropriation theory does not require the tipper to receive any personal benefit to be liable for insider trading).

56. *Id.*; *see also* Gov't's Mem. Law Supp. Suff. Defs.' Guilty Pleas at 1, 4, United States v. Durant, No. 12-cr-887 (S.D.N.Y. Jan. 12, 2015) (explaining the DOJ's position that because the *Durant* prosecution is founded on the "misappropriation" theory of insider trading, and *Newman* involved a prosecution based on the "classical" theory of insider trading, the *Newman* holding will not affect the *Durant* case).

the misappropriation theory.[57]

The Supreme Court endorsed the classical theory of insider trading in the 1980 case, *Chiarella v. United States*. Under the classical theory, a corporate insider violates the anti-fraud provision by trading a corporation's securities "on the basis of material, nonpublic information" about the corporation.[58] In *Chiarella*, the petitioner was convicted by the Second Circuit for violating Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5.[59] While working for a financial printer, the petitioner handled announcements of corporate takeover bids.[60] Without disclosing his knowledge, the petitioner purchased the targeted company stock and sold the shares immediately after the takeover attempts were publicized.[61] The Supreme Court held that the petitioner had not violated the duty to disclose material information because no relationship of trust or confidence existed between petitioner and the shareholders.[62]

Chiarella limited the scope of insider trading liability to individuals who not only possessed material, nonpublic information but also to those who possessed a duty to disclose based on a relationship of trust and confidence between the parties.[63] Since *Chiarella*, however, the Courts no longer limited the duty to disclose or abstain under the classical theory to "traditional" corporate insiders, such as officers and directors. The Supreme Court in *Dirks v. SEC* extended the duty to disclose or abstain to outsiders who can obtain status as "temporary insiders."[64]

A defendant is guilty of violating the misappropriation theory when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.[65] Unlike the

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57. *Id.*; *see also* SEC v. Obus, 693 F.3d 276, 285–86 (2d Cir. 2012) (stating that "[o]ne who has a fiduciary duty of trust and confidence to shareholders (classical theory) or to a source of confidential information (misappropriation theory) and is in receipt of material non-public information has a duty to abstain from trading or to disclose the information publicly").

58. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

59. Chiarella v. United States, 445 U.S. 222, 225 (1980).

60. *Id.* at 224.

61. *Id.*

62. *Id.* at 232–33.

63. Bainbridge, *supra* note 23, at 52.

64. Dirks v. SEC, 463 U.S. 646 (1983); *see also Insider Trading: A Primer*, KATTENMUCHINROSENMAN LLP (Oct. 26, 2009), https://www.kattenlaw.com/Insider-Trading-A-Primer-10-26-2009 (explaining that a temporary insider is someone who enters into a special confidential relationship with an issuer, and as a result is given access to confidential relationship).

65. *See* Kramer Ortman, *SEC v. Bauer: If the Glove Fits, It's Insider Trading*, 63 CATH. U.L. REV. 1075, 1082 (2014) (stating that under the misappropriation theory, "a

classical theory, the misappropriation theory imposes a duty on corporate "outsiders." In *United States v. O'Hagan*, the respondent-attorney purchased common stock and call options of a potential takeover target based upon nonpublic information.[66] During the representation, the respondent purchased call options for the other company's stock and sold those options at a significant profit.[67] Because the respondent was neither an officer nor had any relation to the target company, the classical theory of insider trading did not apply. However, the Supreme Court held that the respondent was guilty of insider trading because he owed a fiduciary duty to his law firm, and when he used his law firm's confidential information to trade, he misappropriated such information to the disadvantage of his firm.[68] Therefore, the Supreme Court held that a corporate *outsider* is guilty of insider trading "when he misappropriates confidential information . . . in breach of a fiduciary duty owed to the source of information."[69]

Courts no longer restrict insider trading to either "corporate insiders" or to "corporate outsiders." Instead courts have expanded insider trading liability to include both insiders ("the tipper") in possession of the material, nonpublic information, and outsiders ("the tippee") who receive the information from the insider and use the information received to trade.[70]

II. FACTS AND PROCEEDINGS OF UNITED STATES V. NEWMAN

Defendants Todd Newman and Anthony Chiasson (collectively "Defendants") appealed their convictions, entered by the United States District Court for the Southern District of New York, following a trial on charges of conspiracy to commit insider trading in violation of 18 U.S.C. § 371, § 10(b) and § 32 of the Securities Exchange Act, SEC Rules 10b-5 and 10b5-2, and 18 U.S.C. § 2.[71] The Second Circuit reversed the lower court's convictions and held that the Government failed to present sufficient evidence that the Defendants willfully engaged in substantive

fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information").

66. United States v. O'Hagan, 521 U.S. 642, 647–48 (1977).

67. *Id.*

68. *See id.* at 653–54, 666.

69. *Id.* at 652.

70. *See* Dirks v. SEC, 463 U.S. 646, 659 (1983) (stating that "not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information to their personal gain").

71. United States v. Newman, 773 F.3d 438, 443 (2014).

insider trading or in a conspiracy to commit insider trading in violation of federal securities laws.[72]

On January 18, 2012, the Government unsealed charges against the Defendants and several other investment professionals.[73] This case focused on the Government's accusation that the Defendants were liable for insider trading after they received information from financial analysts about Dell Inc. ("Dell") and Nvidia Corporation's ("Nvidia") earning numbers before the numbers were publicly released by the corporations and, using that information, executed trade deals.[74] However, the Defendants were several steps removed from the corporate insiders, and there was no evidence that either was aware of the source of the inside information.[75]

The Government alleged that the Defendants were "criminally liable for insider trading because, as sophisticated traders, they should have known that the information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose."[76] On the other hand, counsel for the Defendants argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit, which was required by law to establish tipper liability.[77]

The district court instructed the jury to consider whether the Government had proven, beyond a reasonable doubt, that the Defendants knew the information they received was originally disclosed by an insider, in violation of a duty of confidentiality.[78] On December 17, 2012, the jury returned a verdict of guilty on all counts, and the Defendants appealed the verdict.[79]

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72. *Id.* at 442.

73. *Id.* at 443.

74. *Id.* (stating that Newman and Chiasson earned approximately $4 million and $68 million respectively in profits after receiving the inside information from their portfolio managers).

75. *Id. But see* Petition of the United States for Rehearing and Rehearing *En Banc* at 6–7, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837) [hereinafter United States Petition Rehearing *En Banc*] (describing purposeful steps Newman and Chiasson took to avoid learning where the real source of information came from that they in return traded on and made a profit from).

76. *Newman*, 773 F.3d at 443–44.

77. *Id.* at 444 (asserting that in the defendant's case, because a tippee's liability derives from the liability of the tipper, defendants could not be held liable since no personal benefit was found).

78. *See id.* (stating further that "[t]he mere receipt of material, nonpublic information by a defendant, and even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality").

79. *Id.*

On appeal, the Second Circuit held that to sustain an insider trading conviction against the tippee, the Government must prove each of the following: 1) the corporation entrusted the insider with a fiduciary duty; 2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; 3) the tippee knew of the tipper's breach of fiduciary duty; and 4) the tippee still used that information to trade in a security or further tip another individual for personal benefit.[80] The Second Circuit concluded that the Government's evidence of casual acquaintances between a tipper and tippee, as well as offers of generic career advice and occasional socializing, was insufficient to prove the necessary personal benefit to the insider.[81] Instead, the Second Circuit found that the Government could infer a benefit only upon "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[82] The Second Circuit also found that the Defendants did not know of any benefit received by the tipper. The Court vacated the convictions and remanded the case to the district court to dismiss the indictments with prejudice as they pertained to the Defendants.[83]

III. *NEWMAN*'S AFTERMATH: ANALYZING THE IMPLICATIONS OF THE SECOND CIRCUIT'S DECISION

In overturning the defendant's convictions, the Second Circuit presented a much-needed return to fairness and "sanity" in the judicial system.[84] U.S.

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80. *Newman*, 773 F.3d at 448 (rejecting the government's contention "that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability").

81. *Id.* at 452 (stating that if Court were to accept that two individuals who were alumni of the same school or attended the same church as a personal benefit, then the personal benefit requirement would be a void and any relationship can be inferred as a personal benefit).

82. *Id. But see* United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013) (holding that "personal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*, any reputational benefit that will translate into future earnings").

83. *Newman*, 773 F.3d at 455.

84. *See* Stephen Bainbridge, *U.S. v. Newman: A Big Win for Coherence and Fairness in Insider Trading Law*, PROFESSOR BAINBRIDGE (Dec. 11, 2014, 12:49 PM), http://www.professorbainbridge.com/professorbainbridgecom/2014/12/us-v-newman-a-big-win-for-coherence-and-fairness-in-insider-trading-law.html (agreeing with the Second Circuit's interpretation of law and stating that "Bharara's crusade has destroyed lives and ruined businesses by deploying highly aggressive 'interpretations' of the law that lacked a firm foundation in existing law"); *see also* Charles Gasparino, *Preet's Overreach: Insider-Trading-Case Slapdown*, N.Y. POST (Dec. 11, 2014, 7:53 PM), http://nypost.com/2014/12/11/preets-overreach-insider-trading-case-slapdown/

Attorney Preet Bharara has racked up more than eighty successful insider trading convictions in the past seven years,[85] providing him with an impressive track record and earning himself the reputation as the sheriff of Wall Street.[86] To some critics, Bharara's prosecution of insider trading has focused on successfully arguing that traders "didn't really have to know that the information they were trading on was the illegal variety."[87] Instead, it was good enough for prosecutors to establish that traders should have known the information was illegal[88] and to rely on something as nebulous as friendship to prove the existence of a benefit in lieu of providing that traders paid off their sources to obtain the illegal information.[89] The *Newman* decision successfully puts an end to Bharara's overreaching prosecution of insider trading and reminds the Government that not everyone who trades on nonpublic information is guilty of insider trading.

After *Newman*, the Second Circuit's decision forces the Government and prosecutors to reconsider bringing cases against remote tippees for trading insider information.[90] Now prosecutors' focus on insider trading are directed much more towards guilt than money.[91] Under *Newman*, liability would arise from the insider's intent to benefit the person who receives the inside information: the tippee.[92] Therefore, a tipper who trades based on

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(suggesting that Bharara's "bogus legal reasoning" behind convicting Newman and Chiasson stems from the pressure to convict individuals in an attempt to prove to the public that Wall Street is being held accountable for the damage that led to the 2008 financial crisis).

85. *See Preet Bharara's Key Insider Trading Cases*, N.Y. TIMES (Dec. 10, 2014), http://www.nytimes.com/interactive/2014/07/09/business/dealbook/09insider-timeline.html?_r=0#/#time337_8872 (highlighting some of Bharara's key cases from the eighty-five secured convictions and guilty pleas from traders, analysts, and industry consultants).

86. *See An Outside the Law Prosecutor*, *supra* note 11.

87. *See* Gasparino, *supra* note 84.

88. *Id.*; *see also Newman*, 773 F.3d at 443–44 (2d Cir. 2014) (noting the Government's argument that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they should have known the information they were trading on was illegal).

89. *See* Gasparino, *supra* note 84.

90. *See* Henning, *supra* note 5 (stating that the DOJ is fighting to minimize the impact of the opinion, which raised the bar on what the government must show to establish a violation for trading on confidential information).

91. *See* Matt Levine, *What's Next for Insider Trading Law?*, BLOOMBERG VIEW (Dec. 11, 2014, 6:17 PM), http://www.bloombergview.com/articles/2014-12-11/whats-next-for-insider-trading-law (stating "if you provably [*sic*] knew that you were corruptly obtaining information, then you go to jail, but if you just made a lot of money trading and got some tainted tips, you just have to give the money back").

92. *See* Mark S. Nelson, *SEC to Back U.S. Attorney's Try to Upend Newman*, SEC.

inside information must then give the illegal gains to a friend to be guilty of insider trading.[93]

A. Heightened Standard Analysis

Although the *Newman* case comes as a blow to prosecutors for future insider trading cases, it clarifies the muddled standards for establishing tippee liability within the Second Circuit.[94] In the past, the Second Circuit has articulated two opposing rationales for establishing personal benefit. In some cases, the Court construed *Dirks* to require that the government prove a tippee's knowledge of a benefit to the tipper who violated a fiduciary duty;[95] however, in others, the Court viewed *Dirks* as requiring the government to prove that the tipper received some benefit but that it did not have to not prove that the tippee knew of that benefit.[96]

The *Newman* decision correctly reins in both a prosecutor's ability to bring cases involving insider trading and his or her ability to target remote tippees whose actions are tangentially related to the illegal activity. In *Newman*, the Government continued to overextend insider trading culpability precedent set by courts by relying heavily on prior dicta favorable to their position, instead of analyzing tippee liability in view of the courts' framework.[97]

The Court in *Newman* correctly rejected the Government's argument that it only had to prove that the Defendants traded on material, nonpublic information that they knew insiders had disclosed in breach of a duty of confidentiality.[98] Instead, the Court ruled that the Defendants were guilty of insider trading if they were aware that insiders at technology companies were improperly leaking confidential information to hedge funds in exchange for some personal benefit.[99] While the Defendants profited from

REG. DAILY (Jan. 26, 2015), http://www.dailyreportingsuite.com/securities/news/sec_to_back_u_s_attorney_s_try_to_upend_newman.

93. *See id.*

94. Protess, *supra* note 10 (concluding that the appellate decision "drew a new and more defined line that curtails the boundaries of insider trading liability").

95. *See, e.g.*, United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013).

96. *See, e.g.*, United States v. Jiau, 734 F.3d 147 (2d Cir. 2013); United States v. Libera, 989 F.2d 596 (2d Cir. 1993).

97. *See* United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) (noting the Government's reliance on insider trading cases involving "tippees who directly participated in the tippers breach" and applying these cases to insider trading prosecutions of "remote tippees many levels removed from corporate insiders").

98. *See id.* at 447–48 (demonstrating that the Government cites *Dirks* for the proposition that the Supreme Court *only* required that the "tippee know that the tipper disclosed information in breach of a duty" (citing *Dirks*, 463 U.S. at 660)).

99. *See id.* at 438.

the nonpublic information, the Court found the Defendants so far removed from the initial tips at Dell and NVIDIA that they could not have known of any breach of fiduciary duty in exchange for a benefit.[100] The *Newman* decision is important for convicting remote tippees for the crime of insider trading because it defines the mens rea required for insider trading, namely that the defendant knew of the breach of fiduciary duty for a personal benefit. In *Newman*, the Defendants were four or five people removed from the original source of the inside information. The Court believed this was similar to a situation where a trader, who receives a tip and trades on it, is unaware that his conduct is wrongful because he was unaware of the original source.[101]

This heightened standard imposes the highest burden on the Government and forces prosecutors to reconsider its decision to charge tippees with unmerited accusations. Prosecutors argue that the *Newman* ruling encourages "higher-ranking traders to distance themselves from insider trading leaks, even when reaping big profits from the tips."[102] However, in the case of *Newman*, it is plausible to believe that the Defendants did not know the information was traded on a nonpublic basis for a personal benefit. What started as an illegal tip—exchanged between insiders at the technology companies—wound its way through a network of traders and then reached the Defendants, who were at the end of a long chain of traders.[103]

B. Personal Benefits Analysis

In the *Newman* decision, the Second Circuit revisited the Supreme Court's *Dirks*' "personal benefit" definition, and it added an unprecedented limitation that now drastically limits the Government's ongoing, frivolous prosecution of remote tippees. As mentioned above, in *Dirks*, the Supreme Court held that a breach of fiduciary duty was a breach of confidentiality in exchange for a personal benefit.[104] It further explained that the tipper's breach of fiduciary duty required that the tipper "[will] personally benefit, directly or indirectly, from his disclosure."[105]

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100. *But see* United States Petition for Rehearing *En Banc*, *supra* note 75, at 21 (arguing that the record established that the information the defendants received, namely top-line earnings numbers "were different in kind from any arguably authorized leaks from the subject companies").

101. *See Newman*, 773 F.3d at 450 (discussing the requisite mens rea for insider trading convictions).

102. Protess, *supra* note 10.

103. *Id.*

104. *See* Dirks v. SEC, 463 U.S. 646, 663 (1983).

105. *Id.* at 662.

In the past, prosecutors have successfully argued that mere friendship is enough to prove that a tipper received an indirect benefit from passing on an illegal tip to a friend.[106] However, post-*Newman*, the Government will have to prove 1) the existence of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary of similarly valuable nature,"[107] and 2) that, as stated above, the tippee had knowledge that the tipper received some benefit for the information shared in breach of a fiduciary duty.[108]

In *Newman*, the Government argued that the benefit received for the Dell insiders who worked together—and who previously attended business school together—was career advice.[109] The Government also attempted to establish personal benefits in the NVIDIA tipping chain by arguing that the insiders were close friends who socialized and attended church together.[110] The Second Circuit deemed the Government's evidence of personal benefit insufficient to establish insider trading liability.[111] After the Second Circuit's decision in *Newman*, the Court affirmed the basis for a claim of fraudulent breach, namely that the Government must also show that the tipper's gain "received in exchange for confidential information must be of some consequence."[112] Further, the *Newman* court set a high evidentiary burden for the Government by expressly declaring that, without direct proof of a tippee's knowledge of a benefit to the tipper, such knowledge may not be inferred by virtue of a personal relationship between the tipper and tippee.

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106. *See, e.g.*, SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) ("Personal benefit to the tipper is broadly defined: it includes not only 'pecuniary gain,' such as a cut of the take or a gratuity from the tippee, but also a 'reputational benefit' or the benefit one would obtain from simply 'mak[ing] a gift of confidential information to a trading relative or friend.'" (citing *Dirks v. SEC*, 463 U.S. at 663–64 (1983)); *see also* SEC v. Warde, 151 F.3d 42, 48–49 (2d Cir. 1998) (finding a sufficient showing of personal benefit where a "close friendship" suggested that the tip was intended to benefit the tippee). *See generally* Protess, *supra* note 10.

107. United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (explaining that this often manifests in "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]").

108. *Id.* at 448.

109. *Id.* at 452–53.

110. United States Petition for Rehearing *En Banc*, *supra* note 75, at 6.

111. *Newman*, 773 F.3d at 455 (stating that "where the evidence viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a theory of innocence as a theory of guilt, that evidence necessarily fails to establish guilt beyond a reasonable doubt").

112. *Id.* at 452.

The Court's decision stating that mere friendship is no longer sufficient evidence of a personal benefit heightens the standard for establishing personal benefit. However, the Second Circuit needs a further step to clarify what type of evidence then satisfies this heightened standard.[113] The defense counsel can assert that anything short of a wiretap or coerced information from an informant—that proves the existence of a mutually beneficial friendship—does not satisfy the form of evidence to establish liability.[114]

The Second Circuit's established heightened standard in *Newman* draws a somewhat clearer line for the requirements of insider trading liability, and it provides a framework to determine what qualifies as a "personal benefit." In the past, the Second Circuit has faced some confusion on tippee liability, which may have contributed to the Government's successful ability to charge virtually anyone with insider trading so long as he or she traded using material, nonpublic information.[115] Yet, since the Supreme Court's decision in *Dirks v. SEC*, the Second Circuit has struggled to define what constitutes a "personal benefit." As a result of the "delphic"[116] discussion on the type of personal benefits necessary to establish tippee liability, the Government has been able to pick and choose from the dicta that provide the strongest support for its case.[117] The *Newman* decision correctly reinforces that tippee liability is established by the tippee when he or she knows the information on which he or she is trading was acquired through a breach of a fiduciary duty in exchange for a *meaningful* personal benefit. As the Second Circuit concludes, if the Court were to hold that the Government's proof of personal benefit was established through casual friendships and career advice, then practically anything would qualify as a

113. Brief of Petitioner for Rehearing and Rehearing *En Banc* at 14, *United States v. Newman*, F.3d 438 (2d Cir. 2014) (No. 13-1837) ("It is best uncertain how courts would determine the evidence necessary to satisfy such a standard.").

114. *See* Protess, *supra* note 10 (quoting Jonathan R. Streeter, a lawyer at Dechert who was one of the prosecutors under Bharara in the case of *United States v. Rajaratnam*: "It used to be all the government had to do to prove a benefit was show the people involved were friends—and now they must show a tangible benefit, and that's a big change").

115. *See Newman*, 773 F.3d at 448 (addressing what the court terms as "the doctrinal novelty of [the Government's] recent insider trading prosecutions," especially those targeting remote tippees); *see also* Elkan Abramowitz & Jonathan Sack, *Implications of Reversal of Insider Trading Convictions; White-Collar Crime*, N.Y. L.J. (Jan. 6, 2015) (suggesting that the Court believes the Government was essentially attempting to pin liability on the defendants based on "informational asymmetry").

116. *Newman*, 773 F.3d at 447.

117. *Id.*

benefit.[118]

Newman presents an even stricter return to the *Dirks* holding, with the Second Circuit concluding that, "in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."[119] The Court rejected the Government's argument that they can impose liability can be imposed upon a defendant, based solely on the knowledge of a breach of fiduciary duty. If the Government's request for an en banc rehearing is successful, then the prosecutors may argue that a broader interpretation of *Dirks* should be the standard for establishing a personal benefit. However, this argument will likely fail because it seeks to continue the Government's track record of picking and choosing case law interpretations beneficial to their position.[120] Ultimately, the Government's request for an en banc rehearing was denied by the Second Circuit,[121] and the Government filed a petition for a writ of certiorari on July 30, 2015.[122] The Supreme Court denied certiorari with no explanation on October 5, 2015.[123] As of now, the *Newman* decision firmly establishes that the Government must show that the tippee knew of the personal benefit gained by the tipper in breach of a fiduciary duty.

*C. The Future of Insider Trading Cases Post-*Newman

The Second Circuit's decision in *Newman* will undoubtedly curb the number of cases the Government plans to pursue for insider trading. On the heels of the *Newman* decision, the Defendants who were former employees of Wells Fargo, and who shared inside information of a forthcoming ratings change via e-mail, have now requested the SEC's

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118. *Id.* at 452.

119. *Id.* at 442.

120. *See id.* at 447.

121. *See Second Circuit Rebuffs DOJ and SEC in Denying Rehearing in Newman Insider Trading Case*, THE NAT'L LAW REV. (April 6, 2015), http://www.natlawreview.com/article/second-circuit-rebuffs-doj-and-sec-denying-rehearing-newman-insider-trading-case.

122. *See* Stephanie Russell-Kraft, *DOJ Appeals Insider Trading Ruling to High Court*, Law 360 (July 30, 2015, 11:33 AM), http://www.law360.com/articles/685289/doj-appeals-insider-trading-ruling-to-high-court (noting Solicitor General Verrilli's opinion that the Second Circuit's decision "threatens to destabilize the law elsewhere").

123. *See* Matthew Goldstein & Adam Liptak, *Supreme Court Denies Request to Hear Insider Trading Case*, N.Y. TIMES (Oct. 5, 2015), http://www.nytimes.com/2015/10/06/business/dealbook/supreme-court-denies-request-to-hear-insider-trading-case.html.

dismissal of administrative charges.[124] The Defendants alleged that the benefit was only "their friendship and positive feedback given to the tipper's managers."[125] The SEC contended that the Defendants gave two traders a "sneak preview into [the] upcoming ratings changes and provided them an unfair and illegal advantage on the rest of the markets."[126] Post-*Newman*, the Defendants have filed motions to dismiss, stating that the SEC's case is "fatally flawed in light of the appeal-court ruling, because the agency can't show . . . [that] the former Wells Fargo analyst, tipped for a personal benefit."[127] Ruggieri's case was ultimately dismissed, and the judge held that while the SEC established that the defendant traded on tips he received, there was no proof that the tipper in this case received anything of benefit.[128]

In another case, *United States v. Conradt*, the Government accused five friends of illegally trading based on a secondhand tip about IBM's plan to acquire SPSS, a software company, for $1.2 billion in 2009.[129] In *Conradt*, the Government argued that the defendant, Trent Martin received an

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124. *See* Jean Eaglesham, *Bros or Insider Traders? Ex-Wells Fargo Colleagues Seek to Dismiss SEC Case*, WALL ST. J. (Jan. 12, 2015, 2:03 PM), http://blogs.wsj.com/moneybeat/2015/01/12/bros-or-insider-traders-ex-wells-fargo-colleagues-seek-to-dismiss-sec-case/ (explaining that the defendant's seek dismissal of the SEC's civil case against them because it fails to meet the standards set out in *Newman* for proving illegal activity). *See generally* In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri, SEC Release No. 34-75066, 2015 WL 3413279 (May 28, 2015), https://www.sec.gov/litigation/admin/2015/33-9795.pdf.

125. *See* Henning, *supra* note 5; *see also* Press Release, Two Former Wells Fargo Employees Charged with Insider Trade in Advance of Research Reports Containing Rating Changes (Sept. 29, 2014) (on file with author), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543065774#.VMKTTUfF—M [hereinafter "SEC Press Release on Wells Fargo Employees"] (stating that Bolan Jr.'s tips to Ruggieri, in advance of several market-moving ratings, allowed Ruggieri to generate over $117,000 in profits).

126. *See* SEC Press Release on Wells Fargo Employees, *supra* note 125.

127. *See* Eaglesham, *supra* note 124.

128. *See* Nate Raymond, *Update 2 Ex- Wells Fargo Trader Beats SEC Insider Trading Charges*, REUTERS (Sept. 14, 2015, 5:05 PM), http://www.reuters.com/article/2015/09/14/usa-insidertrading-wellsfargo-idUSL1N11K1MU20150914#VItRJ1dTxul5f02K.97.

129. United States v. Conradt, No. 12 Cr. 887 (S.D.N.Y. Jan. 22, 2015); *see also* Walter Pavlo, *IBM Insider Trading Guilty Pleas Tossed Amid Conflicting Gov't Positions*, FORBES (Jan. 23, 2015, 12:50 PM), http://www.forbes.com/sites/walterpavlo/2015/01/23/ibm-insider-trading-guilty-pleas-tossed-amid-conflicting-govt-positions/print/; Nate Raymond, *U.S. Judge Throws Out Insider Trading Guilty Pleas Over IBM Deal*, REUTERS (Jan. 22, 2015, 6:18 PM), http://www.reuters.com/article/2015/01/22/us-usa-insidertrading-ibm-idUSKBN0KV2KX20150122 (stating that an employee of IBM's law firm told the Defendant, Trent Martin about the company's plan to acquire SPSS Inc. for $1.2 billion).

"indirect gift of confidential information."[130] On January 29, 2015, U.S. District Judge Andrew Carter granted U.S. prosecutors' request to drop insider trading charges against the five defendants but allowed the government to reassert its charges if it successfully challenged *Newman*.[131] During a hearing, the prosecutors stated that "they couldn't prove their case under a new framework that was set by a pivotal appeals court ruling in December," referring to *Newman*.[132] They further stated that the *Newman* decision would "dramatically limit the [G]overnment's ability to prosecute some of the most common culpable and market threatening forms of insider trading."[133] The IBM case is the first case prosecutors dropped following the *Newman* decision, and it could potentially provide a road map for others challenging the Government in future cases concerning insider trading.[134]

As demonstrated above, *Newman*'s requirement of a "meaningful benefit" has already forced both courts and the prosecutors to reconsider cases where there is not enough evidence to prove beyond a reasonable doubt that the defendants are liable for insider trading. The *Newman* decision puts an end to the Government's recent crusade against insider trading,[135] where the Government has frequently stretched precedent and presented scant evidence that, taken together, formed legally conclusory cases.[136] In the case of remote tippees, the Second Circuit has correctly required the Government to prove its case with solid evidence demonstrating that the defendants knew of a breach of fiduciary duty in exchange for a personal benefit amounting to more than just a casual

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130. *See* Pavlo, *supra* note 129.

131. *See* Ed Beeson, *Judge to Dismiss IBM Insider Trading Case at Fed's Request*, LAW360 (Jan. 29, 2015, 11:27 AM), http://www.law360.com/articles/616277/judge-to-dismiss-ibm-insider-trading-case-at-feds-request.

132. Christoper M. Matthews, *Insider-Trading Charges to Be Dropped*, WALL ST. J. (Jan. 29, 2015, 7:31 PM), http://www.wsj.com/articles/justice-department-drops-insider-trading-charges-1422571552.

133. *Id.*

134. *Id.*; *see also* Gregory T. Bolan, Jr., SEC Release No. 877, 2015 WL 5316569 (Sept. 14, 2015).

135. *See An Outside the Law Prosecutor*, *supra* note 11 (opining that the *Newman* reversal finally put a judicial cap to Bharara's quest to expand the definition of "insider trading" to capture nearly every information asymmetry and virtual presumption of guilt).

136. Chung, *supra* note 7 (stating that, until the *Newman* decision, "the Government had chipped away at the *Dirks* benefit test, including by deeming the test satisfied where the tip was in exchange for "maintaining a useful networking contact" (citing United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012)) or merely "making a gift of information to a friend" (citing SEC v. Obus, 693 F.3d 276, 291 (2d Cir. 2012)).

friendship.

The Second Circuit's decision in *Newman* directly impacted another major case, *United States v. Steinberg*.[137] Michael Steinberg, the former portfolio manager of S.A.C. Capital Advisors, L.P. ("SAC Capital"), was convicted in 2013 after a jury found him guilty of generating $1.9 million in illegal profits for SAC Capital.[138] The Southern District of New York sentenced him to three-and-a-half years in prison for conspiracy to commit securities fraud and four counts of securities fraud.[139] In light of the new *Newman* standard for charging remote tippees with insider trading, Steinberg's conviction will likely be overturned by the Government because he traded part of the same information that did not constitute an illegal tip for the Defendants in *Newman*.[140] Others who plead guilty and testified as cooperating witnesses in the trials of the Defendants and Steinberg may also seek to withdraw their guilty pleas.[141]

Contrary to the Government's belief, the *Newman* decision does not shield hedge fund managers from liability when trading on confidential information they receive, by claiming they did not know the identity of the original source.[142] The Government can bring a successful claim of remote insider trading liability by proving that a person knowingly ignored red flags about the questionable nature of the information and did not avoid learning too much: also known as "the ostrich instruction."[143] The *Newman*

137. United States v. Steinberg, 21 F. Supp. 3d 309 (S.D.N.Y. 2014); *see also* Press Release, U.S. Dep't of Justice, SAC Capital Portfolio Manager Michael Steinberg Found Guilty In Manhattan Federal Court Of Insider Trading Charges (Dec. 18, 2013) (on file with author), http://www.justice.gov/usao-sdny/pr/sac-capital-portfolio-manager-michael-steinberg-found-guilty-manhattan-federal-court [hereinafter DOJ Press Release on SAC Capital].

138. *See* DOJ Press Release on SAC Capital, *supra* note 137.

139. *Id.*; *see also* Matthew Goldstein, *Ex-Trader at SAC Fund is Sentenced to 3 Years*, N.Y. TIMES (May 16, 2014, 12:55 PM), http://dealbook.nytimes.com/2014/05/16/ex-sac-capital-trader-steinberg-sentenced-to-3-12-years/?_r=0 (quoting Judge Sullivan stating that Steinberg's prison sentence and $2 million fine, "was necessary to send a message to others on Wall Street that insider trading is not a trivial crime").

140. *See* Goldstein, *supra* note 139.

141. Henning, *supra* note 5.

142. *See* Peter J. Henning, *What an Appeals Court Insider Trading Decision Does and Doesn't Do*, N.Y. TIMES (Dec. 10, 2014, 7:07 PM), http://dealbook.nytimes.com/2014/12/10/what-an-appeals-court-insider-trading-decision-does-and-doesnt-do/ (stating that the government can prove a case of remote tippee liability through a person's "willful blindness").

143. *See* United States v. Goffer, 721 F.3d 113, 124–27 (2d Cir. 2013) (concluding that evidence relating to knowledge and conscious avoidance in tipping chain cases was sufficient to establish tippee scienter); *see also id.* (explaining that the "ostrich instruction" allows a jury to find defendants "can violate the law by putting their heads in the sand when it came to knowing how the information was obtained").

ruling puts pressure on the DOJ and the SEC to show that there was something more tangible passed to the tipper by the tippee than just the "warm feeling" of helping out a friend.[144] However, cases in which a tippee directly gave something of value to a tipper will be largely unaffected.[145]

Ultimately, the *Newman* prosecution presents a "problematic theme in the recent government policy of pursuing the end users of inside information rather than the source."[146] As the *Newman* Court noted, the Government has not yet charged the corporate insiders that leaked the material, nonpublic information with insider trading.[147]

IV. TIME TO MAKE SOME LAWS, CONGRESS

The absence of laws, directly criminalizing insider trading, leaves loopholes in securities law to the advantage of defendants when they are appealing convictions of insider trading. Although the SEC designed Section 10(b) of the Securities Exchange Act as a catch-all clause to prevent fraud, it does not prohibit insider trading. Instead, the Government has used Section 10(b) to prosecute cases by rationalizing that insider trading is a type of securities fraud proscribed by Section 10(b) and SEC Rule 10b-5. The lack of laws specifically tailored to insider trading has essentially allowed judges to wield insider trading precedents the way they see fit.

In these cases, it is important to keep in mind the big picture; investors are being prosecuted by the government for conduct that Congress is either unwilling or unable to define. And, if this is not troublesome enough, the

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144. *See* Matt Levine, *Appeals Court Not So Keen On Insider Trading Crackdown*, Bloomberg View (Dec. 10, 2014, 1:36 PM), http://www.bloombergview.com/articles/2014-12-10/appeals-court-not-so-keen-on-insider-trading-crackdown.

145. *See generally* United States v. Rajaratnam, 719 F.3d 139, 160 (2d Cir. 2013) (holding the defendant guilty of insider trading where the government had sufficient information to prove the defendant received tips personally from insiders and provided money and other benefits to them).

146. Jill E. Fisch, *Newman Reins in Criminal Prosecution of Remote Tippees for Insider Trading*, THE CLS BLUE SKY BLOG (Jan. 28, 2015), http://clsbluesky.law.columbia.edu/2015/01/28/newman-reins-in-criminal-prosecution-of-remote-tippees-for-insider-trading/; *see also* R. Todd Cronan, *Second Circuit Raises the Bar for Government Insider Trading Prosecutions- Practical Implications for the Business Community*, GOODWIN PROCTOR LLP (Dec. 15, 2014), http://www.goodwinprocter.com/Publications/Newsletters/Client-Alert/2014/1215_Second-Circuit-Raises-the-Bar-for-Government-Insider-Trading-Prosecutions.aspx?article=1 (stating that "[o]ver the last few years, the Government has chosen to prosecute high-profile remote tippees without ever criminally pursuing the original source").

147. Cronan, *supra* note 146.

DOJ and the SEC continue to prosecute insider trading cases while simultaneously aiming to expand the boundaries of insider trading on theories that lack precedent.[148] Prosecutors have lost sight of their initial goal—improving the fairness of the markets for investors—and instead, they have crusaded against big corporations and hedge fund managers in a half-hearted effort to mitigate insider trading.[149]

The implications of these frivolous crusades are that investors begin to pull back from market participation for fear of becoming the next victim of overzealous prosecutors. This outcome is why it is crucial for Congress to clearly define what constitutes insider trading activity. Congress has had the opportunity to address insider trading on numerous occasions in the past, but it has repeatedly declined to do so.[150] While the SEC can refine its rules, it would be far more effective for Congress to take the lead and make laws defining and criminalizing insider trading.[151] As Supreme Court Justice Antonin Scalia wrote last year in the denial to grant writ of certiorari for *Whitman v. United States*, "Congress cannot, through ambiguity, effectively leave that function [of defining crimes and fixing punishments] to the courts—much less to an administrative bureaucracy."[152]

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148. United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) ("[T]he Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions [. . . .]").

149. *See* Cronan, *supra* note 146 (citing the *Newman* decision as "some good news for the financial industry, especially hedge funds, arbitrage funds, and other financial entities, that may come into possession of information about public companies where it is difficult to determine if the information is non-public and where the ultimate source is unknown and may be several steps removed from the trader himself").

150. *See* Harvey L. Pitt et al., *Problems of Enforcement in the Multinational Securities Market*, 9 U. PA. J. INT'L L. 375, 382 n.11 (1987) (suggesting Congress specifically declined to define insider trading, while passing the Insider Trading Sanctions Acts of 1984, to avoid a debate over the definition that could have stalled passage of the entire legislative package); *see also* H.R. REP. NO. 100-910, at 11 (1988) (demonstrating Congress' refusal to adopt a definition of insider trading when it enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 because "the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases [. . . .] Accordingly, the Committee [did] not intend to alter the substantive law with respect to insider trading with this legislation.").

151. *See Insider Trading: There Oughta Be a Law*, BLOOMBERG VIEW (Jan. 5, 2015, 8:00 AM), http://www.bloombergview.com/articles/2015-01-05/insider-trading-should-be-against-the-law.

152. *See* James B. Stewart, *Delving Into Morass of Insider Trading*, N.Y. TIMES (Dec. 19, 2014), http://www.nytimes.com/2014/12/20/business/the-insider-trading-morass.html. *See generally* United States v. Whitman, 904 F. Supp. 2d 363 (S.D.N.Y. 2012), *cert. denied*, 135 S. Ct. 352, 354 (2014).

Congress has taken limited steps so far to address insider trading in light of the *Newman* decision. On February 27, 2015, Representative Stephen F. Lynch of Massachusetts introduced the "Ban Insider Trading Act,"[153] and Senators Jack Reed of Rhode Island and Robert Menendez of New Jersey introduced the "Stop Illegal Insider Trading Act" on March 11, 2015.[154] Although these pieces of legislation are a step in the right direction, these acts could do more harm than good. The Senate bill makes it unclear what type of information is prohibited but allows trading on information received from "publicly available sources."[155] The House bill defines "material information as that which would be likely to have a significant effect on the price of a security" without specifying how a "significant" effect is determined.[156] According to the proposed legislation, the Judiciary Branch will still be primarily responsible for defining the scope of prohibition.[157] The issue with urging Congress to make laws specifically prohibiting insider trading is the low chance of success in passing the law and determining if a zero-tolerance policy will make it more difficult to decipher the line between permissible and illegal trades.[158]

CONCLUSION

The Second Circuit's decision in *Newman* is undoubtedly a landmark decision for insider trading cases, especially if courts decide future cases in accordance with *Newman*. In some respects, the Second Circuit merely restates what the Supreme Court held over thirty years ago in *Dirks* on the elements of tippee liability. However, *Newman* presents the added requirement of determining what conduct establishes the critical element of personal benefit thus breaking from past decisions of the Second Circuit.[159] By narrowing the elements prosecutors use to define personal benefit, the Court effectively guarantees that the Government will bring cases for remote tippee liability only after ensuring that sufficient evidence is present to prove the remote tippee's liability.[160] Furthermore, it is important for the

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153. Peter J. Henning, *Court Strikes on Insider Trading, and Congress Lobs Back*, N.Y. TIMES (Mar. 16, 2015), http://www.nytimes.com/2015/03/17/business/dealbook/court-strikes-on-insider-trading-and-congress-lobs-back.html?_r=0.

154. *Id.* (explaining that both the Senate bill and House bill would make it illegal to trade on securities based on information that an individual knows or should have known was nonpublic).

155. *Id.*

156. *Id.*

157. *Id.*

158. *See id.*

159. *See supra* Part IIIA (analyzing the heightened standard and its implications).

160. *See supra* Part IIIB (discussing the elements of personal benefits under

Government to keep in mind that it can still pursue cases based on personal relationships like friendship so long as there is some evidence of the benefit received by the tipper was considered valuable.[161]

Although it is understandable why the SEC and the DOJ objected to the heightened standards *Newman* imposes, the decision does not present an insurmountable hurdle. Instead, the Government simply needs to ensure that it has something more tangible than just friendship to sustain a conviction for remote tippee liability.[162]

Newman).

161. *Id.*

162. *Id.*

COMBATING IMPUNITY: CONTRACTOR LIABILITY FOR TORTURE DURING TIMES OF WAR UNDER THE WARTIME SUSPENSION OF LIMITATIONS ACT

CLAIRE JABBOUR*

This Comment focuses its analysis on the Wartime Suspension of Limitations Act and how it applies to military contractors who commit crimes during times of war. This Comment argues that the Wartime Suspension of Limitations Act, as modified in 2008, applies to the offense of torture if committed during the Iraq and/or Afghanistan conflicts. Applying the 2008 modification of the Wartime Suspension of Limitations Act does not violate the rule against ex post facto *applications of law because the statute of limitations on torture would not have expired by 2008; therefore, there is no retroactive application.*

This Comment looks at the current lay of the land surrounding military contractor liability. Ultimately, this Comment concludes that military contractors enjoy near-impunity, both criminally and civilly, under the current law. In the few circuits where military contractors have been held civilly liable, there continues to be uncertainty about the future stability of the decision.

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INTRODUCTION

The definition of war has changed since World War II—the last officially declared war—ended in the 1940s. During World War II, Congress enacted the Wartime Suspension of Limitations Act ("the WSLA" or "the Act") to give the government time to bring charges against contractors who defrauded the government.[1] In 2008, Congress redefined war under the WSLA to include a modern interpretation; war is not limited to official declarations, but it also includes congressional or presidential authorizations of military force.[2] Numerous wars have occurred between the end of WWII and 2008, all without formal declarations of war by Congress.[3]

Despite the changing nature of war, in 2015, the Supreme Court heard its first case regarding the WSLA since the 1950s. In the 1950s, *Bridges v.*

1. *See* S. REP. NO. 110-431, pt. 1, at 1-2 (2008) ("This legislation will protect American taxpayers from criminal contractor fraud by giving investigators and auditors the time they need to thoroughly review contracts related to the ongoing conflicts in Iraq and Afghanistan.").

2. *See* 18 U.S.C. § 3287 (2008) ("When the United States is at war or Congress has enacted a specific authorization for the use of the Armed Forces, as described in section 5(b) of the War Powers Resolution (50 U.S.C. [§] 1544(b)).").

3. *See* Pub. L. No. 107-40, 115 Stat. 224 (2001) (authorizing the use of military force in Iraq and Afghanistan); *Official Declarations of War by Congress*, UNITED STATES SENATE, https://www.senate.gov/pagelayout/history/h_multi_sections_and_teasers/WarDeclarationsbyCongress.htm (last visited Jan. 24, 2015).

United States and *United States v. Grainger* both held that fraud was an essential element for the WSLA to apply.[4]

Additionally, military contractors have not consistently been held criminally liable for crimes committed while performing a government contract abroad during the conflicts in Iraq and Afghanistan.[5] However, military contractors feel that they are being held accountable because civil cases have been filed, and courts are unwilling to dismiss most of these cases outright.[6] Currently, military contractors, who are facing criticism, have created a practice of changing the name of their company to acquire new government contracts and circumventing liability.[7]

This Comment will raise a number of arguments: 1) that a plain meaning reading of the WSLA expands the Act's reach beyond defrauding the government to include other crimes that are also in the government's interest; 2) that military contractor liability currently is uncertain for crimes like torture; and 3) that courts should apply the *Carter*[8] decision and the plain language reading of the WSLA to *Al Shimari*[9] to establish a precedent

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4. Bridges v. United States, 346 U.S. 209, 232-33 (1953); United States v. Grainger, 346 U.S. 235, 241-42 (1953).

5. *See* The Editorial Board, *Will Anyone Pay for Abu Ghraib?*, N.Y. TIMES (Feb. 5, 2015), http://www.nytimes.com/2015/02/05/opinion/will-anyone-pay-for-abu-ghraib.html?_r=1 (stating that only low level officers have been held accountable for torture in Abu Ghraib, but contractors that gave orders for torture have not been held criminally or civilly liable); *see also* FAR 9.103 (2015) (dictating the policy behind awarding government contracts to outside contractors); FAR 9.104-1 (2015) (noting the factors to consider to determine if a potential contractor is responsible for the purpose of the meeting the reliability requirement); FAR 9.406-2 (2015) (highlighting that a contractor may be ineligible to receive a government contract if the contractor has committed an offense that questions professional responsibility and integrity).

6. *See* Stephen Vladeck, *Military Contractor Liability Returns to the Supreme Court*, LAWFARE BLOG (June 11, 2014, 7:00 AM), http://www.lawfareblog.com/2014/06/military-contractor-liability-returns-to-the-supreme-court/ (arguing that military contractors are attempting to ask the Supreme Court for a precedent rule that provides them with immunity and bars civil liability claims).

7. *See* Nathan Hodge, *Company Once Known as Blackwater Ditches Xe for Yet Another New Name*, WALL ST. J. (Dec. 12, 2011), http://www.wsj.com/articles/SB10001424052970204319004577089021757803802 (rebranding Xe Services to Academi and changing the leadership of the original Blackwater); Mark Landler & Mark Mazzetti, *U.S. Still Using Security Firm it Broke With*, N.Y. TIMES (Aug. 21, 2009), http://www.nytimes.com/2009/08/22/us/22intel.html?_r=0 (highlighting that Blackwater changed its name in 2009 to Xe to continue performance on a government contract).

8. Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497, 1 (U.S. May 26, 2015) (holding that the WSLA can be applied criminally and not civilly).

9. Al Shimari v. CACI Primier Tech., Inc., No. 1:08-cv-00827-GBL-JFA, 2015 U.S. Dist. LEXIS 107511 (E.D. Va. 2015) (Abu Ghraib prison torture case).

for consistent application of military contractor liability.[10] Finally, this Comment will briefly highlight military contractor liability under other statutes.[11]

I. WARTIME CRIMINALS: THE UNITED STATES GOVERNMENT ATTEMPTS TO OVERCOME IMPUNITY

Since WSLA's enactment, it has been modified and extended several times.[12] The lower courts have analyzed the WSLA a limited number of times,[13] and the Supreme Court has analyzed the WSLA a handful of times.[14]

A. When a Bill Becomes a Law: The Passing of the WSLA

In 1942, Congress passed an act suspending the statute of limitations for crimes involving defrauding the government to last until July 1945.[15] In 1944, Congress amended the Act to extend the minimum amount of time before a statute of limitations can begin to run during times of war to a time following the termination of war.[16] This gave the government more time to

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10. *See id.* at *1–3 (E.D. Va. 2015) (determining courts do not have jurisdiction to question military decisions); Al Shimari v. CACI Premier Tech., Inc., 758 F.3d 516, 530–31 (4th Cir. 2014) (favoring military contractor liability over impunity).

11. *See* discussion *infra* Part III.B (showing that there is uncertainty for military contractor liability following the Court's holding in *Kiobel*).

12. *See* 18 U.S.C. § 3287 (2008) (changing the term "times of war" to include Congressionally authorized use of force); Act of June 28, 1948, Pub. L. No. 82-645 ch. 213, sec. 3287, 62 Stat. 683, 828 (1948) (amending the WSLA to apply during all times of war, not just World War II); Surplus Property Act of 1944, Pub. L. No. 78–457, ch. 479, sec. 28, 58 Stat. 767, 781 (1944) (including crimes committed under the Surplus Property Act of 1944); Contract Settlement Act of 1944, Pub. L. No. 78-395, ch. 358, sec. 19(b), 58 Stat. 649, 667 (1944) (extending the suspension of statutes of limitations under WSLA until the termination of World War II); Act of Aug. 24, 1942, Pub. L. No. 77-706, ch. 555, 56 Stat. 747, 747–48 (1942) (passing the WSLA, which allowed for the suspension of the tolling of statutes of limitations until 1945).

13. *See generally* United States v. Prosperi, 573 F. Supp. 2d 436 (D. Mass. 2008) (including conflicts in Afghanistan and Iraq as wars under the WSLA); United States v. Shelton, 816 F. Supp. 1132 (W.D. Tex. 1993) (arguing that the Persian Gulf Conflict did not constitute war for purposes of the WSLA because Congress intended the statute to apply only in times of war that completely consumed and preoccupied the federal government resulting in inability to efficiently prosecute violators of statutes).

14. *See generally* United States v. Smith, 342 U.S. 225 (1952) (limiting the WSLA to crimes committed during times of war, not before or after); Bridges v. United States, 346 U.S. 209 (1953) (limiting the definition of fraud to pecuniary fraud); United States v. Grainger, 346 U.S. 235 (1953) (creating a two-prong test for the WSLA to apply, which stated there must be a violation of a statute that is pecuniary and that violation must have occurred before end of hostilities).

15. 56 Stat. at 747–48.

16. *See* 58 Stat. at 667 (noting that statutes of limitations are "suspended until three years after the termination of hostilities in the present war as proclaimed by the

adjudicate crimes committed during war on the basis that the government had been preoccupied by war when the crimes were committed.[17] Congress amended the Act again to include offenses related to the Surplus Property Act of 1944 ("Surplus Property Act").[18]

In 1948, Congress amended the WSLA for the first time. The WSLA replaced the option of crimes committed in connection with the Surplus Property Act[19] with a broader interpretation that considered crimes "committed in connection with the acquisition, care, handling, custody, control or disposition of any real or personal property of the United States . . . ."[20] This broadening allowed other property crimes committed against the United States to be prosecuted criminally rather than limiting liability only to violations of the Surplus Property Act.[21]

From 1948 to 2008, Congress did not touch the WSLA, and it did not use the Act because Congress had not declared war since World War II.[22] However, Congress modified the WSLA in 2008: during the conflicts in Afghanistan and Iraq.[23] Both the United States Supreme Court and the lower courts have attempted to analyze the WSLA in its various forms with varying results.

President or by . . . the two Houses of Congress").

17. *Smith*, 342 U.S. at 228–29; *Prosperi*, 573 F. Supp. 2d at 448–49.

18. Surplus Property Act of 1944, Pub. L. No. 78-457, ch. 479, sec. 28, 58 Stat. 649, 781 (1944) (amending the WSLA to reflect laws enacted in response to congressional concerns of crimes committed during acts of war such as contractors keeping property bought by the government for use during war but left over after the end of war).

19. Act of June 28, 1948, Pub. L. No. 82-645 ch. 213, sec. 3287, 62 Stat. 683, 828 (1948); *see* Surplus Property Act of 1944, Pub. L. No. 78-457, ch. 479, sec. 28, 58 Stat. 767, 781 (1944) (specifying only crimes committed in violation of the Surplus Property Act of 1944).

20. 62 Stat. at 828.

21. *Id.*; *see* 58 Stat. at 781 (applying a prong of the WSLA only to violations of the Surplus Property Act of 1944).

22. *See* 18 U.S.C. § 3287 (2008) (amending the WSLA for the first time since 1948); 62 Stat. at 828 (amending the WSLA for the last time before 2008); United States v. Smith, 342 U.S. 225, 225–26 (1952) (applying the WSLA to a crime committed after the end of World War II); United States v. Shelton, 816 F. Supp. 1132, 1135 (W.D. Tex. 1993) (addressing congressional intent behind the WSLA for the first time since the 1950s by noting that Congress intended the WSLA to only apply to pervasive wars); *see also* UNITED STATES SENATE, *Official Declarations of War by Congress*, *supra* note 3.

23. *See* 18 U.S.C. § 3287 (modifying the WSLA to apply to congressionally authorized wars).

B. The Courts Intervene: The State of Affairs During the 1940s and 1950s

The Supreme Court has heard few WSLA cases. The first case, in 1952, was *United States v. Smith*, where the appellee committed forgery and check fraud two years after the end of World War II.[24] The Court held that the WSLA only applied to crimes committed during times of war and not crimes that occurred before or after the declared war.[25] The Court determined that the purpose of the WSLA is to allow the government sufficient times to prosecute when busy with war. Therefore, because the actions of the defendant had occurred after the war, the WSLA did not apply.[26]

In 1953, the Court heard two WSLA cases on the same day: *Bridges v. United States* and *United States v. Grainger.* In *Bridges*, the petitioners lied under oath at a naturalization hearing about whether the applicant was a communist.[27] The events in *Bridges* took place after the second amendment to the WSLA in 1944.[28] The Court held that the WSLA only applied to crimes of pecuniary fraud and noted that lying under oath, while considered to be defrauding the government, was not pecuniary.[29] The Court reasoned that the WSLA should be interpreted conservatively because it carves out an exception to bringing cases swiftly and efficiently.[30]

In *Grainger*, the defendants were indicted for providing false claims that items had been purchased to the Community Credit Corporation in an attempt to obtain funds.[31] The Court held the WSLA applies where the crime committed was 1) pecuniary; and 2) was committed before the official termination of war.[32] Accordingly, fraud and conspiracy to commit fraud were enough to trigger the WSLA on this occasion.[33] Additionally,

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24. *Smith*, 342 U.S. at 225–26.

25. *Id.* at 228.

26. *Id.*

27. Bridges v. United States, 346 U.S. 209, 211–12 (1953).

28. Surplus Property Act of 1944, Pub. L. No. 78-457, ch. 479, sec. 28, 58 Stat. 767, 781 (1944); *id.* at 211.

29. *Bridges*, 346 U.S. at 215 (limiting the WSLA to "offenses involving the defrauding of the United States . . . where the fraud is of a pecuniary nature or at least . . . concerning property").

30. *Id.* at 215–16.

31. United States v. Grainger, 346 U.S. 235, 240 (1953).

32. *Id.* at 243–44; *see also Bridges*, 346 U.S. at 215 (holding that the WSLA only applies to crimes of fraud that are pecuniary in nature).

33. *Grainger*, 346 U.S. at 244 (arguing that "the combination of either falsity, fiction, or fraud with the claim . . . applies to a conspiracy to commit fraud").

the statute of limitations would not begin running until three years after the war ended because the President officially declared that the war ended after the crimes occurred; therefore, the defendants could have been indicted for fraud.[34]

Since 1956, the Supreme Court has not heard a case analyzing the WSLA. Interpretation has been left up to the judges of the lower courts, who have taken up the challenge.

C. Sibling Rivalry 101: The Lower Courts Split on the Wartime Suspension of Limitations Act

The lower courts have taken opposing sides when analyzing the WSLA. In *United States v. Shelton*, the District Court for the Western District of Texas held that the Persian Gulf War did not constitute a war because Congress did not officially declare war.[35] The court focused on the fact that Congress intended the WSLA to apply to all-encompassing conflicts that completely preoccupy the government, such as World War II.[36] The court further noted that the WSLA was not used by the government during the Vietnam War, which was overbearing enough to trigger the WSLA, and it found the Persian Gulf War to be similar to the Vietnam War.[37]

Conversely, in *United States v. Prosperi*, the United States District Court for the District of Massachusetts held that the conflicts in Iraq and Afghanistan each constituted wars under the WSLA.[38] The court argued that, under the plain meaning of the WSLA, the term "at war" is broader than declared wars because Congress did not specify "at war" only applied to congressionally declared wars.[39] The court created a factors test to determine if a conflict constitutes time of war:

> (1) the extent of the authorization given by Congress to the President to act; (2) whether the conflict is deemed a "war" under accepted definitions of the term and the rules of international law; (3) the size and scope of the conflict (including the cost of the related procurement effort); and (4) the diversion of resources that might have been expanded on investigation frauds against the government.[40]

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34. *Id.* at 245–47.

35. United States v. Shelton, 816 F. Supp. 1132, 1135 (W.D. Tex. 1993). *Contra* Koohi v. United States, 976 F.2d 1328, 1328 (9th Cir. 1992) (holding the phrase "time of war" in the Federal Tort Claims Act (FTCA) did not require a war to be officially declared by Congress and that the Persian Gulf War constituted a war for the purpose of the FTCA).

36. *Shelton*, 816 F. Supp. at 1135.

37. *See id.*

38. United States v. Prosperi, 573 F. Supp. 2d 436, 454–55 (D. Mass. 2008).

39. *Id.* at 444, 446.

40. *Id.* at 449.

The court noted that the reasoning behind the WSLA's enactment was that the government is too preoccupied during times of war to be able to prosecute fraud cases.[41]

The United States District Court for the Southern District of California reviewed the *Prosperi* decision and came to the opposite conclusion. In *United States v. Western Titanium, Inc.*, the court, much like the *Shelton* court, held the term "at war" was limited to congressionally declared wars.[42] According to the court, the initial *Prosperi* decision created too much uncertainty regarding what constitutes war.[43] The court drew support from the fact that statutes of limitations are typically narrowly construed in consideration of fairness; therefore, "times of war" should be narrowly construed.[44]

Following the enactment of the 2008 amendment, Congress required the courts to consider whether the legislative addition of authorized uses of force applied to the conflicts in Afghanistan and Iraq. In *United States v. BNP Paribas*, the court held that the WSLA does apply to the conflicts and determined that the United States was indeed at war in 2005.[45] The court reasoned that *United States v. Pfluger* stated that the wars in Afghanistan and Iraq did not, in fact, end in 2005; therefore, the statute of limitations could not have begun to toll.[46] The 2008 amendment, therefore, did apply to the conflicts in Afghanistan and Iraq because the statute of limitations on the False Claims Act claim had not run between the criminal offense in 2005 and the 2008 amendment.[47]

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41. *Id.*

42. United States v. W. Titanium, Inc., No. 08-CR-4229-JLS, 2010 U.S. Dist. LEXIS 65786, *10 (S.D. Cal. July 1, 2010).

43. *See id.* at *17 (stating that the uncertainty which results from the *Prosperi* approach is completely at odds with the objectives of finality, notice, and prompt investigation sought to be served by a criminal statute of limitations).

44. *Id.* at *9–10.

45. United States v. BNP Paribas SA, 884 F. Supp. 2d 589, 603, 606 (S.D. Tex. 2012).

46. *Compare BNP Paribas*, 884 F. Supp. 2d at 607 (arguing that neither the toppling of the Afghan government in 2001 nor President Bush's declaration that the fighting in Iraq ended in 2003 satisfied the requirements of the WSLA), *with* United States v. Pfluger, 685 F.3d 481 (5th Cir. 2012) (holding that the plain meaning of the Act requires specific provisions to be met when terminating hostilities).

47. *BNP Paribas*, 884 F. Supp. 2d at 607–08; *see also* United States v. Latimer, No. CR-11-384-R, 2012 U.S. Dist. LEXIS 41854, at *7 (W.D. Okla. Mar. 27, 2012) (agreeing with the court in *BNP Paribas* that statutes of limitations for crimes committed in 2006 could be tolled under the WSLA because the statute of limitations had not expired. Therefore, no *ex post facto* issue exists.).

D. *The Return of the Supreme Court in* United States v. Carter

In the years following the 2008 amendment, the Supreme Court heard a case relating to military contractors in Iraq.[48] In 2005, a military contractor, Kellogg Brown, & Root Services ("KBR"), had a contract to provide services for United States. troops in Iraq.[49] As part of its contract, KBR purified water for the troops, which Carter (the relator–a person related to a case party) tested.[50] KBR told Carter to submit fraudulent and inaccurate timesheets so that KBR could overbill the government.[51] Carter later brought a claim against KBR under the False Claims Act, alleging that KBR defrauded the government.[52]

The Fourth Circuit held that the WSLA does not require a congressional declaration of war, and the war in Iraq constituted war under the WSLA.[53] The court noted that Congress decides when a war begins,[54] and because Congress did not include the term "declared" in the text of the statute, there was no formal declaration requirement.[55] The Fourth Circuit held that neither the President nor Congress had declared an end to hostilities when the crimes in Carter occurred; therefore, either version of the statute is applicable.[56] Further, the Fourth Circuit reasoned that a person related to the plaintiff or defendant ("a relator") could bring a claim under the WSLA because it allows fraud against the United States to be prosecuted.[57] Following further appeals, the Supreme Court ultimately held that the WSLA only applies to criminal offenses.[58] However, the Court did not rule on defining "at war" nor did the Court rule whether the 2008 amendment extended to the entire Iraq and Afghanistan conflicts.[59]

When brought before the Supreme Court, the New England Legal Foundation submitted an amicus brief that reasoned that the WSLA

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48. *See* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497, slip op. at 1 (U.S. May 26, 2015) (noting the case was argued on January 13, 2015).

49. United States *ex rel.* Carter v. Haliburton Co., 710 F. 3d 171, 174 (4th Cir. 2013).

50. *Id.* at 174–75.

51. *Id.* at 175.

52. *Id.*

53. *Id.* at 178.

54. *Id.* at 176 (quoting Lee v. Madigan, 358 U.S. 228, 231 (1959)).

55. *Id.* at 177.

56. *Id.* at 179.

57. *Id.* at 180.

58. Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497, at 1 (U.S. May 26, 2015).

59. *Id.* at 3.

continued to apply to fraud offenses, both pre- and post-2008 amendment; therefore, there should be no argument on whether the types of offenses covered have changed.[60] However, the Supreme Court ultimately held that the WSLA only applies to criminal cases, thereby excluding the need to decide on the application of the WSLA to crimes committed during the Afghanistan and Iraq conflicts before the 2008 amendment.[61] The implications of limiting the WSLA to criminal cases could include liability for military contractors or monetary savings for military contractors if cases like these are automatically dismissed. The Court did not rule on defining "at war," nor did the Court rule whether the 2008 amendment extended to the entire Iraq and Afghanistan conflicts.[62]

II. ARE MILITARY CONTRACTORS LIABLE? DEFINING WARTIME CRIMES BEYOND FRAUD IN IRAQ AND AFGHANISTAN

Military contractor liability for crimes committed during times of war is still uncertain, thereby providing impunity for contractors.[63] To combat the issue of impunity, the WSLA should be interpreted using the ordinary canons of statutory construction.[64]

A. To Fraudulence and Beyond: Based on the Plain Meaning Cannon of Construction, What Does the WSLA Really Cover?

Congress originally limited the WSLA to crimes of fraud; however, Congress extended the WSLA's reach to encompass property, fraud, or crimes committed in the performance of contracts.[65] The "or" separating the three subsections connotes that only one of the claims is required for the WSLA to apply, leaving no requirement for fraud as an essential element.[66]

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60. Brief for New England Legal Foundation as Amicus Curiae Supporting Petitioners, United States *ex rel.* Carter v. Halliburton Co., 710 F.3d 171 (4th Cir. 2013), *rev'd sub nom.* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497 (U.S. May 26, 2015).

61. Kellogg Brown & Root Servs., Inc., No. 12-1497, slip op. at 10–11 (U.S. May 26, 2015).

62. *See generally* Kellogg Brown & Root Servs., Inc., No. 12-1497 (U.S. May 26, 2015).

63. *See* The Editorial Board, *supra* note 5 (stating military contractors are not held liable for torture under current laws).

64. *Cf.* INS v. Cardoza-Fonseca, 480 U.S. 421 (1987) (Scalia, J., concurring) (stating that legislative intent and other canons of interpretation are unnecessary when the statute is clear).

65. *See generally* 18 U.S.C. § 3287 (2008); Act of June 28, 1948, Pub. L. No. 82-645 ch. 213, sec. 3287, 62 Stat. 683, 828 (1948); Surplus Property Act of 1944, Pub. L. No. 78-457, ch. 479, sec. 28, 58 Stat. 767, 781 (1944).

66. *See id.* (listing crimes committed in connection with performance of the

There have been a few cases that have analyzed the WSLA, and of those few, none discussed the third subsection: offenses that deal with the contract. In fact, all of the cases that discuss the WSLA applied the Act only to cases of fraud.[67] When analyzing a statute, if the plain meaning of a statute is unambiguous, then the court needs not continue analyzing the statute.[68] The terms of the statute are assumed to include any and all of Congress' legislative intent of what is to be included and what is to be excluded in the statute.[69] If the statute is clear, then a court does not need to turn to legislative history to analyze the law.[70] When the *Prosperi* court examined the WSLA, the court only found the terms "at war" to be ambiguous.[71] The WSLA can toll other offenses that meet the third subsection, provided that the offenses are criminal in nature.[72]

In examining the WSLA, the term "or" is a connector between three separate elements. A reasonable person reads the term "or" to represent an option between two or more clauses, words, or statements.[73] Therefore, the

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contract).

67. *See* Bridges v. United States, 346 U.S. 209, 215 (1953) (holding that the WSLA only applies to offenses that defraud the government). *See generally* United States v. Grainger, 346 U.S. 235 (1953) (holding that fraud must be essential element of the crime in order to qualify for tolling of statute of limitations under the WSLA).

68. *See* Reiter v. Sonotone Corp., 442 U.S. 330, 337 (1979) (emphasizing that statutory interpretation is a step by step process); *cf.* Maxine D. Goodman, *Reconstructing the Plain Language Rule of Statutory Construction: How and Why*, 65 MONT. L. REV. 229 (2004) (discussing plain meaning rule, including issues and how to modify rule).

69. *See* Richards v. United States, 369 U.S. 1, 9 (1962) (determining that the terms of the Federal Tort Claims Act are the precise terminology that Congress intended).

70. *See* INS v. Cardoza-Fonseca, 480 U.S. 421 (1987) (Scalia, J., Concurring) (noting that, since statutory interpretation is a step-by-step process, the interpreter should not continue to the next step if the statute is clear); United States v. Prosperi, 573 F. Supp. 2d 436, 444 (D. Mass. 2008) (quoting Barnhart v. Sigmon Coal Co., 534 U.S. 438, 461–62 (2002)); *see also* BRYAN A. GARNER & ANTONIN SCALIA, READING LAW: THE INTERPRETATION OF LEGAL TEXTS (2012) (arguing for textualist interpretation of legal materials).

71. *See Prosperi*, 573 F. Supp. 2d at 444–45 (mentioning that Congress may have multiple definitions of term "at war," making it the only portion of the statute. that is vague).

72. *See* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497, slip op. at 10–11 (U.S. May 26, 2015) (holding that the WSLA only applies to criminal offenses).

73. *See Or*, DICTIONARY.COM, http://dictionary.reference.com/browse/or?s=t (last visited Jan. 24, 2015) (defining the term "or" as a term "used to connect words, phrases, or clauses representing alternatives"); *cf.* WILLIAM N. ESKRIDGE, JR., PHILLIP P. FRICKEY, & ELIZABETH GARRETT, CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY 832 (3d ed. 2001) (including discussions on how legislation is made and process of how a statute is created).

WSLA applies to three different offenses: fraud, property, *or* contract.[74] The final subsection should be broken down and read as providing a broad range of options for offenses.[75] Breaking down the third element, the first part provides for a range of options for offenses: "committed in connection with the negotiation, procurement, award, performance, payment for, interim financing, cancelation, or other termination or settlement . . . ."[76] A reasonable person would read the list as giving the option to select one of these applications. The second prong provides a list of three options: "any contract, subcontract, or purchase order,"[77] again connected by the term "or," to mean that the offense must be derived either from an issue falling under the first range of options or from an issue falling under the second range of options relates the first prong.[78] This analysis is similar to the first portion because the terms and connectors are the same—commas between each option followed by an "or"—allowing a reasonable person to assume that it is proper to select one option from the list.[79] The second list, however, has a limit: the option selected must be "connected with or related to the prosecution of the war or directly connected with or related to the authorized use of the Armed Forces, or with any disposition of termination inventory by any war contractor . . . ."[80] Provided that the offense fits into all three parameters of the third subsection, the WSLA applies as based on the plain meaning interpretation.

The extension of the WSLA applies as a tolling statute to the entirety of

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74. *See* 18 U.S.C. § 3287 (2008) (listing options as "(1) involving fraud or attempted fraud against the United States or any agency thereof in any manner . . . or (2) committed in connection with the acquisition, care, handling, custody, control or disposition of any real or personal property of the United States, or (3) committed in connection with the negotiation, procurement, award, performance, payment for, interim financing, cancelation, or other termination or settlement, of any contract, subcontract, or purchase order which is . . . related to the prosecution of the war . . . ").

75. *See id.* (stating that one prong notes that the crime must have been "(3) committed in connection with the negotiation, procurement, award, performance, payment for, interim financing, cancelation, or other termination or settlement, of any contract, subcontract, or purchase order which is connected with or related to the prosecution of the war or directly connected with or related to the authorized use of the Armed Forces, or with any disposition of termination inventory by any war contractor . . . ").

76. *Id.*

77. 18 U.S.C. § 3287.

78. *See id.* (numbering three options of applicability separated by "or"s); *cf. Or*, DICTIONARY.COM, *supra* note 73 (highlighting the definition of the term or as a connector); *cf.* ESKRIDGE, *supra* note 73 (discussing ways by which statutes are created and how legislative intent factors into wording).

79. *Cf. Or*, DICTIONARY.COM, *supra* note 73 (defining the term "or"); ESKRIDGE, *supra* note 77 (noting various theories about legislative intent).

80. 18 U.S.C. § 3287.

Title 18. According to the United States District Court for the District of Columbia, fraud is no longer an essential element required to trigger the WSLA under a violation of the False Claims Act.[81] The court reasoned that the requirement of fraud as an essential element did not stem from the WSLA but from fraud offenses under the False Claims Act, which has since been amended to no longer require fraud as an essential element.[82] Applying the court's opinion, and based on a plain-text reading of the statute, the suggestion that fraud is no longer an essential element allows for a more broad application of the WSLA to other types of criminal offenses that fit the criteria outlined in other subsections of the Act.[83]

B. *What is Torture? How Does the International Definition of Torture Apply Domestically? What Is the Current Lay of the Land Regarding Military Contractor Liability for Torture?*

Under a plain reading of the WSLA, the statute applies more broadly than just to cases of pecuniary fraud.[84] The current legal setting is not ripe for prosecution of torture under other statutes and has currently led to military contractor impunity rather than liability.

The WSLA should apply to the offense of torture because torture is codified in Title 18 of the United States Code.[85] Here, Congress defines torture as "an act committed by a person acting under the color of law specifically intended to inflict severe physical or mental pain or

81. United States *ex rel.* Landis v. Tailwind Sports Corp., 51 F. Supp. 3d 9, 43 (D.D.C. 2014).

82. *Id.*

83. *See* 18 U.S.C. § 3287 (requiring the violation to have occurred during a war or approved use of military force); *cf.* United States *ex rel.* Landis v. Tailwind Sports Corp., 51 F. Supp. 3d. at 43 (holding that since fraud is no longer an essential element of the False Claims Act, it is not necessarily an essential element for the WSLA); Brief for Petitioner, United States *ex rel.* Carter v. Halliburton Co. at 2, 710 F.3d 171 (4th Cir. 2013), *rev'd sub nom.* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, (No. 12-1497) 2014 U.S. S. Ct. Briefs LEXIS 3195, at *36–37 (arguing that the phrase "any offense" should be defined as criminal offense because the WSLA is found in Title 18, which contains only criminal offenses).

84. *But see* Bridges v. United States, 346 U.S. 209, 222 (1953) (applying the WSLA only to crimes involving fraud); United States v. Grainger, 346 U.S. 235, 241 (1953) (noting that fraud must be an essential element of crime for the WSLA to apply).

85. *See* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497, slip op. at 10–11 (U.S. May 26, 2015) (applying the WSLA only to cases of criminal offenses); Brief for Petitioner, United States *ex rel.* Carter v. Halliburton Co., 710 F.3d 171 (4th Cir. 2013), *rev'd sub nom.* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, 134 S. Ct. 375 (2015) (No. 12-1497) at *36–37 (arguing that the WSLA should apply to criminal offenses because it is in Title 18 which only includes criminal offenses).

suffering . . . upon another person within his custody or physical control."[86] Congress codified this definition following the ratification of the Convention Against Torture and Other Cruel, Inhuman, and Degrading Treatment or Punishment.[87] Under a complimentary statute of limitations, the government has eight years to prosecute those who commit crimes of torture either domestically or abroad.[88] Therefore, the statute of limitations for torture committed in 2001, and onward, could not have expired by the enactment of the 2008 WSLA amendment.

The lower courts' inconsistency, and the recent release of the Senate torture report,[89] creates a strong government interest for an increase in time to end military contractor impunity. The issues began with Congress' changing of the official definition of the term "at war," which now includes acts of congressional approval of forces executed in the middle of a conflict that began with the congressional approval of forces.[90] Courts have interpreted the meaning of "at war"; however, courts have not acknowledged that, even though the term may not be certain in domestic law, perpetrators of international crimes are still required to abide by *jus in bello* (laws of war).[91]

Those soldiers who committed torture at Abu Ghraib were held criminally accountable by the United States courts and military tribunals

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86. 18 U.S.C. § 2340 (2014).

87. *See id.* (noting in history that this Act has been modified several times since codification in 1994 following the United States' ratification of the Convention Against Torture).

88. 18 U.S.C. § 3286 (2014) (noting that eight-year statute of limitations was codified in 1994); *see* 18 U.S.C. § 2340A (2014) (noting that "[t]here is jurisdiction over the activity prohibited in subsection (a) if (1) the alleged offender is a national of the United States; or (2) the alleged offender is present in the United States, irrespective of the nationality of the victim or alleged offender . . . ").

89. S. SELECT COMM. ON INTELLIGENCE, COMM. STUDY OF THE CIA'S DETENTION AND INTERROGATION PROGRAM: FINDINGS AND CONCLUSIONS (Comm. Print 2014) (listing various cases of torture during both the conflicts in Iraq, Afghanistan, and the spillover effects into other countries).

90. *Cf.* United States v. Prosperi, 573 F. Supp. 2d 436, 449, 455 (D. Mass. 2008) (stating that conflicts in Iraq and Afghanistan constitute war for purposes of the WSLA).

91. *See generally* Hamdan v. Rumsfeld, 548 U.S. 557, 567 (2004) (holding that the military tribunal that was created to try Hamdan violated the Geneva Conventions which apply during times of war). *Compare* Nathaniel Berman, *Privileging Combat? Contemporary Conflict and the Legal Construction of War*, 43 COLUM. J. TRANSNAT'L L. 1, 3 (2004) (defining *jus in bello* as the laws of how war is conducted, including protection of non-combatants), *with* Robert D. Sloane, *The Cost of Conflation: Preserving the Dualism of* Jus ad Bellum *and* Jus in Bello *in the Contemporary Law of War*, 34 YALE J. INT'L L. 47, 49 (2009) (defining *jus ad bellum* as the laws that dictate the entrance into conflict).

for their participation in the violation of the laws of war.[92] Since military contractors are agents of the United States, they are also required to follow the laws of war.[93] However, because of the current state of the law, there have been issues prosecuting military contractors for crimes committed during times of war.[94] Following the *Kiobel v. Royal Dutch Petroleum Co*[95] decision (holding that the Alien Tort Statute does not apply to crimes committed abroad unless they sufficiently "touch and concern" the United States),[96] the lower courts have been divided on military contractor liability under the Alien Tort Statute.[97] The current circuit split in applying *Kiobel* has left military contractors with an air of uncertainty regarding the potential prosecution of their actions. The *Al Shimari v. CACI Premier Technologies, Inc.* precedent allowed the Fourth Circuit to apply the Alien Tort Statute to hold military contractors liable for activities that touch and concern the United States.[98]

While *Al Shimari* theoretically allows military contractors to be held

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92. *See* CNN Library, *Iraq Prison Abuse Scandal Fast Facts*, CNN (Nov. 7, 2014, 12:41 PM), http://www.cnn.com/2013/10/30/world/meast/iraq-prison-abuse-scandal-fast-facts/ (detailing that in 2006, three years after a detainee died in Abu Ghraib, a sergeant was found guilty for aggravated assault against inmates in Abu Ghraib).

93. *See* Geneva Convention Relative to the Treatment of Prisoners of War art. 3, Aug. 12, 1949, 6 U.S.T. 3316. ("In the case of armed conflict not of an international character occurring in the territory of one of the High Contracting Parties, each Party to the conflict shall be bound to apply, as a minimum, the following provisions . . . . "); Hamdi v. Rumsfeld, 542 U.S. 507, 518 (2004) (listing several sources that dictate that capture is not a form of punishment but is utilized to remove soldiers from the field); *International Humanitarian Law and Private Military/Security Companies*, ICRC (Oct. 12, 2013), https://www.icrc.org/eng/resources/documents/faq/pmsc-faq-150908.htm (noting that military contractors are obligated to follow the laws of war if they take part in military activities).

94. *See* Sonia Tabriz, Note, *The Battlefield Preemption Doctrine: Preempting Tort Claims Against Contractors on the Battlefield to Preserve Federal Interests in Wartime Matters*, 42 PUB. CONT. L.J. 629, 630-31 (2013) (arguing that all courts should adopt Combatant Battlefield Exception as announced in *Saleh v. Titan Corp.*, removing crimes committed by military contractors from the hands of the court to hands of lawmakers). *But see* Anupam Chander, *Reflections on Kiobel: Unshackling Foreign Corporations Kiobel's Unexpected Legacy*, 107 A.J.I.L. 829, 830 (2013) (noting that Alien Tort Claims Act can likely be applied to American corporations because they are likely to meet the "touch and concern" requirement of *Kiobel*).

95. 133 S. Ct. 1659 (2013).

96. *Id.* at 1669.

97. *Compare* Al Shimari v. CACI Premier Tech., Inc., 758 F.3d 516 (4th Cir. 2014) (holding under *Kiobel*, military contractors can be held liable for crimes committed abroad), *with* Saleh v. Titan Corp., 580 F.3d 1 (D.C. Cir. 2009) (holding under *Kiobel* that military contractors cannot be held liable for crimes committed abroad).

98. *See Al Shimari*, 758 F.3d at 530–31 (specifying that in *Al Shimari*, a U.S. military contractor, CACI, was given a contract by the U.S. Department of the Interior).

liable for crimes, which helps combat impunity,[99] other cases heard under statutes other than the Alien Tort Statute have faced troubling results. For example, *Saleh v. Titan Corp.* provides military contractors immunity if these men or women were not the leading commanders on the war field.[100] However, *Saleh* leaves room for impunity for those contractors who were commanded by a leading military officer.[101] The constant back and forth among different courts has caused great confusion between which civil claims can be brought against military contractors and which claims are ineligible.[102]

C. Al Shimari *a la Carte: Is Torture Too Much to Bargain for Under the WSLA?*

Based on a plain reading of the WSLA, the Act can be applied to military contractors who commit crimes outside of pecuniary fraud, too. The facts presented by *Al Shimari* show that military contractors committed an offence—torture, a crime according to Title 18.[103] When one individual subjects another to genital beatings or to being tasered in the head, then the actions serve no other purpose than to cause severe physical pain or harm to an individual.[104] Here, the individuals subject to these conditions were the prisoners at Abu Ghraib; therefore, they were under the custody of the CACI interrogators.[105] Thus, CACI interrogators' actions constituted an offense under the WSLA because CACI's actions fulfill both elements of torture.

Second, to meet the first portion of the WSLA's third subsection, it is

99. *Contra* Al Shimari v. CACI Premier Tech., Inc., No. 1:08-CV-00827-GBL-JFA, 2015 U.S. Dist. LEXIS 107511, at *2-3 (E.D. Va. 2015) (holding that when the facts require the court to question military decisions, the court does not have jurisdiction to decide the claim).

100. *See Saleh*, 580 F.3d at 9.

101. *See id.* (holding that those in leadership positions are responsible for crimes committed).

102. *See id.* (following the decision, *In re* KBR, Inc., which was vacated and remanded by Metzgar v. KBR Inc., 744 F.3d 326, 351–52 (2014)).

103. *See* 18 U.S.C. § 2340 (2014) (noting that the WSLA is located in Title 18); Al Shimari v. CACI Premier Tech., Inc., 758 F.3d 516, 521–22 (4th Cir. 2014) (stating that CACI employees, including interrogators, committed or ordered acts of torture in Abu Ghraib).

104. *See* 18 U.S.C. § 2340 (defining torture to include "an act . . . intended to inflict severe physical or mental pain or suffering . . . "); *Al Shimari*, 758 F.3d at 521–22 (listing various methods of torture used against Iraqis detained in Abu Ghraib, such as prisoners being shot with guns, forced to perform sexual acts, raped, or forced to watch rape, among other unapproved torture methods).

105. *See* 18 U.S.C. § 2340 (requiring custody as a necessary element of torture); *Al Shimari*, 758 F.3d at 521–22 (noting that custody includes not having freedom to leave).

necessary to look at the second "or" list. The second "or" list provides for a choice between "any contract, subcontract, or purchase order . . . ."[106] *Al Shimari* notes, in its facts, that CACI was under contract to provide interrogation services to the military, which it was in the process of performing during Abu Ghraib.[107] Thus, CACI committed torture during the performance of its contract with the Department of Interior.[108] CACI's crimes, therefore, fit the application of the third prong of the WSLA.[109]

The final portion of the third subsection is less obviously applicable than the first two portions of subsection A because, based on the facts, there seemed to be no obvious connection between the third subsection and the facts.[110] However, *Al Shimari* noted that the government hired CACI because there was a "shortage of trained military interrogators[,]"[111] and the government required the interrogators to yield information for the war effort.[112] CACI received the contract because the war required interrogator services, relating the contract to the performance of the war.[113] Therefore, the WSLA can be applied to a military contractor's torture that holds military contractors criminally liable.

The Supreme Court limited the application of the WSLA to criminal offenses. However, the Court did not define the term "at war," which has changed over time. Therefore, it is likely the WSLA could apply torture

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106. *See* 18 U.S.C. § 3287 (2008) (identifying quoted list).

107. *Al Shimari*, 758 F.3d at 521–22.

108. *See id.* (limiting the third prong to crimes committed during multiple stages of a government contract including performance of contract); *Al Shimari*, 758 F.3d at 521–22 (finding CACI was performing under a government contract, providing interrogators, while working in Abu Ghraib).

109. *See* 18 U.S.C. 3287 (identifying that the third prong states that offenses must be "committed in connection with the negotiation, procurement, award, performance, payment for, interim financing, cancelation, or other termination or settlement, of any contract, subcontract, or purchase order which is connected with or related to the prosecution of the war"); *id.* at 521–22 (articulating that CACI was given contract by the U.S. government).

110. *See* 18 U.S.C. 3287 (limiting offenses to those that are "connected with or related to the prosecution of the war or directly connected with or related to the authorized use of the Armed Forces, or with any disposition of termination inventory by any war contractor . . . "); *Al Shimari*, 758 F.3d at 521–22 (highlighting the facts include the purpose of employing CACI, which was to provide interrogation services to the American military).

111. *Al Shimari*, 758 F.3d at 521.

112. *See id.* (highlighting that individuals held at Abu Ghraib were thought to have information about insurgent groups and therefore required the use of skilled interrogators).

113. *See generally* 18 U.S.C. § 3287 (covering crimes committed during authorized uses of military force); *Al Shimari*, 758 F.3d at 521 (noting CACI investigators were instructed by military to torture).

committed during the Iraq and Afghanistan conflicts because torture is a criminal offense, and the statute of limitations had not run when Congress amended WSLA.

III. THE FUTURE OF MILITARY CONTRACTORS: IMMUNITY AND A BLANK CHECK OR JUSTICE?

The future of military contractor liability is still uncertain pending a Supreme Court decision further interpreting the WSLA or clarifying the applicability of the Alien Tort Claims Act.

A. *The Courts Should Seek to Apply Justice, Not Spread Impunity*

The government is not currently holding military contractors liable for crimes they committed during the Iraq and Afghanistan conflicts.[114] However, to move forward, "transitional justice measures—such as criminal prosecutions of perpetrators of atrocities—can be crucial tools to prevent the recurrence of cycles of violence."[115] Prosecution is a clear deterrent to potential perpetrators noting that they may violate the law, but they will not get away without punishment.[116]

Holding military contractors liable for the crimes committed by their employees is not likely to cause a negative backlash.[117] If the government holds contractors liable for their actions abroad, they will change their behavior so that they continue to receive government contracts in the future.[118] However, contractors may also seek to limit their liability by negotiating indemnification clauses into their contracts with the government.[119] Ultimately, though, even if military contractors are held

114. *See In re* KBR, Inc., 925 F. Supp. 2d 752, 772–73 (D. Md. 2013) (holding military contractors exempt from liability for practical and policy reasons); Saleh v. Titan Corp., 580 F.3d 1, 9-10 (D.C. Cir. 2009) (holding that Alien Tort Statute does not apply to military contractors).

115. David Tolbert, *EU Must Protect Bosnia's War Crimes Court*, INTERNATIONAL CENTER FOR TRANSITIONAL JUSTICE (Feb. 8, 2012), http://www.ictj.org/news/eu-must-protect-bosnia's-war-crimes-court.

116. *See generally id.* (arguing that prosecuting war crimes is a clear deterrent).

117. *Cf.* Richard Frankel, *Regulating Privatized Government Through § 1983*, 76 U. CHI. L. REV. 1449, 1453 (2009) (concluding that military contractors should be held liable under *respondeat superior* doctrine).

118. *See* 48 C.F.R. § 52.209-5(a)(1)(i)(B) (2006) (stating that a contractor bidding on a government contract has not "within a three-year period preceding this offer, been convicted of or had a civil judgment rendered against them for: commission of fraud or a criminal offense in connection with obtaining, attempting to obtain, or performing a public . . . contract or subcontract . . . ").

119. *See* VIVIAN S. CHU & KATE M. MANUEL, CONG. RESEARCH SERV., R41755, TORT SUITS AGAINST FEDERAL CONTRACTORS: AN OVERVIEW OF THE LEGAL ISSUES, REP. 22 (2001) (arguing that contractors could potentially make government

liable, they will not shy away from government contracts because of their profitability.[120]

The Supreme Court has not ruled on whether the WSLA applies to offenses whose statutes of limitations had not expired in 2008, when the Act was amended. However, the court in *United States v. BNP Paribas* held that if the statute of limitations had not yet expired when the crime and war otherwise meet all the provisions of a modified tolling statute, then that tolling statute should apply.[121] While at first blush it seems that allowing the 2008 WSLA to apply to offenses committed prior to its enactment would violate the ban on *ex post facto* laws, it actually does not because those laws focus on not holding someone liable for an action that was not defined to be criminal at the time it was committed.[122] In addition to the holding in *United States v. BNP Paribas*, *United States v. Prosperi* made it very clear that, because Congress had not limited war to declared wars by using the term "declared" in the statute, a broader reading of the term at war was appropriate.[123] The courts should apply the 2008 amendment to *Carter* by following the *Prosperi* court's test and thus deem the Iraq conflict a war under the WSLA.[124]

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responsible to pay damages through an indemnification clause but contractors still hold liability).

120. *See* Samuel Weigley, *10 Companies Profitting the Most From War*, USA TODAY (Mar. 10, 2013, 6:10 PM), http://www.usatoday.com/story/money/business/2013/03/10/10-companies-profiting-most-from-war/1970997/ (describing the massive profitability of war. For example, L-3 Communications made $956 million in 2010–11.); *see also* Angelo Young, *And the Winner for the Most Iraq War Contract is KBR, With $39.5 Billion in a Decade*, INT'L BUS. TIMES (Mar. 19, 2013, 10:13 AM), http://www.ibtimes.com/winner-most-iraq-war-contracts-kbr-395-billion-decade-1135905 (noting that KBR received many of its contracts without competition to total $39.5 billion with the next highest recipient of government contract funds at $13.5 billion).

121. *See* United States v. BNP Paribas, 884 F. Supp. 2d 589, 603, 608 (S.D. Tex. 2012) (holding that if a statute of limitations has not expired when a law is modified, the modified law applies).

122. *See id.* (reasoning that the statute of limitations had not expired so the application of the law is not necessarily *ex post facto*); United States v. Prosperi, 573 F. Supp. 2d 436, 443-44, 446 (D. Mass. 2008) (noting a list of factors to consider when determining whether a conflict constitutes as war for the purpose of the WSLA).

123. *See id.* at 605–06 (mentioning that the terms Congress uses in a statute are the terms Congress intended, including omission of words).

124. *See id.* at 607 (identifying that the *Prosperi* court created a factors-balancing test: "(1) the extent of the authorization given by Congress to the President to act; (2) whether the conflict is deemed a "war" under accepted definitions of the term and the rules of international law; (3) the size and scope of the conflict (including the cost of the related procurement effort); and (4) the diversion of resources that might have been expanded on investigation frauds against the government").

B. *"I'll take 'Certainty' for 100," Chief Justice Roberts*

The Supreme Court should take additional WSLA cases because, to achieve certainty that military contractors will be prosecuted for crimes they commit while performing contracts, it is necessary to clarify lower court circuit splits and inconsistencies on this issue.[125] To do this, the Supreme Court can take the next lower court case that discusses military contractor liability for serious crimes committed during the Afghanistan or Iraq conflicts. Alternatively, Congress can pass a law that removes any possible ambiguity that military contractors are indeed held liable for the crimes they commit abroad, during times of war, where these actions are not necessary for the successful performance of their contract.

Lastly, the Court should apply the plain meaning interpretation of the WSLA to extend the reach of the Act. The third prong of the WSLA has not been considered or applied in any lower court case.[126] However, based on the analysis in Part II of this Comment, it is useful for expanding upon offenses eligible to utilize the WSLA's tolling mechanism.[127] Applying the third prong in this test could give the courts or Congress sufficient time to work out all the noted issues with military contractor liability because it will extend the commencement of the tolling of the statute of limitations. Ultimately, the collective goal of the courts and Congress should be to hold military contractors liable in both civil and criminal respects for the crimes they commit while performing contracts abroad during wartime. Military contractors will then be sure to know that if they commit certain crimes, they will be held liable.

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125. *Compare* Al Shimari v. CACI Premier Tech., Inc., 758 F.3d 516, 520 (4th Cir. 2014) (holding that *Kiobel* does not automatically preclude all liability cases against military contractors), *with In re KBR, Inc.*, 925 F. Supp. 2d at 772–73 (advocating for the inability of suits to be brought against military contractors who commit crimes during performance of their contracts), *and Saleh*, 580 F.3d at 9 (noting that military contractors should be automatically exempt from liability).

126. *See generally* United States *ex rel.* Carter v. Halliburton Co., 710 F.3d 171 (4th Cir. 2013) *rev'd sub nom.* Kellogg Brown & Root Servs., Inc. v. United States *ex rel.* Carter, No. 12-1497 (U.S. argued Jan. 13, 2015) (excluding discussion of third prong of the WSLA); *see generally* United States v. BNP Paribas, 884 F. Supp. 2d 589, 589 (S.D. Tex. 2012) (analyzing False Claims Act); *see generally* United States v. Prosperi, 573 F. Supp. 2d 436, 436 (D. Mass. 2008) (focusing on term "at war"); United States v. Grainger, 346 U.S. 235 (1953) (holding that crimes must be pecuniary in nature, but ignoring the third prong of the WSLA); Bridges v. United States, 346 U.S. 209 (1953) (discussing whether a false statement would trigger the WSLA under the second prong of the WSLA and not the third prong).

127. *See* discussion *supra* Part II.B (listing Supreme Court cases that have evaluated the WSLA); Part II.C (identifying lower court cases that have evaluated the WSLA); *see also* 18 U.S.C. § 3287 (2012) (identifying options for types of offenses that the WSLA covers).

CONCLUSION

Today, the United States is on the brink of potentially setting an unfortunate example for the world. Currently, the United States continues to be haunted by the torture committed by military contractors: torture that was sanctioned and deliberately hidden by the CIA. The Supreme Court's decisions in 2015 could shape future military contractor liability in a negative or positive manner. A plain meaning interpretation allows the courts to expand the WSLA to address the rampant impunity and uncertainty of prosecution of military contractors who commit crimes during times of war.[128] The current precedent allows military contractors to be relatively free from prosecution.[129] When potential war criminals are uncertain about whether or not they government will prosecute them, there is less deterrence to keep the potential war criminals from committing crimes.[130] Because torture is included in the same title as the WSLA, the Act should include all crimes enumerated in the same Title 18.[131]

This current state of affairs can be reformed if the Supreme Court adopts a plain meaning interpretation of the WSLA. The plain meaning interpretation will adapt the Act to crimes such as military contractors' acts of torture committed during times of war. Ultimately, military contractors are hired to do a job and do it successfully; committing crimes such as fraud or torture means military contractors are not performing their contracts successfully. For the United States to be able to move forward with preventing future infractions, the Court must seal the impunity gap for military contractors.

128. *See* discussion *supra* Part III.A (arguing that the WSLA as a whole is unambiguous and, therefore, a plain meaning reading is permissible).

129. *See* discussion *supra* Part IV (noting that various statutes do not consistently hold military contractors accountable, which leads to impunity).

130. *See* discussion *supra* Part IV.B (pointing to uncertainty for the lack of deterrence).

131. *See* discussion *supra* Part III.B (mentioning that some offenses in Title 18 are civil while others are criminal and, therefore, that the WSLA should apply to both).

Erratum

Max Stul Oppenheimer, *The Innovator's Dilemma*, 4 Am. U. Bus. L. Rev. 371 (2015).

In our Volume 4 Issue 3, we mistakenly omitted Professor Max Stul Oppenheimer's middle name in his article, *The Innovator's Dilemma*, on the title page and in later footnotes. We would like to extend our apologies to the author, and we would like to note that, at this time, we have corrected the omission on the online databases and on our website.