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TABLE OF CONTENTS

ARTICLES

EMPIRICAL EVIDENCE ON ROBOT TAXATION: LITERATURE REVIEW AND
TECHNICAL ANALYSIS
Bret N. Bogenschneider.....1

THE AB5 EXPERIMENT — SHOULD STATES ADOPT CALIFORNIA’S WORKER
CLASSIFICATION LAW?
Samantha J. Prince.....43

TAKING MISAPPROPRIATION SERIOUSLY: STATE COMMON LAW
DISGORGEMENT ACTIONS FOR INSIDER TRADING
Jeanne L. Schroeder.....97

COMMENTS

THE SEAL HAS BEEN LIFTED: NCAA AND PREDOMINANTLY WHITE COLLEGES
MUST SOON STOP EXPLOITING THEIR BLACK ATHLETES
Daniel Bartlett185

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EMPIRICAL EVIDENCE ON ROBOT TAXATION: LITERATURE REVIEW AND TECHNICAL ANALYSIS

BRET N. BOGENSCHNEIDER*

The literature on robot taxation has continued to expand since 2018 with numerous articles now referring to empirical evidence. The evidence presented in prior studies comprises abstract modeling and statistical pattern reviews with no statistically significant findings reported to date. Notably, one article is an advocacy piece by a tech lobbyist who at one point purchased priority Google results for the search “robot taxation.” In some cases, technical errors are sufficient to reverse the stated results. Examples of error in empirical analyses include (i) motivated reasoning, such as the failure to model simpler or best explanations; (ii) lack of causal analysis; (iii) tax technical errors; (iv) omission of citations to conflicting theory or results; (v) errors in accounting methods; (vi) enhanced degrees of freedom in modeling parameters; and (vii) reliance on economic theories not reflecting robots as a fourth factor of production. The empirical evidence indicates that capital investment, such as in robots, occurs largely in higher tax nations, and that robot density is positively associated with high corporate tax rates, such as in Germany, Japan, South Korea, and the Nordic states, with little or no automation occurring in tax havens where the value of tax deductions for capital investment is zero.

I. Introduction	2
II. Technical Errors in the Empirical Evidence on Robot Taxation	7
III. Literature Review: Empirical Evidence on Robot Taxation	18
A. Technequality (Statistical Trends in EU Public Finances Related to Robots)	18

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B. Tax Foundation (Neoclassical Economics, General Equilibrium Modeling)	24
C. Information Technology and Innovation Foundation (The Case Against Taxing Robots)	27
D. Tyers & Zhou (Robot Tax for Redistribution Model)	32
E. Guerreiro, Rebelo & Teles, Automation and Income Inequality Modeling (Should Robots be Taxed?).....	35
IV. Conclusion	37

I. INTRODUCTION

Tax knowledge not formulated in numbers is of “a meagre and unsatisfactory kind,” at least according to Lord Kelvin.¹ Tax theory, at least as it might be explained by tax lawyers or accountants in words, seems to be doubtable, dubious, or possibly even biased. In comparison to words, numbers feel more certain, clear, and unbiased. John Maynard Keynes famously disagreed with Lord Kelvin in the special value of economic knowledge formulated in numbers, however. Keynes referred to econometrics as a type of “black magic” and not in the nature of scientific inquiry.² As applied to robots and robot taxation, here referring to both traditional robots and other information and communication technologies (“ICT”),³ the empirical scholar looks at the world, sees robots, posits taxes levied on such robots, then provides explanations based on statistical patterns, or abstract modeling, related to capital taxation in this particular form and its predicted effects to the broader economy. James Bessen wrote, for example: “Whether productivity-improving technology is increasing employment in some industries today can, and must, be determined empirically, of course.”⁴ The empirical methodologies of econometrics suffer from significant limitations reducing the reliability and

1. See 1 WILLIAM THOMSON (LORD KELVIN), *POPULAR LECTURES AND ADDRESSES* 73 (1889).

2. John Maynard Keynes, Comment, *On a Method of Statistical Business-Cycle Research*, 50 *ECON. J.* 154, 156 (1940) (“There is no one . . . whom it would be safer to trust with black magic. [T]hat this brand of statistical alchemy is ripe to become a branch of science, I am not yet persuaded. But Newton, Boyle and Locke all played with alchemy. So let him continue.”)

3. As consistent with the usage in the prior literature, the term “robot taxation” refers to the taxation of production robots and other forms of automation, including software and other information and communication technologies.

4. James Bessen, *Automation and Jobs: When Technology Boosts Employment*, 34 *ECON. POL’Y* 589, 593 (2020).

meaningfulness of given results, however.⁵ The few empirical studies conducted thus far, although neither statistically significant nor causal analyses in some cases, have suggested that any taxes on capital, including robot taxes, are bad or inefficient as robot taxes are taken as a tax on capital, which is always presumed to be less efficient in economic terms than wage taxes levied on labor.⁶

An initial concern is whether Bessen is correct that empirical analyses can, or must, be used to formulate economic and tax policy in respect of automation.⁷ A countervailing view was given by Karl Popper in explaining the nature of science and scientific discovery, where the idea is that empirical analyses are not in the nature of bedrock and are always based on an underlying theory.⁸ According to Popper, theory dominates all aspects of empirical work from data gathering to experimentation in the laboratory.⁹ Data is accordingly best viewed as not independent of theory and is rather highly reliant upon it, at least as a matter of science, if not econometrics.¹⁰ Popper wrote:

Science does not rest upon solid bedrock. The bold structure of its theories rises, as it were, above a swamp. It is like a building erected on piles. The piles are driven down from above into the swamp, but not down to any natural or 'given' base; and if we stop driving the piles deeper, it is not because we have reached firm ground. We simply stop when we are satisfied that the piles are firm enough to carry the structure, at least for the time being.¹¹

Partly out of concern that econometric figures and results might not be reliable, the Federal Reserve has previously attempted to replicate leading econometric studies reflecting a decade of econometric work but was largely unable to do so.¹² In particular, the empirical justifications for the heavy

5. See *infra* Part II.

6. See *infra* Part III.

7. See Bessen, *supra* note 4, at 593.

8. KARL POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY 94 (2d ed. 2002).

9. See *id.* at 90 (citing 5 ERNST MACH, DIE PRINZIPIEN DER WAEMELEHRE: HISTORISCH-KRITISCH ENTWICKELT 438 (1896)) ("[T]he theoretician must long before [experimentation] have done his work, or at least what is the most important part of his work: [H]e must have formulated his question as sharply as possible. Thus[,] it is he who shows the experimenter the way. But even the experimenter is not in the main engaged in making exact observations; his work, too, is largely of a theoretical kind. Theory dominates the experimental work from its initial planning up to the finishing touches in the laboratory.").

10. *Id.* at 7.

11. *Id.* at 94.

12. See Richard G. Anderson & William G. Dewald, *Replication and Scientific Standards in Applied Economics a Decade After the Journal of Money, Credit and*

taxation of labor as opposed to capital have been disputed. Undeterred by the apparent inability to repeat results, thus defeating one of the core tenants of modern science, leading econometric scholars have taken Kelvin's Dictum even further than it was first envisaged. The titles of many empirical works in tax policy proclaim more broadly: This is what we *know* about taxation and tax policy.¹³ The expanded version of Kelvin's Dictum is not just that numbers yield a more satiating form of knowledge, but that metrics are the *only* way to know. By this view, scientists look at the world, gather observations, analyze these observations (sometimes with experiments by abstract modeling), and then provide theories or explanations of what they have supposedly observed. Importantly, however, all modeling in respect of robot taxation is at the level of macroeconomic statistics and not firm-level evidence since no specific observational data has been gathered in respect of robot taxation, even in respect of South Korea, which has made various changes to its tax credit for robot taxation and would appear to be a ready case study.¹⁴ As an illustration, if the South Korean tax credit for robot taxation allowed for both deduction and credit for the same investment, this would create a substantial incentive toward automation and might explain in part the extremely high robot density in that nation.¹⁵

In the neoclassical theory of taxation, all taxes on capital are taken to be suboptimal, and wage taxes levied on human workers are preferred. Ironically, empirical analyses premised on numbers are formally unnecessary to the debate rooted in neoclassical economic theory, as every economist can attest that the preference toward a non-taxation of capital in

Banking Project, 76 FED. RESRV. BANK OF ST. LOUIS REV. 79, 81 (1994).

13. See generally Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* (Nat'l Bureau of Econ. Rsch., Working Paper No. 11686, 2005) (examining "economic theory and evidence about who bears the burden of the corporate income tax"); Michael P. Devereux & Simon Loretz, *What Do We Know About Corporate Tax Competition?* (Oxford Univ. Ctr. for Bus. Tax'n, Working Paper No. 12/29, 2012) (reviewing "the empirical literature on competition in source-based taxes on corporate income"), eureka.sbs.ox.ac.uk/4386/1/WP1229.pdf; Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature* (Coase-Sandor Inst. for L. & Econ., Working Paper No. 702, 2014) (reviewing relevant empirical literature on "[t]he issue of tax-motivated income shifting within multinational firms — or 'base erosion and profit shifting' (BEPS)").

14. Robert Kovacev, *A Taxing Dilemma: Robot Taxes and the Challenges of Effective Taxation of AI, Automation and Robotics in the Fourth Industrial Revolution*, 16 OHIO ST. TECH. L.J. 182, 204 (2020) ("There is some anecdotal evidence that the reduction in the automation tax credit has slowed investment in robotics, new industrial robot installations in Korea decreased in 2017 for the first time since 2012. Whether this reflects a causative effect of the reduction in the automation tax credit is unclear. At any rate, Korea remains the most automated economy in the world and there is no indication of widespread abandonment of AI, robotics, or automation.").

15. See *infra* Table 2.

all forms is the current view of tax policy within neoclassical economic theory. Although economists have searched the realm far and wide for empirical evidence of the foregoing theory, no reasonable empirical evidence has ever been provided to support that idea, which is referred to as corporate tax incidence.¹⁶ The prior literature on robot taxation has suggested to the contrary, that the preference for robot workers may be inefficient or at least problematic.¹⁷ That conclusion is accordingly to be taken in contrast to neoclassical economic theory which says precisely the opposite and is based on a production function premised on labor, capital, and land; however, neoclassical economic theory does not directly consider robots or automated workers as a possible fourth independent factor of production. Absent any empirical evidence, we are essentially asked to take economic ideas about tax incidence on faith where the policy result is that the tax base should be assigned to labor in the form of wage taxes on economic efficiency grounds.¹⁸ Many tax professionals familiar with the techniques of aggressive tax avoidance by multinational firms are unwilling to take these assertions on faith alone given their professional experience to the contrary, where multinational firms do nearly everything possible to avoid taxes.¹⁹ If firms can pass on taxes to workers and customers, then it does not make sense that firms would take such pains to avoid taxes. The theory of tax incidence seems to be severely flawed, or at least it seems so to experienced tax practitioners who deal with the reality of aggressive tax avoidance by multinational firms on a daily basis.

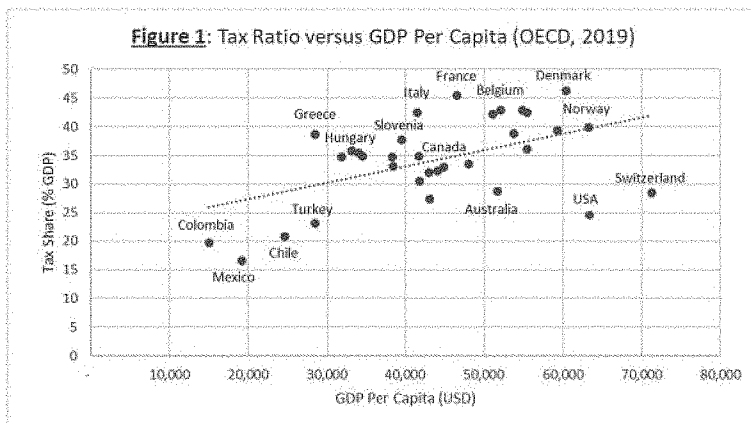
16. See Arnold C. Harberger, *Taxation, Resource Allocation and Welfare*, in *THE ROLE OF DIRECT AND INDIRECT TAXES IN THE FEDERAL RESERVE SYSTEM* 25, 25, 42 (1964), <http://www.nber.org/chapters/c1873.pdf>; Arnold C. Harberger, *Efficiency Effects of Taxes on Income from Capital*, in *EFFECTS OF CORPORATE INCOME TAX* 114–17 (1966).

17. See Rod Tyers & Yixiao Zhou, *Automation, Taxes and Transfers with International Rivalry* 6–7 (CAMA Working Paper No. 44/2018, 2018) (“Payroll taxes generate more revenue than capital income taxes in many countries, and these can encourage the displacement of workers even when it is not otherwise efficient. In the US there is a further incentive to automate because firms can claim accelerated tax deductions for automation equipment, but not for human wages. Less directly, human workers are also consumers who pay consumption taxes, such as retail sales tax (RST) in the US or value added tax (VAT) in the UK. Because robot workers are not consumers, they are not subject to these indirect taxes and so firms can avoid any associated burden. Pre-existing tax policies are therefore not “neutral” as between robot and human workers, but instead [favor] automation.”).

18. Hugo A. Keuzenkamp & Jan R. Magnus, *On Tests and Significance in Econometrics*, 67 J. ECONOMETRICS 5, 6 (1995).

19. See Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 438–45 (2012).

Several simple or best explanations for the economic effects of robot taxation have not been investigated by empirical researchers.²⁰ One simple explanation is that nations with higher tax rates appear to experience faster economic growth than nations with lower tax rates. The empirical data yields a clear trend line in favor of taxes as associated with higher GDP growth in nearly all nations and can be presented on a chart, as has been done below in Figure 1.



The likely reason for this perhaps surprising data is that profitable firms obtain a tax deduction for capital reinvestment, and accordingly, tend to make capital investments into higher tax jurisdictions, such as European nations or Japan, and little or no capital investments into lower or zero-tax jurisdictions, such as Panama or the Cayman Islands.²¹ If robots and automation continue to increase as a share of production, as some scholars have posited a future economy with fully automated production, then perhaps the best empirical observation is that taxes levied on robots should be presumed as necessary to facilitate economic growth. An argument to the contrary would need to explain the broader economic data, that higher taxes seem to cause or to be associated with higher per capita GDP, and then explain why robot workers should continue to be effectively exempt from taxes as a form of capital investment. As has been previously explained, an inefficient, over-investment in automation appears to have occurred as firms chased the valuable tax benefits from hiring robots rather than humans, which may also diminish the tax base and lead to fiscal problems.²² The

20. See *infra* Figure 1.

21. See Bret N. Bogenschneider, *Will Robots Agree to Pay Taxes? Further Tax Implications of Advanced AI*, 22 N.C. J. LAW & TECH. 1, 39–40 (2020) [hereinafter Bogenschneider, *Will Robots Agree to Pay Taxes?*].

22. *Id.* at 4–5 (“[T]he given robot versus human efficiency model does not take into

various reasons to be skeptical about the empirical evidence offered thus far in the context of robot taxation are summarized in Part II. A comprehensive review of the empirical literature on robot taxation is provided in Part III, where the existing empirical literature is categorized based on methodology applied, technical errors, degrees of freedom, and results.

II. TECHNICAL ERRORS IN THE EMPIRICAL EVIDENCE ON ROBOT TAXATION

The field of economics is unique among the social sciences in that it views data gathering as giving rise to theory, whereas modern science views theory as giving rise to a need for data gathering. In respect of tax policy little or no data gathering has occurred, perhaps because tax returns are confidential. In the absence of comprehensive datasets, econometrics often then proceeds as a form of experimentation by abstract modeling. As explained below, such abstract modeling is premised almost exclusively on theory, so the results of modeling reflect the theory applied, which is generally neoclassical economics. The neoclassical economic theory of tax incidence suggests that corporations are always able to shift taxes to others, even if they do not behave so, and even if there has been no reliable empirical data presented to support that belief. All empirical modeling nonetheless proceeds as if that were true. From that largely theoretical premise, the tax base has accordingly been shifted inexorably toward workers in most nations, including the United States, with the notable exception of Switzerland.

A similar line of reasoning premised on neoclassical economic theory has been applied in the context of robot taxation.²³ As long as the modeling and supposed empirical evidence and results on robot taxation meet that litmus test of consistency with neoclassical economic theory, then the results are likely to be acceptable in economic circles. This is broadly true regardless of the methods applied, assuming these are even disclosed. Notably, the Tax Foundation has disclosed the theory upon which it has formulated its modeling assumptions, albeit without disclosing the modeling itself.²⁴ Other advocacy organizations simply post their conclusions on the internet.²⁵ Such results certainly will not be peer-reviewed nor replicated by the Federal

account the relative cost of robots in comparison to human labor, where human labor is less costly than automation at least some of the time. The relative cost of human labor represents the numerator of the given efficiency function (efficiency: *cost per unit output*).”).

23. See *infra* Part II.

24. See *infra* Part III.B.; Hötte et al., *infra* note 46.

25. See, e.g., Robert D. Atkinson, *The Case Against Taxing Robots*, INFO. TECH. & INNOVATION FOUND. (Apr. 8, 2019), <https://itif.org/publications/2019/04/08/case-against-st-taxing-robots>.

Reserve or anyone else.²⁶ Advocacy research performed by the Information Technology and Innovation Foundation (“ITIF”) has indeed been cited by university scholars as it meets the general litmus test of consistency with the theory of corporate tax incidence.²⁷ However, the citation to paid research is indeed a rare occurrence, as paid research is generally not accepted as valid without a formal review. Contrary to that approach, in modern science results are checked by other scholars, and if found to be valid, then advanced to further scientific understanding. Accordingly, as summarized here, many technical reasons for skepticism arise largely from the use of modeling designed to reach a desired result, referred to in the terms of psychology as “motivated reasoning,” rather than to test causal theories with a multiplicity of competing ideas as would be expected in modern science.²⁸

The list of technical errors to be discussed here are as follows:

- i. Failure to model simpler or best explanations;
- ii. Lack of causal analysis;
- iii. Tax technical errors, including omission of wage taxes;
- iv. Omission of citations to conflicting theory or results;
- v. Errors in accounting methods;
- vi. Enhanced degrees of freedom in modeling parameters; and
- vii. Reliance on outdated economic theories not reflecting robots as a factor of production.

Failure to model simpler or best explanations. Empirical research may be premised in numbers; however, the numbers’ meaningfulness depends foremost on the selection of the hypothesis, which is largely a matter of theory. In the case of advocacy research in particular, the hypothesis selected for empirical review may be suboptimal due to *motivated reasoning*. Consider the basic situation where there are three possible causes: A, B, and C, all of which are supported to some degree by a set of variables and other data. The causal theory or hypothesis is then merely the statement that the variables are related in some manner. Assume here that Cause C is the best explanation of causation supported in the given dataset. Ideally, empirical research comprising regressions or other statistical methods would be undertaken expecting to show Cause C. After empirical research, it would be found that Cause C comprises a very significant relationship between the subject variables, whereas Causes A and B reflect a lesser correlation. The empirical results in respect of Cause C would then be very meaningful, that is a change in one variable is thought to cause a change in another variable. For example, if Cause C was the hypothesis that tax increases on robots as a

26. Anderson & Dewald, *supra* note 12, at 79–80

27. See *supra* note 16 and accompanying text.

28. Popper, *supra* note 8.

type of capital will result directly in more or less economic growth, then empirical information related to the causes would be a very relevant piece of information to policymakers. However, the significance of Cause C could only be discovered or known if that cause was investigated as opposed to Causes A or B.

As explained in the preceding paragraph, if and only if a best cause is investigated by empirical researchers would the resulting evidence be considered very helpful in policy formation. An advocate engaged in motivated reasoning may not wish to find the best explanation of cause. Here, continue to imagine that best explanation is Cause C, and the empirical researcher becomes aware through some initial data mining that the data supports that conclusion. However, since the researcher is engaged in motivated reasoning, they do not want to conclude along the lines of Cause C and prefer Cause A, which is only supported by a correlation that is not significant. There is nothing to force the empirical researcher to look at Cause C even if the data strongly supports it as the primary hypothesis for investigation. For this reason, all empirical research depends in significant degree on the good faith and technical ability of the researcher in selecting the appropriate theory and hypothesis for investigation. As explained in Part III, much of the existing literature on robot taxation draws into severe doubt the good faith of empirical researchers given the number and degree of tax technical errors reflected in such research. In many cases, the errors are severe enough to reverse the results, so the empirical researcher purports to reach one conclusion, but the data actually supports the opposite result, such as the theory that robot taxes are likely to aid, not harm, economic growth.

Another problem may arise insofar as the empirical researcher engaged in motivated reasoning agrees that Cause C is the best avenue for research and would be the proper route for empirical observation, but as a matter of bad faith, affirmatively declines to look at the best avenue. In terms of empirical research, the limitation of a robot tax credit in South Korea is an ideal opportunity to investigate “Cause C,” which economic researchers take to be a likely decrease in GDP growth due to a reduction in a robot tax credit.²⁹ The ability for empirical researchers to isolate that variable is vastly simplified in comparison to attempting to study the hypothetical effects of robot tax on Japan or the United States. It seems obvious that empirical research on robot taxation should begin with South Korea which has varied the terms of its robot tax credit and would be exemplary for empirical study.³⁰

Lack of causal analysis. Patterns in datasets are not necessarily causal. All scientific inquiry is intended to relate to causes. The formal statement of

29. See Atkinson, *supra* note 25.

30. Kovacev, *supra* note 14, at 202–04.

causation in empirical work is mandatory because it allows researchers to know the difference between causes and random patterns. The formal statement of expected causes is referred to as the hypothesis, and the origins of that hypothesis as an idea are presented in the theory section of an empirical paper. The hypothesis is essentially the researcher stating what they are looking for and expect to find in empirical work. Where empirical work is not preceded by any theory the analysis may become essentially pattern analysis and identification, often referred to as data mining.³¹ For example, in the modern-day, a computer can be used to repeatedly run regression analyses on variables within a dataset until a pattern is found. The result can then be published as related to a causal theory, even if the researcher did not know of the pattern prior to running the regression. Such a process constitutes the scientific method in reverse, where the researcher backs into knowledge rather than setting out to discover it. Data mining is essentially cheating in empirical research and may result in a substantive problem, whereby operating the scientific method in reverse may generate confusion around whether the pattern identified is meaningful or causal, as all datasets might or likely will contain such patterns that are the result of random chance.

Although data mining is widespread in empirical work, most academic papers include a theory section which is designed to show that the researcher set out to proceed from theory to hypothesis to pattern identification, even if they did not actually do so. Some journalists have speculated that most empirical researchers are engaged in data mining and do not state the theory or hypothesis in advance of undertaking regressions on datasets.³² The pre-statement of the hypothesis prior to running tests, such as regressions, largely establishes that when a pattern is found that such pattern is meaningful because the researcher had an idea of what they expected to find and then ultimately found it as a result of empirical work. However, if an academic comes to empirical analysis without a foundation in proper scientific method, the given empirical results can be perverted. For example, relatively weak patterns can be discovered by data mining. The weak patterns can then be presented as related to a causal theory. An example of a weak pattern might be a simple correlation between two variables. The weaker a pattern the less likely it is that the variables are related such that a change to one might change the other. By data mining the researcher may find a pattern which might be the best pattern to be found in the dataset. However, if the researcher did not set out to find that weak pattern, then the correct answer

31. See Christie Aschwanden, *Science Isn't Broken*, FIFTYTHREEEIGHT (Aug. 19, 2015), <http://fivethirtyeight.com/features/science-isnt-broken/#part1>.

32. See *id.*

is that the dataset did not yield any causal result, or in other words, the researcher did not find what they were looking for. The research result is that the dataset did not yield an empirical result. Importantly, if there are a limited number of datasets available to researchers, then it is possible that empirical research would not function at all as a means of inquiry. Of course, the conclusion that a given dataset did not yield any causal result is not publishable and it is accordingly rare that empirical researchers report not finding something because of empirical research. Empirical researchers can thus feel pressure to publish the weak relation as causal to imply the research was meaningful; this is essentially a deer hunter who does not find any deer but does manage to catch a rabbit.

The result of widespread data mining in empirical research is that nearly all research is declared “meaningful” — everybody comes back with at least a rabbit. However, the identification of weak patterns in datasets is close to meaningless in a broad field such as taxation and tax policy. Every dataset can be expected to contain hundreds of weak patterns that can be discovered by data mining, and some of them are likely to relate to a broad or unstated theory of causation, such as the broadly-stated theory of tax incidence within neoclassical economic theory. The weak pattern does not establish causation to that idea however, because it is much too broad and itself premised in motivated reasoning. Yet, to a journalist or any person that receives the report of the empirical finding of a weak pattern, it is nearly impossible to know that the empirical researcher found one weak pattern of many weak patterns, and accordingly, that the result is actually meaningless and relates only to a broad economic concept of tax incidence. Simply put, every empirical researcher can find a weak pattern in a dataset with sufficient time and relate it broadly by motivated reasoning to an idea taken from economic theory. That type of knowledge is meagre, to say the least, even if it is ostensibly based in numbers.

Tax technical errors. A substantial degree of tax technical error has been introduced by scholars in the context of robot taxation. Such errors relate particularly to misstatements of how individual workers pay taxes and how firms calculate tax liability under applicable tax laws and accounting standards. The source of the error can be traced to an omission of references to conflicting scholarship, of which scholars should have been aware, and citation bias,³³ particularly where tax experts have previously explained how the tax system functions in respect to capital investment, which is different in some respects from what economic theory predicts.³⁴ The differences

33. See Christopher J. Ferguson, *Everybody Knows Psychology Is Not a Real Science*, 70 AM. PSYCH. 527, 535 (2015).

34. See generally Bret N. Bogenschneider & Benjamin Walker, *A Revised ETR*

between tax practice and economic ideology are most pronounced in respect to the calculation of taxable income by firms, where investments yield immediate tax deductions as a matter of tax practice, but may not yield incremental income that is likely to be subjected to tax. The respective errors are largely in three areas summarized here:

(a) *Exclusion of Wage Taxes (social insurance taxes)*. When human beings perform work, a variety of different taxes are levied on that activity. They include federal and state income taxes, federal social security taxes, Medicare taxes, the employer portions of these, unemployment taxes, and indirect taxes levied by the states. In Europe, indirect taxes include the value-added tax, or VAT, in lieu of sales taxes. As explained in the next paragraph, generally speaking, none of these taxes are levied either directly on robot workers, or indirectly on firms due to automation or the use of robot workers.³⁵ A detailed explanation of how human workers and robot workers pay or do not pay each category of existing tax has previously been provided by accounting and law scholars.³⁶ In the list above, wage taxes are withholding taxes taken out of workers' paychecks such as federal social security taxes, Medicare taxes, and unemployment taxes, plus the employer portions of those. Human workers do not receive an income tax deduction for wage taxes paid even though they never receive the money, and any future benefits received are subject to income taxation. Wage taxes are then the primary illustration of double taxation, which is in effect triple taxation when the same income is taxed as social benefits. In both Europe and the United States, such wage taxes comprise roughly an equivalent portion of the tax base as income taxes, although comparisons are difficult because the United States does not have a federal sales tax.³⁷

Severe accounting problems have arisen in respect of how economists set out to measure the wage taxes paid by human workers in the context of robot taxation. Economic theory posits a hypothetical offset that applies against workers and only in the context of wage taxes, where an expectation of possible future social benefits is taken to cancel the cost of wage taxes to

Measure for Capital Re-Investment by Profitable Firms, 37 J. TAX'N INV. 33 (2020) (analyzing "how a firm with surplus cash on its balance sheet might be expected to make that of tax-motivated capital re-investment decision"); Bret N. Bogenschneider, *The Tax Paradox of Capital Investment*, 33 J. TAX'N INV. 59 (2015) (arguing that "the amount of actual taxes paid depends not only on the tax rate but also on the tax base (i.e., the legal concept of 'taxable income') against which the rate will be applied").

35. See Ryan Abbott & Bret Bogenschneider, *Should Robots Pay Taxes? Tax Policy in the Age of Automation*, 12 HARV. L. & POL'Y REV. 145, 150 (2018).

36. *Id.* at 164–67.

37. See *OECD Tax Database*, OECD, <https://www.oecd.org/ctp/tax-policy/tax-database/> (last visited Apr. 10, 2022).

workers. Essentially, each worker books an accrual for a future benefit to be received out of a social program that exactly cancels the cost of wage taxes. No other category of taxpayer follows this special accounting method; however, additionally, economic theory does not address the respective details of how to do the calculation. The approach is not methodological in that no evidence exists to show that the amount of future accrual matches the amount of the taxes payable today, or that the benefit should be expected to accrue to the person actually paying the wage tax. Furthermore, many of the social programs are now unfunded mandates, so even if the approach assumed that future benefits would someday become payable to those who paid them into the system, there is no guarantee. Likewise, the special accounting method is not applied to any other groups of taxpayers that also receive transfer payments or other monies directly from the federal or state governments such as multinational firms or the wealthy.

(b) Tax Deductibility of Capital Re-Investment for Profitable Firms. In respect of income taxation, robots as a form of capital investment yield a tax deduction either immediately as an expense or over a short period of time via accelerated depreciation.³⁸ Prior economic analyses presume the opposite, where robots or automation are taken as a source of income rather than an expense. This is to reverse the entry on the accounting ledger for robot expense to an undefined amount of future income, which economists seem to presume will be a large figure. The flawed idea is essentially that robots as automated workers comprise an incremental revenue stream rather than a depreciable asset. In most business situations, automation is likely to be undertaken by firms that are already profitable in the respective jurisdiction where the robot-type investment is intended either to reduce operating expenses to increase reported earnings, or more likely, to achieve

38. Abbott & Bogenschneider, *supra* note 35, at 164–65 (“The timing of claiming a deduction may have a significant effect on a firm’s tax burden. An accelerated tax deduction means that the deduction may be claimed earlier than its actual economic depreciation (the reduction in the value of an asset over time). For example, assume a robot has a total capital cost of \$100,000 and seven years of useful life, while an employee has a total wage cost of \$100,000 over seven years. If accelerated depreciation for capital is available, the firm may be able to claim a large portion of the \$100,000 depreciation as a tax deduction in year one rather than pro[-]rata over seven years. For instance, the firm might claim tax depreciation for an automated worker of \$50,000 in year one, \$30,000 in year two, \$10,000 in year three, and in diminishing amounts to year seven. By contrast, wage taxes must be deducted as paid (i.e., 1/7th in each year). In this case, a present value benefit will accrue from claiming accelerated tax deductions for automated workers relative to the pro-rata tax deductions for employee wages, even where the \$100,000 capital outlay is paid up-front. This is possible because the present value of the accelerated tax deduction on capital investment is greater than the discounted value of the return the firm could make by investing the free cash held on its balance sheet.”).

after-tax savings by reducing income taxes overall, thereby reducing income tax expenses and increasing reported earnings. The widespread presumption among economists writing on the topic of robot taxation that any multinational firm has or might someday undertake capital investment by automation without considering the favorable tax or revenue effects from that investment seems unlikely.

(c) Marginal Tax Rates versus Average Tax Rates. A significant error arises within economic theory because firms are presumed to pay taxes on marginal profits, even if the firm pays little to no corporate tax. The problem relates to how abstract modeling is performed within econometrics. To conduct abstract modeling, a necessary variable within any relevant equation is the corporate tax rate. In theory, this means the real or actual rate paid by the firm under the parameters of most economic models. Unfortunately, economists do not know the real or actual tax rate and a solution must be found to proceed with abstract modeling to make tax policy recommendations. Amazingly, nearly all econometrics proceed with the corporate statutory rate as the tax rate variable, even though the statutory rate is nearly always higher than the corporate effective tax rate, assuming the firm can claim any tax deductions, credits, or offsets to reduce tax liability. The distinction simply represents the difference between statutory tax rates, or the tax rate written in the Internal Revenue Code, and the average effective rate, or the rate of tax the firm actually pays after all credits and other deductions, especially in the United States where the tax code provides a litany of potential deductions.

The reason that the corporate statutory rate is considered a plausible modeling parameter is an economic concept referred to as marginal tax rates. Marginal tax rates are generally presumed to be equal to the corporate statutory rate. So, where the corporate statutory is inserted as the tax variable for modeling purposes, economists are actually using the marginal tax rate, which just happens to nearly always be the same as the statutory tax rate. A severe problem is that there really is no way to confirm such a marginal rate, or that even if there was such a marginal rate, that it could be calculated for each firm, or that corporate executives would make decisions based on a marginal tax rate rather than an average tax rate. All of this is merely a figment of economic theory — again, there is no empirical evidence for the modeling assumptions that are used to create what economists claim is empirical evidence. The result of using a higher corporate tax rate based on the marginal tax rate, rather than an average tax rate, is that the negative second-order effects of capital taxes are then measured as relatively larger given the supposed higher tax rates. Of course, many tech firms engaged in automation pay some of the lowest effective tax rates of any firm, so there is a significant difference between the marginal tax rate used in the model and

the effective tax rate actually paid by the firm.³⁹ Other modeling parameters might be to take the average corporate tax rate for tech firms, perhaps five percent or less, and use that in the models.⁴⁰ In that case, very little economic effect would likely be registered from robot taxes, either positive or negative large multinationals, in particular, tech firms, simply don't pay much in the way of income taxes.

Omission of Transfer Pricing and other Tax Avoidance Techniques by Multinational Firms. The concern that taxes on capital might cause robots to flee a jurisdiction presumes not only that robots give rise to taxable income, but also that income is taxable in the jurisdiction where the robot is located. But, conditions are neither ideal nor positivist in practice. Every practicing tax lawyer and accountant is aware of this and seeks to undermine the positivist intent of the tax system to the benefit of their clients. The OECD has invested years of effort in attempting to understand the source of non-ideal conditions impacting international tax.⁴¹ Of primary concern, corporate income arises in one jurisdiction and is taxed somewhere else, or not at all.⁴² Tax lawyers and accountants call non-optimality in tax matters by various names such as transfer pricing, aggressive tax avoidance planning, and so on.⁴³ But what that really means is that in terms of tax practice, one cannot presume ideal conditions or matching of taxable income to real events. Economic modeling that does not consider transfer pricing and other means of aggressive tax avoidance by multinational firms is unrealistic and cannot form the basis for viable tax policies.

Omission of citations to conflicting theory or results. The robot tax literature is replete with errors due to the failure to review conflicting theories and results. Examples of the failure to cite to conflicting results: (i) the theory of robot taxation indicates that such a tax may yield efficiency gains by reversal or limitation of an over-investment in robots;⁴⁴ (ii) the

39. Daron Acemoglu et al., *Does the U.S. Tax Code Favor Automation?*, BROOKINGS INST. (Mar. 18, 2020), <https://www.brookings.edu/bpea-articles/does-the-u-s-tax-code-favor-automation/>.

40. See Stephen Gandel, *Amazon Paid a Tax Rate of Just 1.2% Last Year, Versus 14% for Average Americans*, CBS NEWS (Feb. 6, 2020), <https://www.cbsnews.com/news/amazon-taxes-1-2-percent-13-billion-2019/> (noting that "Amazon's 1.2% is low even for corporate America").

41. OECD, *Understanding Tax Avoidance*, YOUTUBE (Jan. 27, 2021), <https://www.oecd.org/tax/beps/>.

42. *Id.*; *Action 5 Harmful Tax Practices*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action5/> (last visited Jan. 11, 2022).

43. See, e.g., *BEPS Action #2 Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action2/> (last visited Jan. 11, 2022).

44. Bogenschneider, *Will Robots Agree to Pay Taxes?*, *supra* note 21, at 19–20

economic theory of tax incidence premised on marginal tax rates has been challenged in the tax literature on the grounds that firms behave as if they do bear the incidence of capital taxation,⁴⁵ hence the theory is patently unrealistic due to aggressive tax avoidance by multinational firms; and (iii) one or more of the empirical studies may have cherry-picked results within their own research to suggest that automation is not meaningful to the tax base.⁴⁶

Errors in accounting methods. Nearly all tax policy analysis depends to some degree on accounting methods. Methods in accounting relate to the calculation of tax rates, such as the rate of corporate taxation, which is itself extremely controversial, or to the amount of taxes collected from workers and whether such should include both income and wage taxes. Economists have been very creative in manipulating accounting methods, where the general meaning of terms is reversed from reality. Any failure to disclose an applicable accounting method used within economic modeling leads to a slight-of-hand in discourse over tax policy because manipulating the accounting method yields an intended result which would be reversed under the normal meaning of words. Research in tax policy that does not disclose special accounting methods then proceeds on parallel tracks with other research where it is possible to reach contrary results on the same data simply by manipulating the way in which empirical results are counted or accounted.

Enhanced degrees of freedom in modeling parameters. Any empirical modeling implies a license to make abstractions to render meaningless results meaningful. This is partly what is referred to as degrees of freedom in the tax literature.⁴⁷ In the context of robot taxation, the license has been severely expanded where seemingly arbitrary categories are applied to yield results, whereas the results should have been given as the opposite or

(“Productivity gains are thought to occur by reducing tax incentives toward over-investment in robots in situations where a human worker could do the job more efficiently apart from the favorable tax treatment currently granted to robots.”).

45. Clausing, *supra* note 19, at 438–45.

46. See generally Kerstin Hötte et al., *Does Automation Erode Governments’ Tax Basis? An Empirical Assessment of Tax Revenues in Europe*, TECHNEQUALITY (Apr. 8, 2021) [hereinafter TECHNEQUALITY], <https://technequality-project.eu/files/d52fdautomationandtaxationv30pdf> (examining “the effects of taxation that result from robot and ICT adoption in Europe” and concluding that “[a]fter 2008, [there is] an ICT-induced increase in capital income, a rise of services, but no effect on taxation”).

47. See generally Daniel N. Shaviro, *On the Relative Generality of Fiscal Language*, in INSTITUTIONAL FOUNDATIONS OF PUBLIC FINANCE: ECONOMIC AND LEGAL PERSPECTIVES 257 (Alan J. Auerbach & Daniel N. Shaviro, eds., 2008) (“Laurence Kotlikoff has played a vital role in demonstrating that prevailing fiscal language terms, such as ‘taxes,’ ‘spending,’ and ‘budget deficits,’ lack fundamental economic content, causing them to be misleading and manipulable.”).

possible inconclusive. A concern over an expansive degree of freedom in empirical work suggests that the researcher has engaged in data mining and used the results to change the analysis criteria to create meaning from non-meaningful data analysis. Illustrations of degrees of freedom include (i) selecting an arbitrary time period for review; (ii) splitting the data sample into meaningful and non-meaningful groups; (iii) positing different types of test data such as automated technology versus industrial robots; (iv) applying arbitrary standards of “strong” versus “weak” results without explaining what those terms mean and then presenting empirical results on such an arbitrary basis; and (v) references to “robot taxation” without defining what type of taxation is contemplated, such as personal taxation of robots versus increased degrees of capital taxation.

Reliance on outdated economic theories not reflecting robots as a fourth factor of production. The economic theories typically applied in the context of robot taxation are that of (i) international tax competition⁴⁸ and (ii) tax incidence analysis.⁴⁹ However, these are not the exclusive economic theories applicable to robot taxation. In addition, a production function is the basis to understand economic output. Robots comprise, at least ostensibly, a fourth factor of production. Robots and other types of automation (referred to as ICT) currently serve as a complement to human labor, performing some tasks in production that human workers might otherwise do. Robots are also a capital asset, but only for tax and accounting purposes. Capital is expended to purchase the robot which then provides production services. The same is also true of labor where capital is expended to rent humans for some period of time ranging from hours to years, and the human worker then provides production services. Land is also taken to be required for production within the production functions applied in economic modeling. The economic framework is not entirely coherent as human workers might band together to eliminate the need for capital, likewise, land might not be required for all types of production in the 21st century. A project for economic theory then is to revise the base model of the production function for the existence of robots. The implications of a revised model of the production function are likely significant and may change the various tax policy recommendations from economic theory.

48. Michael Keen & Kai Konrad, *The Theory of International Tax Competition and Coordination*, in 5 HANDBOOK OF PUBLIC ECONOMICS (2013).

49. See *supra* note 14.

III. LITERATURE REVIEW: EMPIRICAL EVIDENCE ON ROBOT TAXATION

In Part III, the results of various published works purporting to comprise empirical evidence on robot taxation are summarized and reviewed. In each section, the purpose and results of the research are stated. Extensive citation bias is observed in some cases where the citation is given to responsive works that contain references to the original source materials on robot taxation; however, without citation to the original source because it contained conflicting theory or results. The degrees of freedom are also formally estimated with an indication of whether the amount of freedoms are sufficient to reverse the stated results of the respective empirical analysis.

A. Technequality (Statistical Trends in EU Public Finances Related to Robots)

The authors purport to investigate by empirical methods a potential relation between public finances and automation within the European Union.⁵⁰ A methodology section is not provided as the methods are solely pattern analysis and no hypothesis is presented for testing. The discussion section provides an economic literature review presented as three modeling premises of the potential effects of rapid automation processes, including: (i) displacement effects,⁵¹ (ii) reinstatement effects,⁵² and (iii) productivity gains from automation.⁵³ The paper does not address a primary concern with the prior literature, that an over-investment in robots may have occurred due to the heavy tax incentives offered for automation and the displacement of human workers. Much of the analysis is presented as a response to risks to tax collections from rapid automation if taxpaying human workers were displaced with non-taxpaying robot workers, although no citation is given to the prior literature where those concerns were presented. A concern about a risk to the public fisc from the displacement of human taxpayers with non-taxpaying robots formed the basis for much of the initial literature on robot taxation.⁵⁴

50. TECHNEQUALITY, *supra* note 46, at 1–2.

51. See Acemoglu & Restrepo, *infra* note 54 (“At the heart of our framework is the idea that automation and thus AI robotics replace workers in tasks that they previously performed, and via this channel, create a powerful *displacement effect*.”).

52. See Bessen, *supra* note 4 (examining how, under certain circumstances, “productivity-improving technology” can actually increase employment).

53. See Graetz & Michaels, *infra* note 130, at 755 (concluding that an increase in the use of robots corresponded with an increase in productivity, a reduction in output prices, and “no significant implications” on total hours worked).

54. Daron Acemoglu & Pascual Restrepo, *Artificial Intelligence, Automation and Work* 1 (Nat’l Bureau of Econ. Rsch., Working Paper No. 24196, 2018) (“At the heart of

A primary motivation of the *Technequality* paper appears to be an empirically-based response to the thesis that rapid automation could lead to a decrease in tax receipts since human labor comprises much of the tax base.⁵⁵ Even having adopted a similar terminology, here “equality” for tech workers as opposed to “neutrality” between the taxation of human and robot workers as was given in the original research paper,⁵⁶ which appear to be synonymous, although the authors do not give source citation to the research question’s origins, suggesting citation bias.⁵⁷ As illustrated, the *Technequality* authors appear to refer to the initial Abbott and Bogenschneider paper on robot taxation directly although without citation: “Preceding studies argued that policymakers should be concerned about the sustainability of public finances when intelligent machinery replaces labor and undermines the basis of taxation.”⁵⁸ The *Technequality* paper on robot taxation is unique among empirical analyses given the quantity and degrees of freedom in the statistical methodology.

Enhanced Degrees of Freedom in Modeling Parameters. The *Technequality* paper applies at least eight degrees of modeling freedom.⁵⁹ Each of these degrees has the potential to vary results or cause results to appear to be meaningful when they are not. The presence of so many unexplained parameters indicates that the results have been engineered toward a particular finding based on the authors’ motivated reasoning, to push toward the conclusion that the public finances of European nations may not be at risk from rapid automation. These degrees of freedom are: (1)

our framework is the idea that automation and thus AI and robotics replace workers in tasks that they previously performed, and via this channel, create a powerful displacement effect.”).

55. See *TECHNEQUALITY*, *supra* note 46, at 1 (“When ATs diffuse and replace labor at a large scale, the tax basis might be significantly undermined. This argument is put forth to support that a robot tax is needed to ensure the sustainability of public finances.”).

56. Abbott & Bogenschneider, *supra* note 35, at 152 (“The advantage of tax neutrality as between human and automated workers is that it permits the marketplace to adjust without tax distortions. With a level playing field, firms should only automate if it will be more efficient, without taking taxes into account. Since the current tax system favors automated workers, a move toward a neutral tax system could increase the appeal of human workers. Policy solutions could even be implemented to make human workers more appealing than machines in terms of tax costs and benefits, to the extent policy makers choose to discourage automation.”).

57. Ferguson, *supra* note 33, at 535.

58. *TECHNEQUALITY*, *supra* note 46, at 32.

59. See *infra* notes 60–67.

technology type,⁶⁰ (2) stage of diffusion,⁶¹ (3) local conditions,⁶² (4) regions of Europe with different stated results,⁶³ (5) selection of 1995–2006 and 2008–2016 periods,⁶⁴ (6) lack of any baseline,⁶⁵ (7) different long run versus short run,⁶⁶ and (8) strong versus weak results.⁶⁷ Each of these parameters is sufficient to *reverse* the stated inferential results. For example, if we were to ignore a difference between “strong” and “weak” results, the conclusion of the paper would be directly reversed, that is, the weak evidence would indicate a decline in overall tax revenues from automation. Likewise, if we applied other time periods, such as any period post-2016 when automation processes were accelerating, the conclusion would apparently be reversed. Further, if we combined robots with ICT, the results would be stronger, and again the conclusion reversed. In the presence of not less than eight conditions sufficient for reversal, it seems plausible to presume that the empirical results were engineered toward one conclusion, and the true results were, under other reasonable assumptions, precisely the opposite of those presented. The authors have engineered the modeling parameters as reflected in a high number of degrees of freedom to achieve the desired empirical result. In lay terms, no reasonable person would apply all eight conditions simultaneously, the inferences presented are not real, and perhaps, even the opposite of those engineered by the authors.

Lack of Citation to Tax Technical Sources, resulting Errors. A lack of source citations appears to have also led to incremental empirical and tax

60. *TECHNEQUALITY*, *supra* note 46, at 2 (“We find that the impact of automation depends on the technology type and the phase of diffusion.”).

61. *Id.*

62. *Id.* at 3 (“We find: It depends (a) on the type of technology that is considered, (b) on the stage of diffusion, and (c) on local conditions. We provide structural arguments that enable a better understanding of locally specific conditions, the economic impacts of automation and macro-level effects on taxation.”).

63. *Id.* at 20 (“We observe both the share of labor and capital taxation to be positively correlated with factor income shares at the expense of taxes on goods. These observations are robust across different regions and sub-periods . . .”).

64. *Id.* at 22 (“After 2008, we do not observe significant effects on labor market outcomes in automation-intensive industries. We also do not see that automation has any significant impact on capital accumulation and valuation for all periods and sub-periods. [] These relationships are more prevalent before 2007.”).

65. The lack of baseline refers to comparisons of tax rates and revenue of a base amount, then modified at a later period in comparison to the base amount. The failure to establish a baseline for comparison renders nearly all the anecdotal analysis presented unviable.

66. *TECHNEQUALITY*, *supra* note 46, at 32 (“Overall, our findings suggest that there is no strong empirical evidence supporting that tax revenues are negatively affected ATs in the long run.”).

67. *Id.*

technical errors in the respective analysis. As an example, the Technequality authors write: “[B]ut there is no clear reason to assume that automation decisions are affected differently from taxation compared to all other forms of capital investments.”⁶⁸ Strangely, the authors seem to deny any basis for research into robot taxation, which is the topic of their own paper, indicating that the empirical analysis was to deny the implication of the prior research that automation processes are unique because of the non-neutral taxation for labor. Such a “clear reason” for firm decisions as to automation were described extensively in the prior literature on robot taxation, which are to avoid firm level taxes directly or indirectly levied on labor that are not levied on robots as a type of capital investment.⁶⁹ As was previously explained in the literature on robot taxation, firms obviously do not pay social insurance taxes for automated workers in either Europe or the United States, let alone VAT or other type of taxes, which is perhaps the clearest explanation possible of tax avoidance by multinational firms via automation of production processes, contrary to the assertion of the Technequality authors.

Omitted years, period 2016 to 2020. Conspicuously, *not* included in the Technequality paper was data for the year 2007, and for the period 2016–2020. Similar data should have been available to the authors, however. The results in later years may have been inconsistent with the stated results for the given periods 1995–2006 and 2008–2016. The selection of the latter periods appears to be the possible omission of years with conflicting data to present inferential results. The error in omitting 2016–2020 is particularly acute given that automation processes appear to have been accelerating in those years. Furthermore, although the Technequality analysis is backward-looking, no limiting discussion was provided relating to the likely effects of increasing degrees of automation in the forward-looking years from 1995 to the present day, such as the potential for self-checkout machines, self-driving trucks, and other types of automation that were not present during some of the years under review.

Lack of Causal Analysis. The Technequality paper further began with an acknowledgment that no attempt to describe causation was attempted in the study. Despite their lack of causal evidence, the authors found “that the

68. *Id.*

69. Abbott & Bogenschneider, *supra* note 35, at 166 (“The indirect tax system also benefits automated workers at the firm level. Indirect taxation refers to taxes levied on goods and services rather than on profits; the primary examples are the Retail Sales Tax (RST) levied by states and municipalities in the United States and the VAT in most other countries. Employers are thought to bear some of the incidence of indirect tax, as worker salaries and retirement benefits must be increased proportionately to offset the indirect tax. In the case of automated workers, however, the burden of indirect taxes is entirely avoided by the firm because it does not need to provide for a machine’s consumption.”).

impact of automation depends on the technology type and the phase of diffusion,” citing the inverse relationship between robots and aggregate tax revenues.⁷⁰ However, the paper is replete with causal references, and descriptions are given in causal terms throughout the paper.

Illustrations of causal references are as follows:

- (a) “At the country level, the overall effect on labor income was positive We also find evidence for a weak increase in aggregate demand. These effects taken together offer an explanation for the shift from capital taxes towards an increasing relative importance of taxes on labor”⁷¹
- (b) “We find partial support for a robot-induced replacement effect. On the other hand, ICT technologies appear to be labor reinstating”⁷²
- (c) “We observe similar differences across time for the impact of ATs on capital valuation, real income and consumption”⁷³

Errors in Identification of Empirical Research Question. The Technequality authors make a noteworthy claim regarding the scope of their own research: “Instead, we are the first who study empirically the relationship between automation and tax revenues taking adoption decisions as given.”⁷⁴ Here, the idea is that the respective empirical research performed is unique because it excludes taxes from the decision matrix of firms in deciding whether to automate. So, where the original research into robot taxation explained in detail the tax benefits to firms from automation, that is the tax savings resulting from a decision to replace human workers with robot workers, here the idea is that taxes do not have any impact on economic decision making at all — essentially the opposite assumption of all econometric analyses that taxes do affect firm decisions at least at the margin. Unfortunately, in research of this nature, there is typically no way to separate in the empirical datasets decisions made in spite of taxes or as a result of taxes. Therefore, the supposed research question investigated by the Technequality authors simply cannot be answered with the dataset available.

The given results of empirical analysis presented in some sections of the Technequality paper are also confusingly inconsistent with those described in the conclusion section within the same paper. The introduction or summary section of the paper connects declining factor and tax income with that advent of robot labor in the years preceding 2007, a result which is then

70. TECHNEQUALITY, *supra* note 46, at 2.

71. *Id.* at 30.

72. *Id.* at 31.

73. *Id.*

74. *Id.*

denied in the conclusory section of the same paper.⁷⁵

Compare these first two assertions with the third:

- “Until 2007, robot diffusion [led] to decreasing factor and tax income, and a shift from taxes on capital to goods.”⁷⁶
- “We also observed a negative relationship with labor taxes, though less significant.”⁷⁷

With:

- “Overall, our findings suggest that there is no strong empirical evidence supporting that tax revenues are negatively affected ATs in the long run.”⁷⁸

Switching of Research Question in the Conclusory Section to Imply Meaningful Results. The given findings of the *Technequality* paper do not appear to relate directly to the given research questions. The authors write: “[W]e do not observe any significant relationship between ICT and labor income, but instead [with] capital income [sic] rising.”⁷⁹ The authors seem to have shifted the inquiry as to whether the aggregate tax base changed, rather than whether the tax base was shifted from one taxpayer to another. However, the shifting of the tax base from capital to labor obviously does not require a change in the aggregate tax base. Government policymakers might be expected to maintain the tax base and could adjust the collections from one tax base to another to maintain a set of fixed expenditures, that is to increase the taxes levied on labor income or goods and services purchased by labor since less tax was collected from capital. Therefore, one would not necessarily expect to observe a change in the aggregate tax base even if automation was directly affecting the composition of the tax base. Furthermore, the *Technequality* authors identify a strong increase in capital income without a corresponding increase in capital taxes, thus implying a relative shift in taxation, as previously identified in the literature, again neither cited nor discussed in the paper.⁸⁰ The findings then of the authors are given as platitudes that do not have research significance nor relate to the dataset which was the subject of analysis.

75. *Id.* at abstract; *see id.* at 31 (“We find partial support for a robot-induced replacement effect.”).

76. *Id.* at abstract.

77. *Id.* at 30.

78. *Id.* at 32.

79. *Id.* at 31.

80. *See id.* at 31–32 (detailing how the authors recognized an increase in capital income without an increase in taxation after 2008).

*B. Tax Foundation (Neoclassical Economics, General
Equilibrium Modeling)*

The Tax Foundation maintains a simple abstract model of the economy, similar to various government agencies including the Congressional Budget Office, intended to make it possible to render predictions about the effects of a change in tax policy.⁸¹ The Tax Foundation has issued press releases opposed to the taxation of capital, including that of large corporations beyond merely the context of robot taxation.⁸² It has updated its modeling for robot taxation and reached the counterintuitive result: *Increasing the tax burden on automation hurts workers*. Here, the details of the modeling processes followed by the Tax Foundation have not been provided so they cannot be comprehensively summarized for purposes of the literature review. The focus of the press release on robot taxation by the Tax Foundation relates primarily to the findings or conclusions of the abstract modeling claimed to have been performed.

The conclusion appears to be based on a simple general equilibrium model where robot taxes are presumed to be shifted to workers — that is, with any type of corporate tax, including an automation tax, the tax is shifted to workers. As one variable is changed within the equilibrium model it is possible to make projections of resulting changes to other variables in the economy, under the given assumptions of the model, especially as capital taxes are taken to relate to GDP. If the corporate tax is shifted to workers, then the conclusion is that robot taxes hurt workers as all corporate taxes would be presumed to be paid by workers anyway. The further implication is that some workers might wish to tax robots because they have lost their job due to automation, which might be counterproductive in economic terms. The Tax Foundation suggests that robots are further alleged to carry a “tax burden.”⁸³ However, automated or robot workers currently do not pay any taxes either directly or indirectly in the United States. By purchasing robots, firms obtain an accelerated tax deduction comprising incremental benefits, not burdens, for both book and income tax accounting purposes. We have then, in the work of such tax organizations, obvious technical errors in misunderstanding how the tax system works in practice. Robots yield a tax

81. See *Who We Are*, TAX FOUND., <https://taxfoundation.org/about-us/> (last visited Jan. 12, 2022). See generally Milton Friedman, *Essays in Positive Economics* (1953) (theorizing about scientific assumptions, hypotheses, and predictions).

82. See Garrett Watson, *Increasing the Tax Burden on Capital Investment and Automation Hurts Workers*, TAX FOUND. (Nov. 12, 2020), <https://taxfoundation.org/increasing-the-tax-burden-on-automation-hurts-workers/> (explaining that tax policy does not favor capital investments like robot automation or put workers at a disadvantage).

83. See *id.*

benefit to firms from accelerated tax deductions from capital investment where deductions are taken faster than if wages were paid to human workers for the same work.

The abstract modeling performed by the Tax Foundation differs from that of the Technequality empirical analysis because it does not attempt to find patterns in statistical datasets to show actual facts related to the economy, but instead uses a model with built-in assumptions to predict the directional effects of changes to tax policy. Only neoclassical economic theory is applied in the modeling assumptions and process, however. In respect of robot taxation and policy, the result of abstract modeling of a tax increase on automation is the same as any proposed increase in tax on capital. Accordingly, the model is largely unnecessary to inform the direction of tax policy as the model would always favor tax cuts to capital and shifting as much of the tax burden to labor as possible. The direction of change is always the same, irrespective of the current or future tax rates on each factor of production because the economic theories of tax incidence and international tax competition largely eliminate any need to perform modeling because the directional effect is always the same. In other words, even if labor was taxed at 50% and robot capital taxed at 2%, the model would still call for a reduction of tax to capital from 2% to 0% because of the neoclassical parameters applied within the model. The broader purposes of the model are thus to attempt to quantify economic loss from a tax increase or economic benefits from a tax cut, and to give some pretense of modeling beyond mere theory. A limiting factor of the abstract model is of course that tax increases have at times led to increased economic growth, which the neoclassical model obviously would not be able to predict or explain.

Since the abstract modeling performed by the Tax Foundation is premised entirely on neoclassical economic theory, any review of the model then devolves into a discussion of problems within economic theory. Also, since no statistical or empirical data is used in the abstract modeling, any critique relates predominantly to the tax technical errors rather than to limitations in the data. Thus, there are three tax technical errors within the modeling that limit the viability of the results: (i) tax parity between taxation of human and automated workers; (ii) use of marginal tax rates in abstract modeling; and (iii) positing of productivity gains from automation contrary to or without evidence.

Tax parity between taxation of human and automated workers. The initial paper on robot taxation introduced a new concept of tax neutrality between human workers and robot workers. The idea was that automated workers might be less productive than human workers because the return on investment to firms was evaluated post-tax, and that firms may have been chasing the tax benefits from capital investment in a decision to automate.

The topic was extensively debated and cited by other scholars in various fields reflecting a broad consensus that capital is favored under the current tax system.⁸⁴ The Tax Foundation author appears not to have reviewed the tax literature on robot taxation and identified a similar issue, which he referred to as “tax parity” rather than tax neutrality, as was originally proposed.⁸⁵ The Tax Foundation generally argues for such tax incentives to capital as a means to encourage tax motivated investment in the economy. The author proposes the same general idea for robot workers as all capital investment, where the idea is that since labor expense is immediately deductible whereas capital investment is not, this appears to favor labor.⁸⁶ Error was introduced insofar as the discredited ideas within neoclassical economic theory related to immediate expensing of labor costs in comparison to deductions for capital investment. The Tax Foundation author writes: “Labor costs can already be fully deducted from taxable income when they are incurred. Full expensing for capital investment merely ensures that capital is treated symmetrically in the tax code.”⁸⁷ For example, research and development costs allow for immediate deduction of some aspects of robot production and development.⁸⁸ Likewise, accelerated depreciation allows for faster deductibility of capital expenditures, such as robots.⁸⁹

The conclusion given by the Tax Foundation that current law allows full expensing to labor but not capital is objectively wrong, however. The error occurs because capital investment is incurred up front and on a lump sum basis that is depreciated, or taken into account, over time, whereas workers are paid as services are rendered each year. In other words, the capital asset is durable and lasts for many years. As an example, if a robot worker costs \$1 million and lasts for 5 years, whereas a human worker costs \$200,000 per year for 5 years, immediate expensing of the \$1 million for the robot worker yields a major benefit for the company, as the full \$1 million is deductible in year one, which is more valuable due to the time value of money. Even if only one half of the expenditure is deducted in year one, this still yields a

84. See generally Orly Mazur, *Taxing the Robots*, 46 PEPP. L. REV. 277, 280 (2019) (noting a concern that “the increase in profits that robots create will primarily benefit the few companies driving the automation, which will further intensify the existing inequality in the distribution of income, wealth, and influence”); Jay Soled & Kathleen Thomas, *Automation and the Income Tax*, 10 COLUM. J. TAX L. 1, 4 (2018) (“[A] significant disparity still exists between the tax treatment of labor and capital . . .”).

85. Watson, *supra* note 82.

86. See *id.*

87. *Id.*

88. I.R.C. § 174.

89. *Id.* § 168.

\$500,000 rather than a \$200,000 tax deduction which favors capital, not labor.⁹⁰ Accordingly, the Tax Foundation has erred in the discussion of robot taxation based on the value of accelerated tax depreciation on an expensive capital asset, such as a robot or other types of ICT.

Use of marginal tax rates in abstract modeling. The Tax Foundation correctly refers to the use of marginal tax rates in economic modeling, as a response to prior critiques of the low effective tax rates on capital. Although not explained in the discussion, it seems likely that the Tax Foundation's general equilibrium model follows the standard approach within econometric modeling, which is to use marginal tax rates as the levies in the model. For example, if the U.S. corporate tax rate is 21% less than applicable deductions that may yield an effective tax rate of 5% or less, the econometric modeling still inserts the 21% statutory rate because that is considered the marginal rate. The idea is that firms only undertake capital investment to yield a marginal return and that any extra return is taxed at the marginal rate only. However, that reflects error since firms do apply the average (or effective) tax rate in the modeling for capital investment. To its credit, the Tax Foundation discusses the potential for use of effective tax rates in econometric modeling; however, since that was not done in their model the given results are not reliable.

Positing productivity gains from automation contrary to or without evidence. Numerous economists referred to the presumption of efficiency gains from automated workers in comparison to human workers. The idea appears to be that robotic arms on a vehicle assembly line must be more efficient than human workers. But that idea is not so obvious. As has been previously explained, because the tax system heavily favors robots or automated workers it may be that human workers were more efficient in production than some automated workers, and that firms placed automated workers into service because of the tax advantages therefrom. The issue of whether productivity gains result from automation is accordingly unclear. Productivity losses may result from tax-motivated investment in automated workers. Likewise, efficiency gains could result from the reversal of tax incentives for capital that lead to an overinvestment in automation. The preference for capital investment is extreme under the current tax system which presents strong anecdotal evidence of the latter.

C. Information Technology and Innovation Foundation (The Case Against Taxing Robots)

The ITIF's paid advocacy analysis was presented as: *The Case Against*

90. See Abbott & Bogenschneider *supra* note 35, at 164–66.

Taxing Robots.⁹¹ Although the paper does not present any original empirical data on robot taxation, it has been cited by other empirical scholars and at once constituted the first result on any Google search for “robot taxation,” thus meriting further discussion.⁹² The review is based on the original paper’s organization which was presented as a series of empirically-based claims. Each of which is connected to the summary and deemed causal to comprise the case against a robot tax. Here, there is no empirical analysis performed so the literature review is presented as limitations on results interpreting the same or similar data as presented by the ITIF author.

Robots and Automation Do Not Reduce Employment. The empirical literature does not fully support the paper’s assertion or causal claim, although some economists have published theoretical papers suggesting that might be the case.⁹³ Economic scholars broadly agree that robots and automation do displace workers, especially “routine workers,”⁹⁴ but disagree on whether what has been referred to as a reinstatement effect that may be large enough to mitigate the displacement effect.⁹⁵ Some empirical studies

91. Robert D. Atkinson, *The Case Against Taxing Robots* 10 (May 29, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3382824.

92. Google search for “robot taxation” performed July 7, 2011, 4:51 P.M. yielded a result for *The Case Against Taxing Robots*.

93. Sotiris Blanas et al., *Afraid of Machines*, ECON. POLICY 628, 628 (2019) (“The results suggest that software and robots reduced the demand for low- and medium-skill workers, the young and women, especially in manufacturing industries; but raised the demand for high-skill workers, older workers and men, especially in service industries. These findings are consistent with the hypothesis that automation technologies, contrary to other types of capital, replace humans performing routine tasks.”); Graetz & Michaels, *infra* note 130, at 766–67 (“We find no significant relationship between the increased use of industrial robots and overall employment, although we find that robots may be reducing the employment of low-skilled workers.”); Terry Gregory et al., *Racing With or Against the Machine? Evidence from Europe* 3 (CESinfo Working Paper No. 7247, 2018) (“Firstly, RRTC reduces labor demand through *substitution effects*, as declining capital costs incentivize firms in the high-tech tradable sector to substitute capital for routine labor inputs, and to restructure production processes towards routine tasks. Secondly, RRTC induces additional labor demand by increasing product demand, as declining capital costs reduce the prices of tradables — we call this the *product demand effect*. Thirdly, *product demand spillovers* also create additional labor demand: the increase in product demand raises incomes, which is partially spent on low-tech non-tradables, raising local labor demand.”).

94. Blanas, et al. *supra* note 93, at 633 (citing David H. Autor et al., *The Skill Content of Recent Technological Change: An Empirical Exploration*, 118 QUART. J. ECON. 1279 (2003)) (“Recent task-based approaches have found that the employment shares and wages of workers in routine occupations, who happen to fall in the middle of the wage distribution, have declined.”).

95. Acemoglu and Restrepo, *supra* note 54, at 2 (“We argue that there is a more powerful countervailing force that increases the demand for labor as well as the share of labor in national income: *the creation of new tasks*, functions and activities in which

have catalogued a displacement effect larger than any reinstatement effect at various times and in various regions.⁹⁶ The so-called “reinstatement effect” is also misleading because it implies that the same workers that lose jobs due to automation may be reinstated in new jobs later, a view which is not at all supported by the empirical literature. If there is a reinstatement effect, all empirical scholars seem to agree that it would involve a few highly skilled workers earning high salaries substituting for perhaps many lower skilled workers subject to replacement by automation.

Firms That Adopt Robots Still Pay Taxes. Three Pinocchios should be assigned to the ITIF on this false assertion. Firms do not pay wage taxes or indirect taxes for robots or automated workers that are indeed otherwise payable on human workers. The prior literature has catalogued the categories or types of taxes avoided by using robot or automated workers.⁹⁷ By automation, firms also reduce their relative income taxation by the acceleration of deductions from capital investment generally without reduction to reported earnings for the purposes of generally accepted accounting principles (“GAAP”).⁹⁸ If there were a reduction in GAAP earnings, even with cash tax savings, most multinational firms would probably not be as interested in automation. Accordingly, cash tax savings, albeit *without* a reduction in reported earnings, are necessary to foster capital investment in automation through the tax code. Notably, each of these necessary conditions are present under current tax and accounting standards. Although many high technology companies pay little, if any, income taxes, it is possible that some firms might after automating to some degree. However, these firms pay very low effective tax rates, especially after the Tax Cuts and Jobs Act, which reduced the statutory corporate tax rate to twenty-one percent.⁹⁹ Any taxes paid by capital are magnitudes less than the effective tax rates paid by human workers in comparison. By analogy, the argument that robots still pay taxes is akin to saying that lettuce still has calories in comparison to donuts. The claim is technically true but is

labor has a comparative advantage relative to machines.”).

96. *Id.*

97. See Abbott & Bogenschneider, *supra* note 35, at 164–67.

98. *Id.* at 166 (“Where tax depreciation is accelerated relative to *book* depreciation (the amount reported on financial statements), a firm may generally claim a profit (or earnings benefit) to reported earnings from the tax benefit. Thus, a large corporation enjoys a book benefit to reported financial earnings from the differential in depreciation periods. Any firm seeking to accelerate reported earnings could use automation to achieve such a timing benefit. This increase to reported earnings may be an even more significant motivation for large firms to automate than a cash tax savings.”).

99. Tax Cuts and Jobs Act of 2017, Pub. L. No. 1197, 131 Stat 2054 (codified as amended in scattered sections of the I.R.C.).

misleading to readers that are not tax experts and unable to gauge the very low rates of tax paid by large multinationals in the present day.

Tax Incentives for Investing in Robots Spur National Economic Competitiveness. Although this assertion may seem intuitively correct to persons who have taken an introductory course in economic theory, the tax technical literature has drawn that claim into significant doubt. This is because tax deductions are worth more to multinational firms within higher tax jurisdictions than elsewhere. Firms that are profitable around the world, including most U.S. multinationals, may choose to make capital investment in higher tax jurisdictions to claim the tax deductions from capital investment. Therefore, capital investment for automation should be expected to flow into higher tax jurisdictions and not away, which is ironically, exactly what we observe in empirical terms but has not been identified by empirical researchers.¹⁰⁰ Most automation investment seems to flow into and not away from higher tax rates. Aggressive tax avoidance planning, including transfer pricing techniques, can then be used to remove any taxable income arising from the automation to other jurisdictions to avoid any residual tax. In any case, the gross income of firms is also taken to be simply maintained, and not increased, from a transition of human workers to robot workers with the primary benefit being cost savings. For example, where a profitable multinational firm has a production facility in both Japan, which levies taxes at very high rates, and the United States, which levies taxes at moderate rates, the tax accountants at that firm may maximize the value of tax deductions by channeling the investment into Japan whilst simply ignoring the potential for future income from the capital investment. The availability of aggressive tax avoidance planning and transfer pricing to multinational firms enables them to avoid any ultimate tax anyway. However, these techniques are ignored within neoclassical economic theory because firms are thought not to bear the incidence of wage taxation. However, the very existence of aggressive tax avoidance indicates that firms behave as if they do bear the incidence of both capital and wage taxation at least to some significant degree.

Taxing Robots would Slow GDP Growth. An empirical assertion about the potential for slowing GDP growth by taxation is really the core economic claim that concerns capital investors with any robot tax proposal. Note, however, that the policy matter involves shifting of the tax base further from capital to labor. As firms substitute automated workers, the tax base is proportionately reduced and less funds are paid into social security and other programs. So, the assertion is not whether any taxes reduce GDP growth;

100. See *supra* Figure 1.

rather, assuming that taxes are to be payable by persons with a given society, the appropriate question is really whether robot taxes reduce GDP growth more than taxes levied directly on workers. This is not necessarily to posit taxes as a zero-sum game, but to simply acknowledge the potential for differing efficiency results under relatively higher taxation of labor. Neoclassical economic theory suggests that any capital taxes may reduce economic growth, but there are strong technical reasons to doubt this claim. Furthermore, little or no reliable empirical evidence has ever been presented by economists that capital taxes reduce economic growth. As illustrated in Figure 1, higher taxes are associated with faster economic growth in most nations. This is also true within lower tax nations over time, including the United States. Lower tax nations experience slower economic or GDP growth than higher tax nations, with a lesser association in the United States. The broad mobility of capital around the world over the past seventy years strongly indicates that if capital migrated away from taxes, the opposite empirical data should have been observed where higher tax nations experienced diminished rates of economic growth. The key tenant of neoclassical economic theory, that GDP growth might be negatively affected by higher tax rates on capital as such increases, seems unlikely. Rather, robot taxes may serve as a boon for capital re-investment for firms seeking to reduce taxes by obtaining tax deductions for capital investment.

Governments Need to Tax Robots Because There Will Be Little Else Left to Tax. The origins of this claim by the ITIF are unclear and, since they are not cited, may comprise a straw man fallacy. The primary concern of tax scholars is not that there will be nothing left to tax, but instead, that in lieu of a robot tax more of the tax base will be shifted to labor as large corporations automate and thereby fail to pay much or any taxes. Many tax experts in the United States have discussed a potential for implementation of a VAT or possibly a wealth tax as opposed to a robot tax, which in comparison is a relatively new tax policy proposal.¹⁰¹ In the future, if revenue needs from taxation increase or become more desirable, as opposed to incremental borrowing, it seems entirely possible that a debate will ensue on whether a VAT, wealth tax, or robot tax is most advantageous. In empirical terms, however, there is no limitation on implementing only one, or all of these together, or possibly even simply taxing only human labor and exempting the wealthy and large corporations from any taxation at all, as many economists would prefer. For example, if we follow the reasoning of neoclassical economic theory, one might simply increase levies against

101. See, e.g., Reuven S. Avi-Yonah, *Designing a Federal VAT: Summary and Recommendations* (June 2009) (unpublished manuscript) (on file with the University of Michigan Law School's Law & Economics Working Papers Archive: 2003–2009).

workers from the current rates of roughly 50% to 60%, to perhaps a 90% effective rate, and thereby eliminate all other forms of taxation entirely, such as a robot tax or even the corporate tax. As the tax rates on human workers trend toward full taxation of 100%, however, this would again ironically seem to be a type of socialism. In this neo-socialism of full tax exemption for large corporations, people would be required to perform work, except all the profits from work would be transferred to either the government or their employers and persons could live only by government-transferred payments. Essentially, workers would receive very little or possibly even no money from performing work on behalf of their employers. From this perspective, some taxation of capital is actually required to avoid a type of feudal-style socialism, which inspired many of the libertarian theorists in 19th century Britain during the Industrial Revolution when automation was also a major policy issue. The discussion seems to have come full circle as to whether human workers are entitled to much or any of the fruits of their own labor given the extremely high rates of wage taxation and the refusal by unwilling governments to levy tax on the wealthy or large corporations.

Ad hominem attacks. In the ITIF paper, each section of the paper begins with personal attacks directed at scholars that have written on robot taxation by calling them bad names or implying they are liberals, and so on.¹⁰² Reference was also made to news reporting in the New York Times, except without any credit to the existence of the scholarly research underlying the news reporting, implying that the news reporter had simply made up all of the tax technical analysis related to robot taxation rather than reported on legitimate scholarly research.¹⁰³ The ITIF also does not provide a funding disclosure of the organization and appears to function as a tech lobbying organization as it relates to robot taxation.

D. Tyers & Zhou (Robot Tax for Redistribution Model)

The Tyers and Zhou paper described automation as a governmental policy decision with international rivalry largely between the European Union, China, and the United States.¹⁰⁴ Tax effects are described not as a result of

102. See, e.g., Atkinson, *supra* note 25, at 7 (“Many on the tax robots bandwagon have argued for taxing robots because otherwise inequality will grow, particularly because the share of total income going to labor will fall.”).

103. See Eduardo Porter, *Don't Fight the Robots. Tax Them.*, N.Y. TIMES (Feb. 23, 2019), <https://www.nytimes.com/2019/02/23/sunday-review/tax-artificial-intelligence.html>.

104. Rod Tyers & Yixiao Zhou, *Automation, Taxes and Transfers with International Rivalry* 8–9 (Ctr. for Applied Macroeconomic Analysis, Working Paper No. 44/2018, 2018), https://cama.crawford.anu.edu.au/sites/default/files/publication/cama_crawford_anu_edu_au/2018-09/44_2018_tyers_zhou.pdf.

automation, but as a governmental design potentially to offset displacement of lower-skilled workers due to automation. In tax terms, this modeling approach reflects an earmarking of special taxes to particular projects related to automation. The premise is that either capital or consumption taxes could be implemented with the funds targeted specifically to offset the harms caused to particular persons by rapid automation. Specific reference to China was given from the command description policy decisions reflected in the modeling, which might be considered most relevant to that nation as it is not clear whether the United States has the policy flexibility to implement such a command framework even if policymakers wanted to do so.¹⁰⁵ The effects of the tax increase intended to offset the effects of automation were then modeled and described in Rawlsian and utilitarian terms. The Rawlsian goals of the incremental tax were ultimately found to be met in Europe, but not in other jurisdictions. However, other economic results were found to be negative due to the taxation of mobile capital.¹⁰⁶

Potential Diminishment of Tax Base. Tyers and Zhou gave some indication that they are aware of the differences in the design of the tax system between China and the United States.¹⁰⁷ However, it is possible that these differences were not investigated in the draft version of the initial paper on robot taxation which explained the potential for diminishment in the tax base, especially in the United States, due to its heavy reliance on the taxation

105. *Id.* at 18–19 (“Next consider the financing of the policy by increases in the tax rates on capital income. Under a Rawlsian criterion all regions would implement the policy as before, though by a small margin the low-skilled would prefer collective rather than unilateral implementation. By the other criteria the US would not, the EU might on total welfare grounds and the Chinese would not. Stabili[z]ing the Gini by this means would require capital income tax rates to rise by about 15 percentage points for the three regions. This would be politically difficult, though more affordable in the case of China than the consumption tax option. If, by some means, the three large economies were forced to implement the policy, a total welfare criterion would have them preferring to finance it by capital income taxation, while a real GDP criterion would see governments preferring the consumption tax.”).

106. *Id.* at 19–20 (“In our modelling we first examine whether there is a national, economic, first-mover advantage in implementing automation by individual countries, finding no evidence for this due to positive economic spill-overs that act through capital earnings and financing costs. Indeed, unless Rawlsian policy criteria are ubiquitous, in which case governments would resist implementation, the technology twist is a dominant strategy for all regions. We then turn to balance-preserving fiscal interventions to inhibit changes in income inequality, focusing on the earned income tax credit system and the stabili[z]ation of the Gini coefficient. With the preservation of fiscal balance we find only weak spillover effects, even where financing is via taxes on income from internationally mobile capital. [] [I]nternational spillovers from interventions that retain fiscal balance appear too small for there to be a more egalitarian global equilibrium.”).

107. *See id.* at 17.

of labor.¹⁰⁸ In any case, the results of the paper are limited by the lack of empirical modeling of a potential diminishment of the tax base from automation processes that displace human workers and replace them with robots or automated workers.

Earmarking Tax to Worker Displacement Due to Automation. The tax technical literature differs broadly from the public policy literature of other social scholars writing about potential changes to tax policy as it relates to the *earmarking* of tax proceeds from a particular policy proposal. Tax lawyers and accountants usually do not earmark tax proposals to particular projects. If a tax levy is proposed, it is typically presumed by tax experts that any proceeds would be paid to the general fund. Social science scholars often do propose earmarking, as was famously recommended in respect of the taxation of sugar sweetened beverages.¹⁰⁹ Here, the social idea is that taxes are a means to influence a social outcome, both by economic means of deterrence of an undesirable social behavior through taxation (i.e., “If you want less of something, tax it”), and also, the spending of the tax revenue on social programs related to the social issue. Regarding the sugar beverage taxation, the social program proposed was a re-education program for social classes that chose to consume sugar beverages.¹¹⁰

In the context of robot taxation, the social program often proposed is referred to as Universal Basic Income (“UBI”).¹¹¹ The idea is that displaced workers would receive a minimum government stipend as their jobs are eliminated by automation. If someday, all human jobs were eliminated by automation, as a few futurists have proposed, then all persons would presumably receive such a UBI stipend. However, any discussion of social programs to be purchased with tax revenue from robot taxation undermines one of the key aspects of tax policy relevant to the discussion, which is that human workers pay taxes at nosebleed rates. If it is true that “*if you want less of something, tax it*,” then, in the United States at least, the activity subject to tax is productive work. A skeptic might presume that U.S. policymakers have done everything possible to discourage productive work by human workers, as opposed to robots or automated workers. Although the disincentive effects to lower-income persons from high wage taxes are not considered within economic theory, reliable empirical data to support

108. Abbott & Bogenschneider, *supra* note 35.

109. See Kelly Brownell et. al., *The Public Health and Economic Benefits of Taxing Sugar-Sweetened Beverages*, 361 NEW ENG. J. MED. 1599 (2009).

110. See Kelly Brownell & Nicole L. Novak, *Taxation as Prevention as a Treatment for Obesity: The Case of Sugar Sweetened Beverages*, 17 CURRENT PHARM. DESIGN 1218 (2011).

111. See Cynthia Estlund, *What Should We Do After Work? Automation and Employment Law*, 128 YALE L.J. 254, 323 (2018).

that modeling parameter does not yet exist, and there are strong anecdotal reasons to think that the reduction of the high taxes levied on workers would have positive and salient social effects. An offset or slowing of the rapid shifting of the tax base from capital to labor is a key benefit of robot tax proposals and the discussion of a UBI earmark to be paid to non-working adults from the proceeds of robot taxes is really a separate policy objective which might be debated based on its own merits.

E. Guerreiro, Rebelo & Teles, Automation and Income Inequality Modeling (Should Robots be Taxed?)

The Guerreiro et al., paper compares potential efficiency results and relative inequality under several modeling parameters related to automation and effects on labor demand.¹¹² The modeling proposals are broadly that of Mirrless' optimal taxation and a modification of the Heathcote, Storesletten, and Violante model for lump sum tax rebates to taxpayers.¹¹³ The paper relates in significant part to the design of optimal taxation systems, which are largely hypothetical inquiries within doctrinal econometrics so research inquiry along these lines is then how robot taxes may fit within economic ideas about optimal taxation. Since robot taxes are a type of capital, where capital taxes are universally disfavored as a matter of optimal taxation, the line of inquiry of Guerreiro et al., seems to be whether inequality considerations may change that result and to model various tax re-configuration scenarios based on projected changes to the demand for labor.

Economic Modeling relates to Unrealistic Tax Proposals. The Mirrless and other modeling proposals given by Guerreiro et al., are widely debated based on the technical grounds of econometrics and economic theory. However, it is unclear whether or how such optimal tax proposals could be implemented in practice and would require significant changes or “re-

112. Joao Guerreiro et al., *Should Robots Be Taxed?* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23806, 2020).

113. See Emanuel Gasteiger & Klaus Prettnner, *A Note on Automation, Stagnation, and the Implications of a Robot Tax 2* (Sch. of Bus. & Econ. Discussion Paper 2017/17, 2017) (“While the standard neoclassical growth models of Solow (1956), Cass (1965), Koopmans (1965), and Diamond (1965) lead to remarkably similar predictions with regards to the growth effects of household’s savings behavior and investment decisions, they lead to diametrically opposed predictions with regards to the growth effects of automation. Models of automation based on Solow (1956), Cass (1965), and Koopmans (1965), in which households save a part of their wage income and a part of their asset income, imply that automation could lead to perpetual long-run growth even without (exogenous or endogenous) technological progress. However, models of automation based on the canonical overlapping generations (OLG) framework of Diamond (1965), in which households save *exclusively* out of wage income, imply economic stagnation in the face of automation.”) (citations omitted).

configurations” of the tax system in the United States, which appear to be politically infeasible. As the authors wrote: “Mirrleesian tax systems are known to be complex and potentially difficult to implement in practice.”¹¹⁴ The discussion of the robot tax in relation to sweeping policy changes is only broadly helpful to tax policy discourse. A tax rebate proposal along the lines of Heathcote et al., appears to be similar but not identical to a UBI funded by robot taxes, as modeled by other economists. A potential difference between a tax rebate and UBI would be that a non-refundable rebate would only be payable to individual persons working and thereby potentially paying income taxes. The Earned Income Tax Credit (“EITC”) is partly a refundable credit where income tax liability is not required. Notably, the issue of income tax refundability and the EITC is often confused because the EITC is similar in quantum to wage withholding taxes as opposed to income taxes.

Other Means to Reduce Inequality. A policy objective of the Guerreiro et al., paper is the reduction of inequality in the United States by or through the tax system, particularly as it relates to routine workers.¹¹⁵ Presumably, routine workers are lower-income wage workers. Guerreiro et al., reasonably investigate under what modeling conditions a robot tax levied on capital might reduce inequality.¹¹⁶ However, a simpler and more direct means to reduce inequality would be simply to reduce wage taxes on lower income workers, either using the proceeds of any robot tax or perhaps not. As at least one philosopher has identified, the goal of reducing the taxes paid by routine workers may be a difficult objective in policy terms.¹¹⁷ A more realistic policy objective may be to slow down the increasing acceleration toward the heavy taxation of workers, particularly in the United States. In simple terms, if the goal is to reduce inequality in the United States, the most direct means to do so would be tax cuts for lower-income persons, who often are subjected to average tax rates over fifty percent, or at least not to increase those taxes any further.

Tax Rebates (or UBI) with Sources of Revenue other than Robot Taxation. The premise of the Guerreiro et al., paper is the potential for robot taxes to reduce inequality.¹¹⁸ The modeling is then performed based on a re-

114. See Guerreiro, et al., *supra* note 112.

115. *Id.* at 1 (“Our model has two types of occupations, which we call routine and non-routine.”).

116. See *id.* at 1–2 (considering the effect lump-sum taxes can have if the government starts to observe worker types).

117. See, e.g., Tom Parr, *Automation, Unemployment, and Taxation*, 48 SOCIAL THEORY & PRAC. 357 (2022).

118. See Guerreiro et al., *supra* note 112, at 3 (“[I]t is optimal for the planner to tax robots to help redistribute income toward routine workers of the initial older generations

configuration of the tax system. A simple response to that approach is that other sources of revenue could be identified as intended to reduce inequality besides robot taxes. Although automation processes may be taken as a source of inequality, both executive pay¹¹⁹ and the effective non-taxation of wealthy individuals,¹²⁰ are also sources of inequality. Furthermore, a robot tax could be levied in several of the eleven forms proposed in the literature,¹²¹ several of which would not require a full re-configuration of the tax system, which is undesirable in policy terms.

IV. CONCLUSION

Econometric modeling has been presented as a type of empirical evidence to suggest that higher taxes on capital, including robot taxation, would diminish economic productivity in several ways. A few scholars have suggested that robot taxes might represent a tax on the most innovative segment of the economy, which would then be doubly misguided, or perhaps even illogical. The issue in respect of robot taxation is how to interpret these conflicting results, especially those purporting to be empirical evidence. Shall we consider the empirical evidence a purer form of knowledge that might yield true and reliable knowledge? Or, shall we consider it as a form of “black magic” to be viewed with skepticism?

The flawed idea often applied in the context of robot taxation is that empirics comprise bedrock. Empirics, which denies any role for theory, may serve as a means to conceal an underlying theory and allow motivated reasoning to be presented in objective terms. In the context of robot taxation, a causal theory for empirical testing has in some cases not been presented at all, and the supposed empirical results are presented as the rawest form of data-mining.¹²² Such results are simply not in the nature of science or

who are still in the labor force.”).

119. See Thomas Piketty & Immanuel Saez, *Income Inequality in the United States, 1913–1998*, 118 QUART. J. ECON. 1 (2003); THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* (2014).

120. See Jesse Eisinger et al., *The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, PROPUBLICA (June 8, 2021, 5:00 AM), <https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax> (detailing how ProPublica has obtained a vast cache of IRS information showing how billionaires like Jeff Bezos, Elon Musk, and Warren Buffett pay little in income tax compared to their massive wealth — sometimes, even nothing).

121. See Bogenschneider, *Will Robots Agree to Pay Taxes?*, *supra* note 21, at 11–13.

122. See J. Doyne Farmer, *Hypotheses Non Fingo: Problems with the Scientific Method in Economics*, 20 J. ECON. METH. 377 (2013); Cornelis A. Los, *A Scientific View of Economic Data Analysis*, 17 E. ECON. J. 61, 61 (1991) (“The results of the alternative, or reverse, regressions are ignored. That is regrettable from a scientific point of view,

scientific inquiry.¹²³ In many cases within robot taxation, motivated reasoning is obvious.¹²⁴ As a prime example, consider conclusions from an economist based on OECD data from the year 2016, that forward-looking predictions by the author occurring in the year 2018 about the risk of automation to the tax base to occur prospectively in the future are empirically unfounded based on abstract modeling of historical data.¹²⁵ Such data suggests that in a model with ‘routine’ workers, who are at risk of being replaced by robots, and ‘non-routine’ workers, who are not, a fall in the price of robots will raise tax revenue. While this conclusion may be entirely plausible, except for the possibility that the future has not happened yet, backward looking econometric modeling based on arbitrary categories of routine and non-routine workers, may not predict future events very well. As Keuzenkamp & Magnus stated in regards to such econometric analyses: “It must be admitted that it is hard (but perhaps not impossible) to find a convincing example of a meaningful economic proposition, that has been rejected (or definitively supported) by econometric tests.”¹²⁶

A causal mechanism or link is also missing from the empirical analysis relating to how lower-priced robots might be expected to raise any tax revenue.¹²⁷ Since robots are not subject to wage taxes (such as social security and Medicare), indirect taxes (such as property and sales taxes), or much in the way of income taxes, and often serve to directly reduce the income taxes of firms that engage in automation, failure to tax them actually exacerbates the displacement of human workers by the non-neutrality of a tax system where robots as a type of capital are heavily favored in comparison to human labor. It should be viewed as at least possible that an over-investment in robots and other automation technology may have already occurred in the broader economy as firms set out to claim the disproportionate tax benefits offered to capital, of which robots are one part. Reversal of the tax

since the results of the reverse regressions often conflict disturbingly with the results of regressions selected on the basis of a *priori* theory.”)

123. See David F. Hendry, *Econometrics — Alchemy or Science?*, 47 *ECONOMICA* 387, 401 (1980).

124. For a description of motivated reasoning, see Nathan Walter & Nikita A. Salovich, *Unchecked vs. Uncheckable: How Opinion-Based Claims Can Impede Corrections of Misinformation*, 24 *MASS COMM’N & SOC’Y* 500 (2021).

125. OECD, *ECONOMIC SURVEYS: UNITED STATES JUNE 2018* 52 (2018), <http://www.oecd.org/economy/surveys/Overview-United-States2018-OECD.pdf>.

126. Keuzenkamp & Magnus, *supra* note 18, at 6.

127. See David H. Autor, *Why Are There Still So Many Jobs? The History and Future of Workplace Automation*, 29 *J. ECON. PERSPECTIVES* 3, 7 (2015) (“First, workers are more likely to benefit directly from automation if they supply tasks that are complemented by automation, but not if they primarily (or exclusively) supply tasks that are substituted.”).

exemptions to robots may yield an efficiency *gain* as human workers performed work in lieu of robots. That is of course, since humans were more efficient than robots in some aspects of production. Only by using an outdated economic model, which does not take robots as a fourth factor of production, is it then possible to think that robots are always more efficient in production than human workers based on production functions without that fourth factor of production with special characteristics, such as tax benefits. In the real economy, *less efficient* robots appear to have in some cases been placed in service partly to obtain the overwhelming tax incentives offered for using robots rather than human workers. Although economic theory does not cognize any deadweight loss from worker taxes, as it does for taxes on the wealthy or large corporations, it seems reasonable to think that further efficiency gains could result from a zero-sum reduction of the taxes levied on workers if robots took on a larger or meaningful share of the tax base.¹²⁸

Flaws in the methods applied by researchers including a failure to disclose the methods applied in the respective empirical work, strongly implies that further empirical research is necessary. Since the ITIF organization has purchased priority Google search results for the term “robot taxation,” it draws into question whether conflicting theory and evidence was properly taken into consideration to reach the desired policy conclusion, and whether that work is reliable enough to be cited by university scholars. Likewise, the Tax Foundation has not disclosed any of the parameters or modeling of their work on robot taxes, so there is no way to check whether any work was actually done, done well, or to replicate the results, a required condition of modern science. The stated results were consistent with standard neoclassical economic theory that capital should never be taxed on efficiency grounds based on the premise that no efficiency gains are includable for possible reductions on the taxation of human workers by the payment of some taxes by robots.

As a prime illustration of the risks of automation to the labor force, economists readily admit that self-driving vehicles comprise a severe risk to some routine workers which they refer to as: “[D]rivers with few recognized qualifications, including many immigrants from less developed countries.”¹²⁹

128. For an explanation of the term “deadweight loss,” see Martin Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax*, 81 REV. ECON. & STAT. 674, 674 (1999).

129. Georg Graetz & Guy Michaels, *Robots at Work*, 5 REV. ECON. & STAT. 753, 767 (2018) (“Another area where autonomous machines hold both promise and threat to jobs is self-driving vehicles. If and when they become commercially viable, self-driving cars offer a more convenient, more flexible, and safer mode of transportation. At the same time, they pose a threat to the employment of drivers with few recognized qualifications,

However, the Teamsters Union currently numbers 1.4 million members in the United States alone, and the total number of non-unionized drivers may be as many as 3 or 4 times that amount. Assuming that the only profession at risk of obsolescence by automation was “drivers,” that one profession comprises between 2% and 5% of the total labor force in the United States, comprising conservatively (depending on the relative salary levels of drivers) as much as 4% to 8% of aggregate tax collections. The assertion that automation does not comprise a risk to tax collections reflects an attempt to use deductive reasoning to substitute for actual data. As Lawrence Summers, now an outspoken critic of robot taxes,¹³⁰ once wrote: “Reliance on deductive reasoning rather than theory based on empirical evidence is particularly pernicious when economists insist that the only meaningful questions are the ones their most recent models are designed to address.”¹³¹ Empirical research accordingly may be helpful at times and could form the basis of policymaking, such as in cases where empirical results might strongly support one view and not another. But the policy issues associated with robot taxation are not such a simple case. Policymakers have a duty to consider the possibility that many other professions, beyond just “drivers,” may also be at risk due to rapid automation. Since labor bears the vast majority of the tax base in most OECD countries the risk to government finances is severe notwithstanding base empirical models that may suggest to the contrary.

The empirical evidence on robot taxation is not the type of evidence that would be considered reliable empirical evidence with significant results as in the social sciences; rather, the given conclusions are merely statistical reviews and raw modeling reliant on neoclassical economic theory. The results are not significant in statistical terms, nor any more reliable than any other normative applications of theory. In respect of the Technequality paper in particular, no causal analysis was presented and accordingly, no testing was performed from which significant results might be derived. The motivation for a full tax exemption for robots as a type of capital is of course a tenant of standard neoclassical economic theory. However, such results may not hold any significance beyond theory, and have no significance at all if the given theory does not explain causation and serve to predict future events. Because robots and other ICT comprise a fourth factor of production

including many immigrants from less developed countries.”).

130. See Sarah Kessler, *Lawrence Summers Says Bill Gates' Idea for a Robot Tax is "Profoundly Misguided"*, QUARTZ (Mar. 6, 2017), <https://qz.com/925412/lawrence-summers-says-billgates-idea-for-a-robot-tax-is-profoundly-misguided/>.

131. Lawrence H Summers, *The Scientific Illusion in Empirical Macroeconomics*, 93 SCANDINAVIAN J. ECON. 129, 145 (1991).

not cognized within the present version of economics, it seems reasonable to think that an outdated economic theory premised on land, capital, and labor as the three exclusive factors of production is unlikely to comprise a causal theory accurate enough to be used to formulate tax policy. Future empirical studies on robot taxation should also consider the strong association between tax share and per capita GDP where nations that levy tax including on capital seem to grow faster than those that do not. The causal mechanism reflected in the empirical data not cognized by neoclassical economic theory is that capital investment for robots is tax deductible for profitable firms yielding an income tax benefit as opposed to burden, and accordingly, firms may be likely to undertake robot investment in nations with higher tax rates.¹³² The empirical data is consistent with this view and indicates that nearly all capital investment in robots takes place in higher tax nations, and almost none in tax havens or lower tax nations. Broadly speaking, nearly all capital re-investment occurs in higher tax nations. Robot density is positively associated with very high corporate tax rates, such as in Germany, Japan, South Korea, and the Nordic states, and almost no automation occurs in tax havens or nations with lower corporate tax rates where the value tax deductions for capital investment is zero.¹³³

Table 2. Robot Density* and Corporate Tax Rates^A

	Robot Density	Corporate Tax Rate
Top		
South Korea	631	25%
Singapore	488	17%
Germany	309	30%
Japan	303	26.1%
Sweden	223	21.4%
Denmark	211	22%
USA	189	21%, 35% (2018)
	Robot Density	Corporate Tax Rate
Bottom		
Panama	<1 est.	0%
Cayman Islands	<1 est.	0%
Ireland	<1 est.	15%-
Russia	3	15%
Phillipines	3	25%
India	3	25%+
Indonesia	5	25%
*Robot Density Data per IFR (Iterational Federation of Robotics) Press Release https://ifr.org/ifr-press-releases/news/robot-density-rises-globally		
^A Tax rates public sources		

132. See *supra* Figure 1.

133. See *infra* Table 2.

* * *

THE AB5 EXPERIMENT — SHOULD STATES ADOPT CALIFORNIA’S WORKER CLASSIFICATION LAW?

SAMANTHA J. PRINCE*

A worker’s classification as either independent contractor or employee drives whether a worker is entitled to minimum wage, overtime, worker’s compensation, unemployment compensation, anti-discrimination protection, National Labor Relations Act protections, and many other safety-net protections. During the COVID-19 pandemic, unemployment protections were extended to independent contractors, but this is not the norm and is not slated to continue post-pandemic. Classifying certain workers, particularly those who work in the app-based economy, is challenging, so states are looking for an answer — either through their own innovation or through that of other states. California’s answer was AB5.

AB5’s goals were to correct misclassification issues for app-based drivers and other workers. A plethora of workers including court reporters, freelance writers and photographers, coaches, truckers, performing artists (mimes, magicians, comedians, etc.), and musicians rebuked AB5. AB5 is well known beyond California’s borders as it received, and continues to receive, nationwide attention predominantly because it reclassified app-based drivers (such as Uber, Lyft, DoorDash, etc.) as employees.

As Justice Brandeis said, one of the benefits of federalism is that

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states can act as “laboratories of democracy.” Experimental federalism can provide for collective learning across the states if they are all experimenting, but often states look to one another for innovative solutions so that they can free-ride instead of experiment. Some states that are looking for an improved worker classification law seek to learn from, and potentially free-ride on, California’s AB5 “experiment.” In considering whether to adopt AB5 or a similar statute, states should consider, at a minimum, three factors: relevancy of the law to their state, ease in obtaining information about the law, and the costs to adopt, implement, and enforce the law. This Article assists policymakers and interest groups by providing a detailed look at the AB5 experiment. It applies the aforementioned three factors and determines that California’s law, while well-intentioned is likely not valuable for, or adoptable by, other states or the federal government partly because it contains 109 exemptions.

Ultimately, this Article concludes that to maximize the benefits of experimental federalism, a group of states, both homogenous and heterogenous to California, should experiment with more novel approaches to reach an optimal solution to worker (mis)classification. Adopting California’s worker classification law will result in states following a sub-optimal law and in premature convergence delaying states from reaching a better solution. Workers need protections, but California’s worker classification law does not sufficiently satisfy this need. Further experimentation is required.

I. Introduction	45
II. Background	48
A. The Problem — Why Worker Classification Matters	49
B. The Modern Workforce	52
III. California’s Approach: AB5	54
A. The Goals of AB5	56
B. The Tests of AB5	57
i. The ABC Test	57
ii. The Borello Test	59
C. The Issues Created by AB5	60
D. Carving out Exemptions from the ABC Test	66
E. Prop 22 — Exempting Rideshare and Delivery App Drivers	69
IV. Experiment or Free-Ride — What to do?	71
A. California — A Recognized First-Mover	74
B. Diffusion Mechanisms	77
i. Mechanism: Imitation	77
ii. Mechanism: Learning	79

C. Policymakers Seek to Learn the Experiment's	
Results Before Free-Riding	81
D. Applying the Galle and Leahy Diffusion Factors	84
i. Relevancy	84
ii. Information	85
iii. Costs	88
E. Analyzing the Potential Diffusion of	
California's WCL	89
V. Conclusion	92
Appendix A — List of the 109 exemptions from the ABC	
test portion of California's worker classification law:	94

I. INTRODUCTION

*"Among the potential benefits of American federalism is the ability of states to serve as policy laboratories, adopting novel policies to address their needs, abandoning unsuccessful attempts, and learning from the success of similar states."*¹

State policymakers are like scientists. Scientists see a problem and seek to create a solution. Policymakers see a problem and seek to create a solution, too. Both experiment in isolation — scientists in a physical laboratory; policymakers within their borders. "It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."²

Both scientists and policymakers provide the results of their experiments so that others can learn from them. States in which policymakers create novel policies to address problems serve as policy laboratories — they experiment. A goal of experimental federalism is to reach an optimal policy through multiple states experimenting. When legislative experiments are successful, other policymakers will be more prone to adopt (or free-ride on) the legislation being tested.³ But if free-riding occurs before an optimal solution is reached, then the result is premature convergence — getting stuck in using a sub-optimal statute. Additionally, if policymakers adopt a statute

1. Craig Volden, *States as Policy Laboratories: Emulating Success in the Children's Health Insurance Program*, 50 AM. J. POL. SCI. 294, 294 (2006).

2. Justice Louis Dembitz Brandeis is well known for this quote from his lengthy dissenting opinion in a case about a law Oklahoma created to regulate the sale of ice. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

3. Volden, *supra* note 1, at 294.

without considering the experiment's results, the benefit of experimenting within that closed universe of a particular state is untapped.

California has long been regarded as one of the most legally innovative states.⁴ And California serves as a “first-mover” when tackling many salient issues such as environmental, social, and data privacy policies.

In 2019, California policymakers set out to solve another problem — the wage and labor inequities that California app-based workers and others face when their statuses are misclassified as independent contractors.⁵ Workers classified as “independent contractors” suffer a lack of minimum wage and overtime pay, and the absence of safety-net protections like workers' compensation and unemployment insurance.⁶ As a solution, the California legislature enacted Assembly Bill 5, known as AB5.⁷ And so the experiment began.

This Article begins by walking you through the AB5 experiment and California workers' reaction to AB5. It then outlines the results thus far and the next phase in the experiment. It concludes by describing how state policymakers can utilize the results, and what state policymakers (and

4. Melissa Maynard, *Which States are Most Innovative?*, PEW CHARITABLE TR. (Nov. 19, 2012), <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2012/11/19/which-states-are-most-innovative> (“‘California was always a fairly innovative state, but it has become even more so,’ Boehmke says. ‘It’s not only first but it’s first by a large margin. It’s 50 percent more innovative than the second most innovative state.’”); Frederick J. Boehmke & Paul Skinner, *State Policy Innovativeness Revisited*, 12 STATE POL. & POL’Y Q., 303, 320 (2012) (displaying a chart mapping the innovation of States); see Virginia Gray, *Innovation in the States: A Diffusion Study*, 67 AM. POL. SCI. REV. 1174, 1184 (1973) (listing California and New York as most innovative); see also Jack L. Walker, *The Diffusion of Innovations among the American States*, 63 AM. POL. SCI. REV. 880, 883 (1969) (ranking California as the third most innovative state).

5. Worker misclassification is an issue that continues to plague the United States’ workforce. See discussion *infra* Part II.A for the effects of classifying workers as employees versus independent contractors.

6. The COVID-19 crisis brought to light the importance of providing unemployment insurance to all workers, not just employees. As well as showing that it can be done. One prominent example is the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which expanded states’ ability to provide unemployment insurance for workers impacted by the COVID-19 pandemic, including independent contractors. Pub. L. No. 116-136, 134 Stat. 281 (2020). “‘If we think unemployment insurance is a good idea, why would you be excluding work that’s now characteristic of so many jobs?’ asked Erica Groshen, a senior labor economics advisor at Cornell University and former commissioner of the Bureau of Labor Statistics.” Greg Iacurci, *13 Million Gig Workers Getting Unemployment Benefits, 41% of the Total*, CNBC, <https://www.cnbc.com/2020/07/06/pua-unemployment-benefits-being-paid-to-about-13-million-americans.html> (last updated July 7, 2020).

7. Assemb. B. No. 5, § 2 (Cal. 2020) (adding LABOR CODE § 2750.3; effective Jan. 1, 2020).

Congress) should consider when deciding to adopt legislation like AB5, thus highlighting that state and federal legislators are still talking about AB5.⁸

Part II starts with a discussion of the problem that California was trying to solve — worker misclassification and the uncertainty surrounding the *Dynamex v. Superior Court of Los Angeles*⁹ decision. This Part sets forth the various ways that worker classification impacts a worker's life and livelihood, as well as the economy. Part II then provides an overview of the current state of California's (and most states') changing workforce to include non-traditional work like app-based work.

Through AB5, California codified presumptive employee status for workers in an effort to fix misclassification issues. Part III explains the creation of AB5 and how it works. This Part presents reactions from workers, some of whom do not want to be reclassified as employees. While not all will be represented herein, workers who spoke out regarding AB5 included court reporters, freelance writers and photographers, coaches, truckers, performing artists (mimes, magicians, comedians, etc.), and musicians. As more industry representatives spoke up, additional exemptions to AB5 were codified into California's worker classification law ("WCL")¹⁰ — 109 exemptions in total.¹¹ More and more, California's WCL has started to look like grandma's patchwork quilt and less like a solution that other states will want, or be able, to adopt. This Part concludes with a review of the minimization of the WCL's goals due to this patchwork, carved-up approach and the passing of Proposition 22 ("Prop 22").

Part IV discusses the benefits of experimental federalism and ways to predict whether a statute or policy will diffuse using California's WCL as a case study. Then, this Part explains two different mechanisms through which legislation diffuses among states: learning and imitation. This Part explains factors helpful to policymakers contemplating free-riding on another state's legislation: relevancy of the policy to the contemplating state, the ease of obtaining credible information from another state, and the costs of adopting,

8. See, e.g., John Lopez, *Senate Majority Leader Chuck Schumer Addresses ABC Questions on PRO Act*, MCHENRY CNTY. BLOG (Feb. 26, 2021), <http://mchenrycountyblog.com/2021/02/26/schumer020621/> (reporting Schumer assured Freelancers Union that the U.S. Congress in the PRO Act will not make the same mistakes made in California with AB5); see also 166 CONG. REC. H898 (daily ed. Feb. 6, 2020) (statement of Rep. Virginia Foxx) ("[T]his . . . is little more than an attempt to protect the few well-connected interests that received a carveout from the California Democrats' disastrous Assembly Bill 5")

9. 416 P.3d 1 (2018).

10. The focus of this Article expands from the AB5 experiment into the California worker classification law generally to include AB2257 where applicable. It will refer to California's current worker classification law as the WCL.

11. Assemb. B. No. 2257 § 2 (Cal. 2020) (adding Article 1.5 and repealing LAB. CODE § 2750.3; effective Sept. 4, 2020). See Appendix A.

implementing, and executing the statute. Part IV identifies that policymakers from various states have admitted to waiting for the results of the AB5 experiment before deciding to free-ride by adopting it. It then analyzes whether states are likely to free-ride on the WCL and shows that free-riding will be detrimental to achieving optimal worker classification laws.

Finally, this Article concludes that though the AB5 experiment provides state policymakers with valuable information to consider, it should not be adopted by other states or the federal government in its current iteration. The continued experimentation through repeated amendments, while well-intentioned, is unlikely to provide an optimal solution in the near term, if at all, and therefore fails to provide an adoptable statute for other states. I contend that to maximize the benefits of experimental federalism, states, both heterogenous and homogenous to California, should consider California's experience and then start their own experiments. We have so much more to learn and will be best poised to do so if states are willing to experiment and share, rather than free-ride on California's law.

II. BACKGROUND

Work is changing.¹² And the change is being brought on by both hiring entities and workers. Hiring entities are taking steps to change work. Consider automation.¹³ More specifically, consider receptionists, and how most businesses now have auto attendants or if they do have individuals who answer, those individuals are often not in an office. Amazon utilized a heavily automated Human Resources department during the pandemic in place of their usual human staff.¹⁴ Also, consider that hiring entities know that under current law it is economically cheaper to hire independent contractors than employees, and so they gravitate toward a business model or practice that utilizes more independent contractors.¹⁵

Some workers are also gravitating toward a preference for independence.¹⁶

12. See *The Future of Work: Preserving Worker Protections in the Modern Economy: Before the Subcomm. on Health, Emp., Lab., and Pensions and the Subcomm. on Workforce Prots.*, 116th Cong. 1 (2019); see also, Robert Sprague, *Updating Legal Norms for a Precarious Workforce*, 35 A.B.A. J. LAB. & EMP. L. 86–91 (2020).

13. Sprague, *supra* note 12 at 87–88, 88 n.16; see also, Kathryn Kisska-Schulze & Karie Davis-Nozemack, *Humans vs. Robots: Rethinking Tax Policy for a More Sustainable Future*, 79 MD. L. REV. 1009, 1009 n.2, 1018–21 (2020).

14. Jodi Kantor, Karen Weise, & Grace Ashford, *Power and Peril: 5 Takeaways on Amazon's Employment Machine*, N.Y. TIMES (June 16, 2021), <https://www.nytimes.com/2021/06/15/us/politics/amazon-warehouse-workers.html>.

15. See *infra* Part II.A.

16. See, André Dua, Kweilin Ellingrud, Michael Lazar, Ryan Luby, Matthew Petric, Alex Ulyett, & Tucker Van Aken, *Unequal America: Ten Insights on the State of Economic Opportunity*, MCKINSEY & COMPANY (May 26, 2021), <https://www.mckinsey.com/about-us/covid-response-center/inclusive-economy/unequal-america-ten-insights->

Whether it is freelancing (“swing[ing] from project to project”¹⁷), starting their own business, or working for app-based companies, the opportunities are abundant.¹⁸ Many people who work traditional jobs are doing something on the side to supplement their income.¹⁹ Furthermore, some people have family obligations and need work flexibility.²⁰ Regardless of the reason, many workers need and want flexibility; thus, they are driving, delivering, repairing, cleaning, taking care of others’ loved ones, and the like.

While our economy and work have been changing, our legislatures and governmental agencies are struggling with how to balance protecting all workers and preserving the desired independence of those who want and need it. At the heart of this struggle is classifying workers. This Part discusses why worker classification matters, and the modern workforce.

A. The Problem — Why Worker Classification Matters

The United States has been classifying workers as either “employees” or “independent contractors” since 1857.²¹ A worker’s classification has

on-the-state-of-economic-opportunity. The McKinsey report admits that it is difficult to quantify how many people are working in contract, freelance, or temporary positions but shows that of those polled, one-third of the workers prefer being independent while two-thirds would prefer to be employed.

17. Dua, Ellingrud, Lazar, Luby, Petric, Ulyett, & Van Aken, *supra* note 16, at 36 n.25; see also, Dan Kedney, *1 in 3 Americans Work on a Freelance Basis*, TIME (Sept. 4, 2014, 2:05 PM), <https://time.com/3268440/americans-freelance/>.

18. See Jennifer Pinsof, *A New Take on an Old Problem: Employee Misclassification in the Modern Gig-Economy*, 22 MICH. TELECOMM. & TECH. L. REV. 341, 352 n.63–64 (2016) (citing to a 2015 GAO study “estimat[ing] that the non-traditional workforce . . . comprised of 35.3 percent of all employed workers in 2006 [rising to] 40.4 percent in 2010” and further noting the “significant increase from a 1999 DOL study, which found that [non-traditional employment] comprised only 9.3 percent of America’s workforce”).

19. Martha C. White, *Who’s Got a Side Hustle? Postgrad and People Earning \$80,000 or More*, NBC, <https://www.nbcnews.com/business/business-news/who-s-got-side-hustle-postgrads-people-earning-80-000-n1013621> (last updated June 5, 2019) (finding approximately half of Americans supplement their income with a secondary source).

20. Liya Palagashvili, Comment Letter on Department of Labor’s Proposed Rule Change, “Independent Contractor Status under the Fair Labor Standards Act” (Oct. 26, 2020), https://www.mercatus.org/system/files/palagashvili_-_pic_-_dol_proposed_rule_change_on_employee_v._independent_contractor_economic_realities_test_pic_-_v1.pdf.

21. The common law distinction between employees and independent contractors originated in England and was originally an agency law question. It was first transplanted into the United States via *Boswell v. Laird*, 8 Cal. 469, 489–90 (1857). See also Richard R. Carlson, *Why the Law Still Can’t Tell an Employee When it Sees One and How it Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295, 302–03 (2001) (discussing pre-industrial worker classifications); Gerard M. Stevens, *The Test of the Employment Relation*, 38 MICH. L. REV. 188 (1939) (discussing the control test used to determine employment relationships).

economic, social, and legal importance. Those who are considered employees qualify for benefits and have certain legal protections that independent contractors do not.²² The effects of being classified as an employee include, among other things, discrimination protection, tax, economic, and labor rights (e.g., right to class certification, right to organize, wage/hour benefits, workers' compensation, unemployment compensation), fiduciary duties, and tort liability.²³ For instance, employees are protected from discrimination but independent contractors are not.²⁴ Moreover, employees have taxes withheld from their paycheck²⁵ and their employer pays half of their social security and Medicare taxes,²⁶ but since independent contractors do not have "employers," they must remit their own taxes and pay their social security and Medicare taxes in their entirety.²⁷ Employees also have a right to organize and be part of a class in court cases, whereas independent contractors do not.²⁸ Additionally, employees, unless they are exempt, are protected by minimum wage and hour laws — independent contractors do not have these protections.²⁹ Where legal duties are concerned, employees owe their employers fiduciary duties while independent contractors do not,³⁰ and an employee's tortious acts can cause

22. See Matthew T. Bodie, *Participation as a Theory of Employment*, 89 NOTRE DAME L. REV. 661, 666–67 (2013).

23. *Id.*; see also V.B. Dubal, *Wage Slave or Entrepreneur?: Contesting the Dualism of Legal Worker Identities*, 105 CAL. L. REV. 65, 74–75 (2017).

24. See 42 U.S.C. § 2000e-2(a) (prohibiting discrimination by an employer because of an employee's "race, color, religion, sex, or national origin"); 29 U.S.C. § 623(a)(1) (prohibiting discrimination by an employer because of an employee's age); 42 U.S.C. § 12112(a) (prohibiting discrimination by an employer because of an employee's disability). *Contra* Orly Lobel, *Coase & the Platform Economy*, in THE CAMBRIDGE HANDBOOK OF THE LAW AND SHARING ECONOMY 67, 75 (Nestor M. Davidson, Michèle Finck, & John J. Infranca eds., 2018) (arguing that some policies, such as anti-discrimination laws, should apply to all who provide labor regardless of their employee status).

25. See I.R.C. §§ 3401(c), 3402 (requiring that employers withhold taxes for employees).

26. See *id.* §§ 3101, 3121(d).

27. Independent contractors remit their social security and Medicare taxes on Schedule SE when filing their Form 1040. See *Self-Employment Tax (Social Security and Medicare Taxes)*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes> (last updated Mar. 14, 2022).

28. See 29 U.S.C. §§ 152(3), 157.

29. See *id.* §§ 206–07 (providing minimum wage and overtime protection for employees).

30. RESTATEMENT (SECOND) OF AGENCY § 387 (AM. L. INST. 1958); Terry A. O'Neill, *Employees' Duty of Loyalty and the Corporate Constituency Debate*, 25 CONN. L. REV. 681, 685 (1993) ("All employees owe a fiduciary duty of loyalty to their employer . . .").

their employer to be vicariously liable through *respondeat superior* for those acts, but this is not true for independent contractors (save for some select circumstances).³¹ Also, employment-related benefits such as participation in an employer's 401(k) plan and health insurance exist for employees (often on a tax-free basis), but if independent contractors want those benefits, they have to acquire them themselves. Finally, independent contractors are not covered by an employer's workers' compensation insurance and are not generally entitled to unemployment compensation.³²

One would expect that since workers have to be classified as one or the other, that there is an easy way to determine that status. Unfortunately, that could not be further from the truth.³³ For some workers, the determination is, in fact, easier than others, but for many non-traditional workers it is complex.³⁴ There are numerous distinct factor-based tests from common

31. Compare RESTATEMENT (THIRD) OF AGENCY § 2.04 (AM. L. INST. 2006) (assigning liability to employers for the "torts committed by employees while acting within the scope of their employment"), with RESTATEMENT (SECOND) OF TORTS § 409 (AM. L. INST. 1965) ("Except as stated in §§ 410–429, the employer of an independent contractor is not liable for physical harm caused to another by an act or omission of the contractor or his servants.").

32. During the Coronavirus Pandemic, the Federal Government enacted the CARES Act to provide states with the ability to open unemployment compensation to independent contractors, including app-based workers. See Assemb. B. No. 5 § 2 (Cal. 2020) (adding LAB. CODE § 2750.3; effective Jan. 1, 2020). Although this legislation would seem to recognize the importance of all workers to having unemployment insurance, the current state of affairs in the United States is to only provide it for employees.

33. Misclassifying workers is a rampant problem. For some hiring entities, the misclassification of workers is unintentional and happens as a result of confusion. There are other hiring entities that deliberately misclassify workers because it is economically advantageous. See Anna Deknatel & Lauren Hoff-Downing, *ABC on the Books and in the Courts: An Analysis of Recent Independent Contractor and Misclassification Statutes*, 18 U. PA. J. L. & SOC. CHANGE 53, 79–81 (2015) (describing how employers may strategize to misclassify workers); see also Orly Lobel, *The Gig Economy & The Future of Employment and Labor Law*, 51 U. S. FLA. L. REV. 51, 59 (2017) ("Misclassification cases are difficult because the legal test used to determine employee status is notoriously messy. Like a good law school hypothetical, the facts of each of these cases lend themselves to a cluttered balancing test.")

34. See Brishen Rogers, *Employment Rights in the Platform Economy: Getting Back to Basics*, 10 HARV. L. & POL'Y REV. 479, 493–96 (2016) (arguing that applying factors will yield over- or under-inclusiveness, making results unpredictable and difficult to discern, and using an example of a difficult determination: "Uber and Lyft drivers are neither clearly employees nor clearly independent contractors under existing tests, as typically understood," but as a normative matter, drivers should be classified as employees); see also Michael H. LeRoy, *Bare Minimum: Stripping Pay for Independent Contractors in the Share Economy*, 23 WM. & MARY J. WOMEN & L. 249, 260–68 (2017) (arguing that exotic dancers should be classified as employees and reporting that out of "seventy-five federal and state court rulings on wage and hour claims by dancers who work for strip clubs, . . . only three courts ruled that dancers were independent contractors," however, "thirty-eight rulings determined that dancers were employees,"

law, regulatory agencies, and legislation, and they all apply the facts and circumstances to draw their conclusion on the appropriate classification, yielding inconsistent and thus confusing results.³⁵ These tests primarily consider control in some way, but because the factors used for each test vary, a worker can be classified as an employee under state labor laws but as an independent contractor under state or federal tax laws. Differing standards across numerous statutes “ha[ve] created a situation where the assignment of responsibility has become opaque and less predictable for workers and business organizations.”³⁶

This causes great uncertainty, and complexity in our workforce. Workers do not know what they are legally entitled to and hiring entities do not know what their obligations are. However, workers deserve to be more equally protected.³⁷ The next section discusses the modern workforce and why change is needed in worker classification laws.

B. The Modern Workforce

“The modern workplace has been profoundly transformed.”³⁸

More and more, workers are gravitating toward different ways to earn money. Many people who work traditional jobs are supplementing their income with side jobs.³⁹ Some workers, like parents, need more flexibility than a traditional job can provide, so they have turned toward making their own way, or working within the app-based economy.⁴⁰

and the rest did not determine employment status).

35. E.g., Samantha J. Prince, *The Shoe Is About to Drop for the Platform Economy: Understanding the Current Worker Classification Landscape in Preparation for a Changed World*, 52 UNIV. MEM. L. REV. 101, 134–35 (2022); see Tanya Goldman & David Weil, *Who’s Responsible Here? Establishing Legal Responsibility in the Fissured Workplace* 28 (Inst. for New Econ. Thinking, Working Paper No. 114, 2020).

36. Goldman & Weil, *supra* note 35 at 59; see Lobel, *supra* note 33, at 68 (noting that the digital platform poses a variety of regulatory challenges, such as worker classification).

37. See Symposium, Andrew Stewart & Jim Stanford, *Regulating Work in the Gig Economy: What are the Options?*, 28 ECON. & LAB. L. REL. REV. 420, 422 (2017).

38. DAVID WEIL, *THE FISSURED WORKPLACE: WHY WORK BECAME SO BAD FOR SO MANY AND WHAT CAN BE DONE TO IMPROVE IT* 7 (2014).

39. In fact, according to Brett Collins et al., the exponential growth in work in the online platform economy “is driven by individuals whose primary annual income derives from traditional jobs and who supplement that income with platform-mediated work.” Brett Collins, Andrew, Garin, Emilie Jackson, Dmitri Koustas, & Mark Payne, *Is Gig Work Replacing Traditional Employment? Evidence from Two Decades of Tax Returns* 3 (Mar. 25, 2019) (unpublished manuscript), <https://www.irs.gov/pub/irs-soi/19rpgigworkreplacingtraditionalemployment.pdf>.

40. Dani Blum & Laura Vanderkam, *The Gig Economy Offers Parents Options and Obstacles*, N.Y. TIMES (Feb. 18, 2020), <https://www.nytimes.com/2020/02/18/parenting/gig-economy-part-time-work.html> (noting the number of parents working in the gig

“Gig,” “platform,” or “app-based” businesses are internet marketplaces that connect producers or service providers with consumers, as opposed to creating a product and dealing directly with the consumer.⁴¹ One UK governmental study used a working definition to characterize the gig or app-based economy as, the “exchange of [labor] for money between individuals or companies via digital platforms that actively facilitate matching between providers and customers, on a short-term and payment by task basis.”⁴² Said another way, the gig economy is a popular online business model by which: individuals with “underutilized assets” — whether they be “time, particular skills, vehicles, household goods, spare bedrooms, or even home-cooked meals — connect with other people or businesses seeking those assets.”⁴³ Probably the most well-known app-based businesses include: Uber, Lyft, Postmates, DoorDash, Instacart, goPuff, Handy, Washio, Caviar, Fiverr, GrubHub, Amazon Flex, TaskRabbit, Thumbtack, Upwork, Freelancer, YourMechanic, and Amazon Mechanical Turk. So many platforms exist that it is easy to imagine a point at which any type of work — no matter how complicated or how dependent on others — could be ordered with the click of an app.⁴⁴

As Dean Weil has acknowledged, “[e]mployment is no longer the clear relationship between a well-defined employer and a worker.”⁴⁵ Workers that are classified as independent contractors are no longer primarily those who are entrepreneurs with bargaining power.⁴⁶ This is particularly true in the non-traditional, app-based world. In considering this shift from traditional employer/employee relationships to app-based work, we can see a

economy is increasing).

41. See Marshall W. Van Alstyne, Geoffrey G. Parker & Sangeet Pau Choudary, *Pipelines, Platforms, and the New Rules of Strategy*, HARV. BUS. REV. (Apr. 2016), <https://hbr.org/2016/04/pipelines-platforms-and-the-new-rules-of-strategy>; see also Marina Lao, *Workers in the “Gig” Economy: The Case for Extending the Antitrust Labor Exemption*, 51 U.C. DAVIS L. REV. 1543, 1572–73 (2018); Keith Cunningham-Parmeter, *Gig-Dependence: Finding the Real Independent Contractors of Platform Work*, 39 N. ILL. U. L. REV. 379, 386 (2019).

42. Katriina Lepanjuuri, Robert Wishart & Peter Cornick, *The Characteristics of those in the Gig Economy*, DEP’T BUS., ENERGY & INDUS. STRATEGY 9 (Feb. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/687553/The_characteristics_of_those_in_the_gig_economy.pdf.

43. Robert Sprague, *Worker (Mis)Classification in the Sharing Economy: Trying to Fit Square Pegs into Round Holes*, 31 A.B.A. J. LAB. & EMP. L. 53, 54 (2015).

44. *The Future of Gig Work is Female: A Study on the Behaviors and Career Aspirations of Women in the Gig Economy* HYPERWALLET (2017), https://www.hyperwallet.com/app/uploads/HW_The_Future_of_Gig_Work_is_Female.pdf (noting gig work can also be divided into three categories, only one of which is app-based: professional freelancers, direct sales (like Mary Kay), and app-based platforms).

45. See WEIL, *supra* note 38, at 7.

46. See *id.* at 23–25.

“downward pressure on wages and benefits, murkiness about who bears responsibility for work conditions, and increased likelihood that basic labor standards will be violated.”⁴⁷ In just a few words, Dean Weil’s statement says a lot. It sets forth an important reason why policymakers are concerned with classification of their workers, particularly app-based workers, and one reason why the California legislature enacted AB5. Part III addresses California’s unique approach to classifying workers and the commencement of what I refer to as its “experiment.”

III. CALIFORNIA’S APPROACH: AB5

In addressing its labor and wage issues, California seemingly had three choices: 1) keep the status quo (using the *Borello* test);⁴⁸ 2) adopt a law from another state — that was utilized by its Supreme Court in *Dynamex*⁴⁹ — and customize it to California’s unique and large workforce; or 3) create a novel approach. Ultimately, California implemented a unique combination of the first two options.

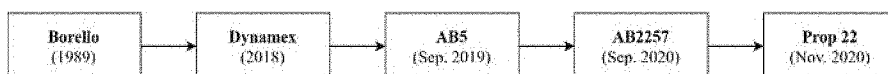


Fig. 1 Depiction of the life and composition of California’s WCL.

47. *Id.* at 8. This in turn leads to a “rise in profitability for the lead companies who operate at the top of industries and increasingly precarious working conditions for workers at lower levels.” *Id.*; see also Dubal, *supra* note 23, at 103. See generally Peter Gibbins, *Extending Employee Protections to Gig-Economy Workers Through the Entrepreneurial Opportunity Test of Fedex Home Delivery*, 57 WASH. U. J. L. & POL’Y 183, 194–95 (2018) (noting that modern supply chains, outsourcing and franchise networks which exert “‘downward pressure on wages,’ and the growing gig economy are all examples of” this clear shift away from traditional employer/employee relationships).

48. *S.G. Borello & Sons, Inc. v. Dep’t of Indus. Rels.*, 769 P.2d 399 (Cal. 1989). In 1989, the California Supreme Court reviewed numerous tests for determining worker classification and determined that the “control-of-work details” factor test should be used. See *infra* Part III.B.ii. The case involved workers’ compensation coverage for cucumber harvesting workers. The court ultimately decided when applying the factors that the workers were employees, not independent contractors. This factor test is what is referred to as the “*Borello* test” throughout this Article.

49. In 2018, the California Supreme Court first utilized the ABC test in the worker classification case *Dynamex Operations West, Inc. v. Superior Court of Los Angeles County*. 416 P.3d 1 (Cal. 2018). The court decided that Dynamex’s one-day delivery service drivers are employees for purposes of the California wage order governing the transportation industry. *Id.* at 7. In CAL. CODE REGS. tit. 8 § 11090.2(D), the wage order defines “employ” to mean “to engage, suffer or permit to work.” See *id.* at 13. The court implemented that standard by incorporating the ABC test for the first time in California. *Id.* at 7, 34.

On September 18, 2019, California enacted Assembly Bill 5.⁵⁰ AB5 codified the ABC test from a similar Massachusetts statute⁵¹ after it was used by the California Supreme Court in *Dynamex*.⁵² Because the *Dynamex* court's use of the ABC test confused businesses and workers, the California legislature was compelled to "act fast" to provide clarity.⁵³ AB5, which includes the ABC test, was created to fix the misclassification problem by purportedly making it "easier" for hiring entities to know how to classify workers. It does this by presuming that certain workers are employees unless the three elements of the ABC test are met.⁵⁴ If the elements are proven, then a worker is classified as an independent contractor. That sounds straightforward enough, but in application it is not.

AB5 and its use of the ABC test codified important protections for workers who come within the presumptive employee status. However, there was significant outcry from businesses, workers, and organizations with respect to the default employee classification.⁵⁵ And, some workers have said that AB5 will destroy their industries.⁵⁶ The California legislature continues to amend the statute to address vocalized concerns through carve-outs from the ABC test portion of AB5.

This Part discusses the goals of AB5 by setting forth the statute and its carve-outs. It then details how Prop 22 minimized AB5's mission to protect app-based drivers by continuing to characterize them as independent contractors and providing fewer benefits than they would receive as employees.

50. See *supra* notes 7–8 and accompanying text. California's AB5 statute was enacted to give more workers in its labor force certain state labor law protections. App-based and other workers are being misclassified as independent contractors and are thereby being exploited through lack of employment law protections: minimum wage, overtime, workers' compensation coverage, and unemployment compensation coverage.

51. MASS. GEN. LAWS ch. 149, § 148B (2020). Nearly two-thirds of states use the ABC test to determine unemployment insurance eligibility, but California's use of it goes well beyond how other states have used the ABC test. See U.S. DEP'T OF LABOR, COVERAGE 1-4-1-6 (2014), <http://www.ows.doleta.gov/unemploy/pdf/uilawcompar/2014/covrage.pdf>.

52. *Dynamex*, 416 P.3d at 35–42.

53. Lorena Gonzalez, *Understanding AB2257, Follow Up Legislation to AB5, and Its Impact on the Arts Sector*, CALIFORNIANS FOR THE ARTS (Oct. 7, 2020), <https://www.californiansforthearts.org/calendar/2020/10/7/understanding-ab-2257-the-follow-up-legislation-to-ab-5-and-its-impact-on-the-arts-sector>.

54. See *infra* Part III.B.i; see also Deknatel & Hoff-Downing, *supra* note 33, at 98.

55. E.g., 166 Cong. Rec. H894 (daily ed. Feb. 6, 2020) (Statement of Rep. Ryan) (entering into the Record a copy of a letter written by an employee explaining the negative public reaction to the default employee classification and referencing the effects of AB5 in California); see also *id.* (statement of Rep. Wright).

56. *Id.* at H890 (statement of Rep. Foxx) (recounting the experience of an American Sign Language interpreter who, after the implementation of AB5, lost all three of his agencies).

A. The Goals of AB5

California Assemblywoman Lorena Gonzalez set forth the goals of AB5 when she addressed the California Assembly while proposing amendments to the newly enacted AB5:

In 2019, I authored AB 5 to provide clarity for workers, businesses and taxpayers in the wake of the California Supreme Court's unanimous 2018 *Dynamex* ruling that established a three-part ABC test for determining employment status. The stricter test makes it clear that workers who have been historically misclassified and kept off payroll as employees — including janitorial workers, construction workers, port truck drivers, home health aides, hotel and hospitality workers, delivery and rideshare drivers — are entitled to basic employment rights under all of the state's labor laws, such as the right to minimum wage, overtime, unemployment insurance, workers' compensation, paid sick days, paid family leave, workplace protections against discrimination and retaliation, and the right to form or join a union.⁵⁷

California's inclusion of the ABC test in AB5 is well-intentioned and can produce some good results for some workers. "[T]he ABC [t]est is a shield by which workers may protect themselves from the coercion, undue pressure, and unequal bargaining power of [hiring entities] wishing to minimize labor costs while exploiting the unfortunate situation of the unemployed worker."⁵⁸ It provides that currently misclassified workers be reclassified as employees so that they will be entitled to minimum wage, overtime, workers' compensation, and unemployment insurance.⁵⁹ While this applies to more than gig/app-based work, many considered AB5 a "gig worker law."

After eight years of looking the other way, California officials are finally enforcing the rule of law against . . . so-called gig companies Because regulators chose not to enforce existing labor laws against the companies, they were allowed to grow precarious work — not just in this state, but all over the world.⁶⁰

57. *Hearing on AB 1850 Before the Cal. Assemb. Comm. on Appropriations* 2020 Leg. Sess. 2 (June 2, 2020) (statement of Chair Lorena Gonzalez), https://leginfo.ca.gov/faces/billAnalysisClient.xhtml?bill_id=201920200AB1850.

58. Christopher J. Cotnoir, *Employees or Independent Contractors: A Call for Revision of Maine's Unemployment Compensation "ABC Test"*, 46 ME. L. REV. 325, 344 (1994).

59. *See* Assemb. B. No. 5, § 2 (Cal. 2020) (adding LAB. CODE § 2750.3; effective Jan. 1, 2020).

60. Michael Hiltzik, *Pressure Builds on Uber and Lyft under California's Gig Worker Law*, L.A. TIMES (July 3, 2020, 6:00 AM), <https://www.latimes.com/business/story/2020-07-03/uber-lyft-ab5-contractor> (quoting Professor Veena Dubal, labor law expert at UC's Hastings School of Law).

Thus, the statute is a “step in the right direction” toward protecting app-based workers around the country.⁶¹

AB5 and other presumption-of-employee laws are designed to eliminate or reduce worker misclassification. This is not a unique phenomenon; rebuttable presumptions favoring a default employee status have been implemented in numerous countries, most recently as part of the European Union Commission’s Proposed Directive to establish minimum labor standards for app-based workers in its member states.⁶² Having a default status can minimize uncertainty for both hiring entities and workers.⁶³

B. The Tests of AB5

To clarify the *Dynamex* decision’s applicability, California enacted AB5 and its initial iteration became effective January 1, 2020.⁶⁴ AB5 incorporated the ABC test but added an extensive list of occupational exceptions⁶⁵ that will be tested under California’s previously established *Borello* test⁶⁶ instead of the ABC test.⁶⁷

i. The ABC Test

The ABC test portion of AB5 reads:

[A] person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied: (A) The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact. (B) The person performs work that is outside the usual course of the hiring entity’s business. (C) The person is customarily engaged in an independently established

61. Brian A. Brown II, *Your Uber Driver is Here, but Their Benefits Are Not: The ABC Test, Assembly Bill 5 and Regulating Gig Economy Employers*, 15 BROOK. J. CORP. FIN. & COM. L. 183, 208 (2020).

62. Seth D. Harris & Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First Century Work: The “Independent Worker,”* HAMILTON PROJECT 6 (2015) (citing ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), NON REGULAR EMPLOYMENT, JOB SECURITY AND THE LABOUR MARKET DIVIDE (2014)), <http://www.oecd.org/els/emp/emo2014-annex-chapter4.pdf>. (“(e.g., Czech Republic, Estonia, France [in selected circumstances], Mexico, The Netherlands, [and] Portugal).”); *Proposal for a Directive of the European Parliament and of the Council on Improving Working Conditions in Platform Work*, at 3 COM (2021) 762 final (Dec. 9, 2021); see also Prince, *supra* note 35, at Part III.A.

63. See Harris & Krueger, *supra* note 62, at 6.

64. Assemb. B. No. 5, § 2 (Cal. 2020) (adding LAB. CODE § 2750.3; effective Jan. 1, 2020).

65. See *infra* Appendix A.

66. See *infra* Part III.B.ii.

67. *Id.*

trade, occupation, or business of the same nature as that involved in the work performed.⁶⁸

California's version of the ABC test very closely mimics that of Massachusetts.⁶⁹ The ABC test presumes employee status unless the hiring entity satisfies all elements of the test, in which case the worker will be classified as an independent contractor.⁷⁰ If the worker is deemed an employee under the test, they are entitled to coverage under the California labor laws: minimum wage, overtime pay, workers' compensation, and unemployment. This application of the ABC test is broader than in other states and provides uniformity across California's labor code.⁷¹

Numerous states and commenters favor the presumption of employment because it challenges employers who may have been trying to utilize certain business models to evade the law.⁷² The presumption puts employers on notice that "they must observe the independent contracting boundaries."⁷³

Ron Herrera, Teamsters International Vice President and Director of the Port Division, lauded the new statute by stating, "[t]he ABC test [contained within AB5] . . . streamlines the process of establishing employee status . . . [which is] even more pressing during this current public health and humanitarian crisis where port truck drivers are suffering disproportionately from the impacts of the coronavirus pandemic due to rampant and systemic misclassification"⁷⁴

Since the ABC test part of AB5 has only three elements, it is simpler and should conceivably improve predictability, thereby reducing uncertainty.⁷⁵ Thus, it is heralded by worker spokespersons as the "most objective" test and "the most difficult for employers to manipulate."⁷⁶ Because hiring entities

68. CAL. LAB. CODE § 2750.3(a) (West 2020).

69. See *supra* note 44 and accompanying text. "Massachusetts did not create the ABC test," but rather, Maine did in 1935. Deknatel & Hoff-Downing, *supra* note 33, at 65, 65 n.66.

70. *ABC Test*, CORNELL L. SCHL. LEGAL INFO. INST., https://www.law.cornell.edu/wex/abc_test (last visited Jan. 8, 2022).

71. See Deknatel & Hoff-Downing, *supra* note 33 at 64–71 (describing various states' application of the ABC test).

72. *Id.* at 71–72.

73. *Id.* at 72. But see Karen R. Hamed, Georgine M. Kryda, & Elizabeth A. Milito, *Creating a Workable Legal Standard for Defining an Independent Contractor*, 4 J. BUS. ENTREPRENEURSHIP & L. 93, 102 (2010) ("[B]y creating the presumption of employment, the ABC Test makes it harder for employers to create unconventional employment relationships with workers.").

74. Press Release, Teamsters Port Division Director Comments on AB5 (Mar. 21, 2020), <https://teamster.org/2020/03/teamsters-port-division-director-comments-ab5/>.

75. Prince, *supra* note 35, at 154.

76. Deknatel & Hoff-Downing, *supra* note 33, at 67 (citing CATHERINE K. RUCKELSHAUS & SARAH LEBERSTEIN, NELP SUMMARY OF INDEPENDENT CONTRACTOR REFORMS 5 (2011), <https://www.nelp.org/wp-content/uploads/2015/03/2011Independen>

financially benefit from classifying workers as independent contractors, it seems appropriate that they be forced to overcome the presumption. However, scholars have pointed out that “the ABC test is no panacea with respect to employee/independent contractor classification,”⁷⁷ that it is “no model of clarity,”⁷⁸ that it “may result in both over- and under-inclusiveness,”⁷⁹ and that it “introduces new interpretative challenges to the determination of employee status.”⁸⁰ The carve-outs provided for in AB5 (and subsequently AB2257) appear to be California’s way of dealing with the over-inclusiveness;⁸¹ however, one can posit that it has gone too far with its law — many workers are now back to where they started, making the law under-inclusive (again).

ii. *The Borello Test*

The next statutory section in AB5 provides that the ABC test, and correspondingly its presumptive employee status, does not apply to certain occupations as codified. Instead, classification as an employee or independent contractor for those delineated occupations shall be governed by *Borello*.⁸² The *Borello* test has been used by California since 1989 and is still retained for certain occupations that are deemed exempt from the ABC test.⁸³ Like the ABC test, the *Borello* test analyzes the extent of the hiring entity’s control over the alleged employee. But unlike the ABC test, the *Borello* test employs a multi-factor test to determine a worker’s classification. These factors have evolved to become.⁸⁴

tContractorReformUpdate.pdf.

77. Robert Sprague, *Using the ABC Test to Classify Workers: End of the Platform-Based Business Model or Status Quo Ante?*, 11 WM. & MARY BUS. L. REV. 733, 767 (2020).

78. Edward A. Zelinsky, *Defining Who is an Employee After A.B.5: Trading Uniformity and Simplicity for Expanded Coverage*, 70 CATHOLIC U. L. REV. 1, 26 (2020).

79. Goldman & Weil, *supra* note 35, at 46.

80. Zelinsky, *supra* note 78, at 29; *see also* Christopher Buscaglia, *Crafting a Legislative Solution to the Economic Harm of Employee Misclassification*, 9 U.C. DAVIS BUS. L. J. 111, 129 (2008).

81. Other states provide carve-outs as well but none as many as California. For example, *see* Cotnoir, *supra* note 58, at 332–34 (stating that — at the time of their writing — Maine’s Employment Security Law contained thirty-seven carve-outs from the ABC test.)

82. CAL. LAB. CODE § 2750.3(b) (West 2020); *see* S.G. Borello & Sons, Inc. v. Dep’t of Indus. Rels., 769 P.2d 399 (1989). *See generally* Benjamin Powell, *Identity Crisis: The Misclassification of California Uber Drivers*, 50 LOY. L.A. L. REV. 459 (2017) (discussing the *Borello* Framework and its application to Uber).

83. There are currently 109 such exemptions. *See* Appendix A.

84. The most up-to-date list of factors used under the *Borello* test is provided by California Department of Industrial Relations. *Independent Contractor Versus Employee*, CAL. DEP’T INDUS. RELS., https://www.dir.ca.gov/dlse/faq_indepen

- (a) Whether the potential employer has all necessary control over the manner and means of accomplishing the result desired (although such control need not be direct, actually exercised or detailed);
- (b) Whether the worker performing services holds themselves out as being engaged in an occupation or business distinct from that of the employer;
- (c) Whether the work is a regular or integral part of the employer's business;
- (d) Whether the employer or the worker supplies the instrumentalities, tools, and the place for the worker doing the work;
- (e) Whether the worker has invested in the business, such as in the equipment or materials required by their task;
- (f) Whether the service provided requires a special skill;
- (g) The kind of occupation, and whether the work is usually done under the direction of the employer or by a specialist without supervision;
- (h) The worker's opportunity for profit or loss depending on their managerial skill;
- (i) The length of time for which the services are to be performed;
- (j) The degree of permanence of the working relationship;
- (k) The method of payment, whether by time or by the job;
- (l) Whether the worker hires their own employees;
- (m) Whether the employer has a right to fire at will or whether a termination gives rise to an action for breach of contract; and
- (n) Whether or not the worker and the potential employer believe they are creating an employer-employee relationship (this may be relevant, but the legal determination of employment status is not based on whether the parties believe they have an employer-employee relationship).

The *Borello* test is generally used when the ABC test does not apply (*see* Appendix A for the ABC test exemptions). However, for some workers, the *Borello* test will not apply instead of the ABC test unless the hiring entity satisfies other requirements first.⁸⁵ AB5 is quite complex and likely difficult for the public to understand and comply with.⁸⁶

C. The Issues Created by AB5

*"California's A.B. 5, is an obsolete artifact of an American economy in which labor markets were defined primarily by factories and traditional trades."*⁸⁷

dentcontractor.htm (last updated Jan. 2022).

85. *Id.*

86. *See* Zelinsky, *supra* note 78, at 26–34.

87. Henry H. Perritt, Jr. Comment Letter to the Department of Labor's Wage & Hour Division's Notice of Proposed Rulemaking 1 (Oct. 2020) (on file with author). Professor Perritt, former Deputy Under Secretary of Labor (Ford administration), continues: "Legal categories of work must evolve to reflect how new technologies have changed the way workers interact with those that pay for their services."

While AB5 was created to provide clarity from the *Dynamex* opinion, using the ABC test's elements does not necessarily accomplish this goal.⁸⁸ For example, for purposes of the second element, how does one define the term “usual course of business,” and what is deemed to be “outside” of it? The California courts will be left to decide how to define such ambiguities, and this can lead to uncertainty.⁸⁹ “Leaving this task up to the judicial branch will potentially take years to get a clear determination of how the test is to be applied and also may not follow exactly the legislative intent.”⁹⁰

AB5 was designed to protect workers, but it also serves to protect employers “who compete with companies that misclassify, and to shield California from the loss of revenue from companies using misclassification to avoid payment obligations such as payroll taxes, premiums for workers’ compensation, Social Security, unemployment, and disability insurance.”⁹¹ Despite these important goals, AB5 was not embraced with open arms by all.

Problematically, not all workers want to, or can, give up their independent working relationships.⁹² Under the current U.S. binary worker classification regime — employee or independent contractor — when hiring entities control their workers, those workers are more likely to be considered employees.⁹³ Many American workers who are currently classified as

88. Zelinsky, *supra* note 78, at 33 (“Whatever the merits of A.B.5 might be, uniformity, simplicity, and certainty are not among these.”).

89. See Brown II, *supra* note 61, at 204 (advocating for defined terms in the statute to reduce uncertainty and showing that there were varying interpretations of the ABC test in Massachusetts).

90. *Id.* at 205.

91. Chris Carosa, *Will California’s AB5 Law Gag Your Gig Retirement*, FORBES (Feb. 27, 2020), <https://www.forbes.com/sites/chriscarosa/2020/02/27/will-californias-ab5-law-gag-your-gig-retirement/?sh=4609a43b6518> (quoting Paul Kramer, Director of Compliance at WorkForce in the greater Detroit Area).

92. Kevin Kiley, *AB 5 Stories: Testimonials of Californians Who Have Lost Their Livelihoods*, https://ad06.asmrc.org/sites/default/files/districts/ad06/files/AB5%20Booklet_0.pdf (quoting Marlene, “AB 5 has impacted my life. I am self employed by choice. I do not want to be an employee nor do I want to lose my tax exemptions as a company. I should not be forced into employment relationships with my clients, most of which will not hire me anymore if they are forced to become my employers. This law will destroy my business.”).

93. “The control test holds that a worker is an employee if the hiring entity ‘controlled or had the right to control the manner and means’ of the worker’s work.” SAMANTHA J. PRINCE, ENTREPRENEURSHIP LAW: COMPANY CREATION, <https://psu.pb.unizin.org/expsk909/chapter/tests/>.

[S]everal federal statutes and their corresponding administrative agencies use the control test to determine a worker’s classification for reasons other than tort liability: Age Discrimination in Employment Act (ADEA), Americans with Disabilities Act (ADA), Employee Retirement Income Security Act (ERISA), Federal Unemployment Tax Act (FUTA), Federal Insurance Contributions Act (FICA), Internal Revenue Code (IRC), National Labor Relations Act (NLRA), Occupational Safety and Health Act (OSHA), Title VII of the Civil Rights Act of

independent contractors and enjoy their autonomy to work when they want and for how many hours they want, view laws that will reclassify them as laws that will strip them of their freedoms.⁹⁴ They do not want to relinquish their “freedom from non-interference” (no supervisory intervention, no one setting their schedule, no one capping their earning potential) or their “freedom from non-domination” (no one with power to discipline and restrict choices and no one to put workers in a state of uncertainty that will constrain their autonomy).⁹⁵ Workers assume that if the law requires them to be employees, that the hiring entity who is now an employer, will impose more control over them or strip them of their freedoms. This does not have to be the case, but in practicality, it likely is.⁹⁶

Some independent contractors find AB5 insulting as they feel they can adequately negotiate their own contracts.⁹⁷ As Americans, we live in a “society and culture [that] values personal autonomy, rugged individualism, self-determination, and self-reliance.”⁹⁸ Americans appreciate and sometimes insist upon autonomy.⁹⁹ This insistence or preference for autonomy aligns with our modern workforce that seeks flexibility to do other things and to spend less time in a particular job; i.e., “how to manage their livelihood.”¹⁰⁰ However, not all workers have bargaining power and this

1964, and the Worker Adjustment and Retraining Notification Act (WARN).

Id.; see also Bodie, *supra* note 22, at 679; Michael W. Fox, *Whos' an Employee, Who's the Employer? It's Not as Easy as You Might Think*, 2016 TXCLE ADV. BUS. L. 1, appendix 25 (2016).

94. Deepa Das Acevedo, *Unbundling Freedom in the Sharing Economy*, 91 S. CAL. L. REV. 793, 797 (2018).

95. *Id.* at 808–25.

96. See generally *Dynamex Operations W. Inc. v. Super. Ct. L.A. Cnty.*, 416 P.3d 1, 38 n.28 (Cal. 2018) (“[I]f a business concludes that it improves the morale and/or productivity of a category of workers to afford them the freedom to set their own hours or to accept or decline a particular assignment, the business may do so while still treating the workers as employees . . .”).

97. “One artistic director at last week’s rally summed it up for the Chico Enterprise-Record: ‘We are not stupid. We do not need to be saved from ourselves. We can negotiate our own contracts. AB5 is insulting.’” 166 CONG. REC. H891 (daily ed. Feb. 6, 2020).

98. Peter H. Huang & Kelly J. Poore, *Can You Hear Me Later and Believe Me Now? Behavioral Law and Economics of Chronic Repeated Ambient Acoustic Pollution Causing Noise-Induced (Hidden) Hearing Loss*, 29 S. CAL. REV. L. & SOC. JUST. 193, 209 (2020).

99. See Kiley, *supra* note 92 (quoting Amy, “Having this AB 5 in place will completely change how I work and when I work. I am a notary public, commissioned by the State of California. I perform notary acts for the general public and loan signings for title companies. I choose when and where I work. With these uncertain times set before us today, people like me need the flexibility to be there for our children, assisting with their distance learning and working around their schedule. I choose when I work, I choose how much I work! Why are our choices being taken away?”).

100. See Jennifer Wright, *Why California’s AB-5 is a Threat to the American Way of*

should be a consideration when determining an optimal worker classification law.¹⁰¹

Additionally, AB5 has been criticized as legislation that is detrimental to women who rely on alternative, flexible work arrangements.¹⁰² Caregivers, who are disproportionately women, require flexible hours and may rely on flexible work for their primary job as well as a supplemental job.¹⁰³ When it comes to the app-based economy, if one removes ridesharing drivers (predominately men) from the calculation, women constitute a larger share of platform workers.¹⁰⁴ Women who are unable to satisfy the requirements of traditional work arrangements and yet will be classified as employees under AB5, will suffer great harm by having difficulty in getting/keeping these work relationships.¹⁰⁵ Take Rona Prestler talking about her work

Life, N.Y. POST (Oct. 26, 2019, 12:28 PM), <https://nypost.com/2019/10/26/why-californias-ab-5-is-a-threat-to-the-american-way-of-life/>.

101. See Rogers, *supra* note 34, at 494 (noting that there exists “unequal bargaining power” between some workers and hiring entities, signaling a “democratic deficit and/or inequality”); Noah D. Zatz, *Beyond Misclassification: Tackling the Independent Contractor Problem Without Redefining Employment*, 26 A.B.A. J. LAB. & EMP. L. 279, 282–83 (2011); Guy Davidov, *The Three Axes of Employment Relationships: A Characterization of Workers in Need of Protection*, 52 U. TORONTO L.J. 357, 377–87 (2002). But see Goldman & Weil, *supra* note 35, at 59.

102. See Palagashvili, *supra* note 20 (detailing how AB5 may be harmful to women).

103. See JAMES MANYIKA, SUSAN LUND, JACQUES BUGHIN, KELSEY ROBINSON, JAN MISCHKE & DEEPA MAHAJAN, INDEPENDENT WORK: CHOICE, NECESSITY, AND THE GIG ECONOMY 76 (2016). “Women were significantly more likely to note that flexibility was a more important motivator for independent work than men (74 percent vs. 59 percent).” Palagashvili, *supra* note 20, at 3 (quoting MBO PARTNERS, THE STATE OF INDEPENDENCE IN AMERICA: RISING CONFIDENCE AMID A MATURING MARKET 5 (2017)); see also Linda N. Edwards & Elizabeth Field-Hendrey, *Home-Based Work and Women’s Labor Force Decisions*, 20 J. LAB. ECON. 170 (2002).

104. See DIANA FARRELL, FIONA GREIG & AMAR HAMOUDI, THE ONLINE PLATFORM ECONOMY IN 2018: DRIVERS, WORKERS, SELLERS, AND LESSORS 18, 22 (2018); see also HYPERWALLET, *supra* note 44; Lawrence F. Katz & Alan B. Krueger, *Understanding Trends in Alternative Work Arrangements in the United States* (Nat’l Bureau of Econ. Rsch., Working Paper No. 25425, 2019); Lawrence F. Katz & Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015* (Nat’l Bureau of Econ. Rsch., Working Paper No. 22667, 2018).

105. Palagashvili, *supra* note 20, at 5 (“Proponents of policies such as California’s AB 5 overlook the consequences of such policies for the types of independent jobs that attract women. [] [T]o the extent that specific platform companies such as Etsy and Care.com provide flexibility of work for those who need it and extend work opportunities to women who would otherwise be unable to take on traditional employment, challenges to the legal classification of independent contractors could disproportionately hinder women’s participation on those platforms. In fact, when debating the legislation, California did not compare the potential benefits and the potential harms of AB 5 specifically to women.”); see also Elaine Pofeldt, *California’s AB5 Leaves Women Business Owners Reeling*, FORBES (Jan. 19, 2020, 8:23 PM), <https://www.forbes.com/sites/elainepofeldt/2020/01/19/californias-ab5-leaves-women-business-owners-reeling/?sh=d9cf6385ef36>.

through HireMyMom.com:

I would work before [my kids] woke up. I had a nanny come in the morning. I'd hang out with the kids during the afternoon and get back to work at night. I got in a good number of hours with minimal childcare. It was just perfect.¹⁰⁶

AB5 can change a worker's classification by law, but it cannot require hiring entities to continue to use California workers who have been reclassified as employees.

I've been a freelance writer and editor for 25 years. Working freelance has allowed me to raise my daughter from the day she came home from the hospital to the present (she's 10), pick and choose both the work I do and the hours and days I do it, and work with incredible employers who have (with very few exceptions) ALWAYS had my best interests at heart. AB5 will force me to leave jobs that I've held for over a decade and join a growing pool of other freelancers who are grabbing at the few freelance jobs that will be left for us.¹⁰⁷

This comment highlights the issue of availability — that there will be fewer employee jobs than there are freelancers that need to work.

As a result of either confusion or being forced to reclassify workers as employees, some hiring entities are rebuffing California workers and using out-of-state workers who are not covered by California's AB5 or an ABC test-like statute.¹⁰⁸ Take for example, Vox Media's announcement that in

106. Pofeldt, *supra* note 105; *see also*, Kiley, *supra* note 92 (quoting Jessica, "As a freelance court reporter, I choose when to work, what jobs to take . . . I do not want to be an employee. As a new mom I can tell agencies that I only want afternoon work . . . or that I only want to work on Tuesdays and Thursdays. As an employee, I would not get to pick a schedule that works for me.").

107. *See* Kiley, *supra* note 92 (quoting Paul).

108. *See, e.g., id.* (quoting Janet, "There is no way my clients are going to hire me as an employee to work on sporadic projects during the year, so I will lose the ability to augment my social security and I'm not eligible for SNAP benefits. I'm 67 years old, on Social Security [sic] and if I can't find a full time job at this point, I can't pay the rent and eat."); *id.* (quoting Deborah, "I'm a 67-year-old grandmother living on Social Security. Up until Jan 1st I was also an online transcriptionist earning approx \$200 a month in much needed additional income. I love the work and it is a perfect fit for work-from-home situations, however due to AB 5, California residents were dropped by the world-wide company I was working for."); *id.* (quoting Sarah, "I have been a full time small business owner and artist for 10 years and this law is hurting small businesses. This law makes it difficult for small businesses to hire independent writers, graphic designers, virtual assistants, marketing reps, and other necessary Gig work that helps small businesses to be able to grow. It's going to take the arts, music, literature, and culture out of our lives by forcing artists to either incorporate, which is extremely cost prohibitive in California, or to stop producing art, meaning that the patrons of the arts will lose access to art programming that enriches the lives of the people in our communities. People who choose to work as Freelance workers have chosen this path because they want the flexibility to set their own hours and rates and work when they want and they will no longer be able to excel in their creative fields under AB5. This law hurts the lower and middle class people who have side gigs, creative gigs, or are

order to comply with AB5, it will cease using all California freelance writers that report on the California sports teams for its SB Nation blogs.¹⁰⁹ Instead, it reported that it will hire 20 full-time and part-time employees to replace those 200 ‘low-paid’ freelancers.¹¹⁰ Hiring 20 employees at the expense of replacing 200 other workers is likely an unintended result of AB5’s presumption and the larger scale good it attempts to accomplish. Another example was put forth by Rona Prestler, the HireMyMom.com worker noted above. One client of hers let her go because they could not afford to pay her salary, and an out-of-state client let her go “concerned that a lack of clarity in the language of [AB5] might lead to a risk of fines later on.”¹¹¹

Because of AB5’s sweeping reclassification of some workers, numerous businesses and workers have expressed their concerns, frustration, and sometimes anger.¹¹² Thus, organizations representing industries spoke out. In February 2020, the Sacramento Bee reported that the California legislature had “nearly three dozen bills” to consider as to how “to clean up or repeal the landmark gig economy law.”¹¹³ In response to organizational pleas, in September 2020, the California legislature passed AB2257, a law that replaced AB5 with more exemptions (now, 109 in total).¹¹⁴ Because the legislature and Uber could not reach an agreement for an app-based driver

trying to launch their own small business.”).

109. Susanna Hussain, *Vox Media Cuts Hundreds of Freelance Journalists as AB5 Changes Loom*, L.A. TIMES (Dec. 17, 2019, 3:00 AM), <https://www.latimes.com/business/story/2019-12-17/vox-media-cuts-hundreds-freelancers-ab5>.

110. *Id.* This was Vox Media’s stance prior to the enactment of AB2257, and it may have changed now that AB2257 eliminated the thirty-five pieces per year requirement that brought freelance writers within the purview of AB5’s ABC test.

111. Pofeldt, *supra* note 105; see Cotnoir, *supra* note 58, at 344 (“[The ABC Test] creates a burden for truly ‘independent contractors’ who might not find work due to employers’ fear of unemployment contribution liability determined long after the services have been fully performed . . .”).

112.

The debates over AB5 in California, however, resulted in the legislature excluding a number of occupations from the ABC test, including, for example, licensed insurance agents, . . . doctors and dentists, lawyers, architects, engineers, registered securities broker-dealers or investment advisers, direct sales salespersons, real estate licensees, and workers providing licensed barber or cosmetology services, and others performing work under a contract for professional services, with another business entity, or pursuant to a subcontract in the construction industry.

Goldman & Weil, *supra* note 35, at 49.

113. “Democrats say the law needs fine-tuning; Republicans want to overhaul it.” Hannah Wiley, *California’s New Labor Law is a Work in Progress. Here’s How Lawmakers Could Change It*, SACRAMENTO BEE (Feb. 24, 2020, 10:02 AM), <https://www.sacbee.com/news/politics-government/capitol-alert/article240264901.html#storylink=cpy>.

114. See *infra* Part III.D.

exemption, well-known driving app-based companies went to the people and successfully gained exemption (albeit temporarily) from AB5's reach by winning a California November 2020 ballot initiative, Prop 22.¹¹⁵ Prop 22 has been working its way through the California court system and currently has been found unconstitutional.¹¹⁶

D. Carving out Exemptions from the ABC Test

*"[AB5] is replete with exceptions, exemptions and interpretive challenges which make the law of employee status even more complicated and unclear than it was before."*¹¹⁷

The ABC test in the WCL was designed to catch hiring entities who misclassify workers as independent contractors. However, because some workers are legitimately independent contractors or the industries in which they operate cannot function by over-inclusively reclassifying workers to employee status, the California legislature included carve-outs or exemptions in AB5 and even more in AB2257. Seemingly, this is necessary to accommodate business models that are not misclassifying workers. But sometimes, "legislatures will . . . include carve-outs, which often reflect *political* will and power rather than a need to re-balance power in a working relationship."¹¹⁸ This is not a new concept when it comes to the ABC test.¹¹⁹

Initially, there were over 50 exemptions from the ABC test to be considered under *Borello*. These carve-outs can be viewed as a product of politics and industries coming forward to criticize using the ABC test for select occupations.¹²⁰ However, the carve-outs also represent California's customization of the ABC test to fit the needs of its residents and an attempt to avoid over-inclusiveness. While some commentators criticize the carve-outs, others laud them.¹²¹

Freelancers of many kinds, particularly freelance writers, photojournalists, and photographers, expressed their concerns over AB5 as enacted in

115. See *infra* Part III.E.

116. See *id.*

117. Zelinsky, *supra* note 78, at 3–4 ("A.B.5 . . . make[s] the law of employee status even more complex and less uniform than it was before.").

118. Goldman & Weil, *supra* note 35, at 50.

119. See Cotnoir, *supra* note 58, at 332–34.

120. See *supra* note 112.

121. See Zelinsky, *supra* note 78, at 34–38 (noting criticisms of the carve-outs). See generally Letter from Sean P. Redmond, Exec. Dir., Lab. Pol'y Emp. Pol'y Div., U.S. Chamber of Com. to Sen. Stephen M. Sweeney (Nov. 13, 2019), <https://www.uschamber.com/comment/letter-opposing-new-jersey-senate-bill-s-4204> (supporting the carve-outs).

September 2019.¹²² Initially, under AB5, if these workers submitted items to one hiring entity more than thirty-five times per year, they would be tested under the ABC test and classified as an employee. However, these workers are now on the list of ABC test exemptions and will therefore be tested under the *Borello* test.¹²³ And the initial thirty-five times per year submission threshold was repealed by AB2257.¹²⁴ Further, meetings between groups representing freelancers of various professions and Assemblywoman Lorena Gonzalez yielded additional amendments to AB5 outside of the exemptions that would “strike a balance and protect employment opportunities in these professions . . . [by] specify[ing] that a contractor cannot replace an employee position.”¹²⁵

Another industry that was initially disrupted by AB5 was the music industry. It is markedly freelanced and music professionals collaborate throughout the year with different employers on one or more projects.¹²⁶ Once AB5 was signed into law, the California music and performing arts workers overwhelmingly said that the law was going to hurt their careers and the industry as a whole.¹²⁷ In April 2020, California Assemblywoman Lorena Gonzalez announced, that she had been working with individuals in the music industry to understand AB5’s impact on their profession.¹²⁸ As a result, AB2257 provided for an extensive list of carve-outs for the music industry.¹²⁹

AB5’s initial carve-outs have been subsequently supplemented by those in AB2257 in an effort to accommodate workers in several industries. One of the WCL’s goals continues to be to clarify the business-to-business

122. See Greg Dool, *CA Freelance Writers “Encouraged” By Latest AB 5 Development*, FOLIO (Feb. 28, 2020), <https://www.foliomag.com/ab5-update-freelance-writers-encouraged-proposed-amendment-text/> (speaking to freelance writers who were worried about the effects the original AB5 may have on their careers).

123. See *infra* Appendix A.

124. See Richard Reibstein, *AB2257: Not Much Better Than AB5 for Most Industries in California Using Independent Contractors*, JD SUPRA (Sept. 8, 2020), <https://www.jdsupra.com/legalnews/ab2257-not-much-better-than-ab5-for-35040/>.

125. See Dool, *supra* note 122.

126. Andrea Domanick, *The Music Industry Gets Relief From California’s AB5 Gig Economy Law*, KCRW MUSIC NEWS (Apr. 21, 2020), <https://www.kcrw.com/music/articles/musicians-ab-5-gig-economy-law>.

127. See Makeda Easter, *The AB5 Backlash: Singers, Actors, Dancers, Theaters Sound Off on Freelance Law*, L.A. TIMES (Feb. 12, 2020, 2:16 PM), <https://www.latimes.com/entertainment-arts/story/2020-02-12/how-ab5-is-impacting-california-readers-in-the-performing-arts>.

128. See Press Release, Lorena Gonzalez, *Lorena Gonzalez Announces Pending Changes to How AB 5 Applies to the Music Industry* (Apr. 17, 2020), <https://www.californiansforthearts.org/ab-5-in-the-news/2020/4/17/lorena-gonzalez-announces-changes-to-how-ab-5-applies-to-freelancer-writers-and-journalists>.

129. See *infra* Appendix A.

contracting relationships exemption and referral agency relationships exemption.¹³⁰ Including the foregoing, there are 109 exemptions from the ABC test in the WCL.¹³¹ Accordingly, AB2257 does not simplify or clarify a worker's classification but rather creates "rigid exemptions" with detailed conditions.¹³²

While there are numerous exemptions, AB2257 fails to carve out exemptions for the numerous independent contractors that are similarly situated to those who have lobbied and achieved exemption but could not or did not lobby.¹³³ This provides for disparity among certain workers and makes one wonder if more carve-outs are or should be forthcoming. Additionally, California truckers, movie and television employees, and app-based companies are notably excluded from the new exemptions.¹³⁴ Can the WCL meet its goal of expanding employment under the ABC test when so

130. See Chris Micheli, *AB 5 'Fix: New Exemptions Added to California's Independent Contractor Law*, CAL. GLOBE (Sept. 14, 2020, 2:20 PM), <https://californiaglobe.com/section-2/ab-5-fix-new-exemptions-added-to-californias-independent-contractor-law/>.

131. See *id.*; see also *infra* Appendix A (providing a list of exemptions from AB5 and AB2257).

132. See Reibstein, *supra* note 124 (discussing the shortcomings of both AB5 and AB2257, specifically noting key deficiencies in AB2257's exemptions).

133. See *id.*

134. See Aaron H. Cole, *AB 2257 Enacts Significant Changes to AB 5 on Classification of Workers as Independent Contractors*, NAT'L L. REV. (Oct. 13, 2020), <https://www.natlawreview.com/article/ab-2257-enacts-significant-changes-to-ab-5-classification-workers-independent>; Micheli, *supra* note 130. For example, the trucking industry expressed its dissatisfaction early on with the WCL's ABC test (then AB5) by bringing a series of suits in the California courts seeking exemption or preemption through the Federal Aviation Administration Authorization Act of 1994 ("FAAAA"). *People v. Super. Ct. of L.A. Cnty.*, 57 Cal. App. 5th 619, 630 (Cal. Ct. App. 2020) (holding that the ABC test is not preempted by the FAAAA because it is a "generally applicable employment law that does not prohibit the use of independent contractors, and therefore does not have an impermissible effect on prices, routes, or services"); *People v. Cal Cartage Transp. Exp., LLC*, No. BC689320, 2020 WL 497132, at *10 (L.A. Super. Ct. Jan. 8, 2020) (holding that "the ABC Test has an impermissible effect on motor carriers' 'price[s], route[s], [and] service[s]' and is preempted by the FAAAA"); *Cal. Trucking Ass'n v. Becerra*, 433 F. Supp. 3d 1154 (S.D. Cal. 2020) (granting a preliminary injunction based on trucker plaintiff's questions of whether AB 5 would be preempted by FAAAA). The Ninth Circuit held that the application of AB5 to truckers (motor carriers) is not preempted by the FAAAA, and therefore, truckers will be tested under the WCL. *Cal. Trucking Ass'n v. Bonta*, 996 F.3d 644 (9th Cir. 2021). On June 21, 2021, the Ninth Circuit denied the California Trucking Association's petition for rehearing *en banc*, but the Ninth Circuit did grant the Association's motion to stay the issuance of the mandate so that the Association can file a writ of certiorari with the Supreme Court. *Cal. Trucking Ass'n v. Bonta*, Nos. 20-55106, 20-55107, 2021 U.S. App. LEXIS 18434 (9th Cir. June 21, 2021); *Cal. Trucking Ass'n v. Bonta*, Nos. 20-55106, 20-55107, 2021 U.S. App. LEXIS 18752 (9th Cir. June 23, 2021).

many occupations and industries are exempt from it and still tested under the same test they've been tested under for over thirty years?

E. Prop 22 — Exempting Rideshare and Delivery App Drivers

AB5 was painted as a law focused on correcting worker misclassification in the gig economy, particularly for app-based drivers. As shown above, its coverage extends well beyond what many consider the “gig economy,” including those workers not involved in app-based companies. But some app-based companies may no longer have to worry about California’s WCL (depending on future outcomes of constitutionality challenges), particularly the large ones, thanks to Prop 22.

In October 2020, the California Court of Appeal held that Uber drivers were employees under AB5.¹³⁵ Uber, Lyft, and DoorDash successfully added Prop 22 to the November 2020 ballot.¹³⁶ Prop 22 asked California residents to vote yes to define their “app-based transportation (rideshare) and delivery drivers as independent contractors and adopt labor and wage policies specific to app-based drivers and companies.”¹³⁷ A “yes” vote meant that the WCL’s ABC test would not apply to their app-based drivers, rendering the result in *People v. Uber* moot.¹³⁸ Conversely, a “no” vote would have meant that the WCL would be used to decide whether app-based drivers were employees or independent contractors and would have allowed the court decision to remain applicable.¹³⁹

Rideshare and delivery app companies invested \$205 million¹⁴⁰ into campaigns for the California voters to vote “yes” — that the WCL does not apply to app-based drivers.¹⁴¹ Prop 22 passed with 9,958,425 votes (58.63%).¹⁴² Therefore, so long as Prop 22 is upheld constitutionally,¹⁴³ the

135. See *People v. Uber Tech., Inc.*, 56 Cal. App. 5th 266, 313–14 (Cal. Ct. App. 2020).

136. *California Proposition 22, App-Based Drivers as Contractors and Labor Policies Initiative (2020)*, BALLOTPEDIA, [https://ballotpedia.org/California_Proposition_22_App-Based_Drivers_as_Contractors_and_Labor_Policies_Initiative_\(2020\)](https://ballotpedia.org/California_Proposition_22_App-Based_Drivers_as_Contractors_and_Labor_Policies_Initiative_(2020)) (last visited Jan. 12, 2022).

137. *Id.*

138. See *id.*

139. *Id.*

140. *Id.* Corporate supporters of Prop 22 were DoorDash, Instacart, Lyft, Postmates, and Uber.

141. *Id.*; see also Meredith Whittaker, ‘Those in Power Won’t Give Up Willingly’: Veena Dubal and Meredith Whittaker on the Future of Organizing Under Prop 22, ONEZERO (Nov. 5, 2020), <https://onezero.medium.com/prop-22-where-do-gig-workers-go-from-here-e6eaa3ee2324>.

142. *California Proposition 22, App-Based Drivers as Contractors and Labor Policies Initiative (2020)*, *supra* note 136.

143. See *id.* (outlining a constitutional challenge to Prop 22).

WCL cannot be applied to rideshare and delivery app drivers — i.e., such workers will be deemed independent contractors and cannot be considered employees under the WCL.¹⁴⁴ Though Prop 22 bars the drivers from being considered employees, thus disqualifying them from receiving all of the protections that the WCL grants, it did require that they receive certain pay and benefits, just not the level of protection they would receive if covered by the WCL.¹⁴⁵ As such, the passing of Prop 22 is already causing a downward spiral, exacerbating the disaggregation of employment. At least one company in California is firing driver-employees in favor of using DoorDash workers who are cheaper labor because they are independent contractors and now exempt from California employment laws.¹⁴⁶ This causes unfair competition and puts workers who were fired, so their employer could use unprotected drivers, either on the unemployment line or partaking in app-based work with less protections and benefits than they were previously entitled to. We can do better.

Part IV discusses experimental federalism and diffusion at the state level. It also addresses the diffusion mechanisms, learning and imitation, and applies the Galle and Leahy diffusion factors of relevancy, information, and costs. Part IV then provides an analysis of the potential diffusion of the WCL to other states.

144. See, e.g., *Castellanos v. California*, No. S266551, 2021 Cal. LEXIS 833 (Cal. Feb. 3, 2021) (granting judicial notice). But see *Castellanos v. California*, No. RG21088725, 2021 Cal. Super. LEXIS 7285, at *18 (Super. Ct. Cal. Cnty. Alameda Aug. 20, 2021) (ruling that Prop 22 was unconstitutional because it “limits the power of the future legislature to define app-based drivers as workers subject to workers’ compensation law”). Uber et al. are expected to appeal the ruling.

145. Under Prop 22, drivers are to be paid 120% of California’s minimum wage. The wages will be paid during times that drivers have a passenger in their vehicle. If a driver works at least fifteen hours per week, they will be entitled to a health care stipend. Prop 22 also mandates that drivers receive safety training and entitlement to breaks if they drive more than twelve hours in a twenty-four-hour period. Prop 22 also requires that drivers be enrolled in injury protection insurance. Both Uber and Lyft have responded differently to these requirements. See Kim Lyons, *Uber and Lyft Roll Out New Benefits for California Drivers under Prop 22*, THE VERGE (Dec. 14, 2020), <https://www.theverge.com/2020/12/14/22174600/uber-lyft-new-benefits-california-drivers-prop-22-gig-economy>. But see Veronica Irwin, *Rideshare Drivers Report Being Short Changed*, SF WEEKLY (July 19, 2021), <https://www.sfweekly.com/top-stories/rideshare-drivers-report-being-short-changed/> (discussing the amounts Lyft and Uber collect from passengers’ total payment to drivers).

146. “In California hundreds of Albertsons employees are being swapped for DoorDash Inc. workers . . .” Josh Eidelson, *The Gig Economy is Coming for Millions of American Jobs*, BLOOMBERG BUSINESSWEEK (Feb. 17, 2021, 4:00 AM), <https://www.bloomberg.com/news/features/2021-02-17/gig-economy-coming-for-millions-of-u-s-jobs-after-california-s-uber-lyft-vote>.

IV. EXPERIMENT OR FREE-RIDE — WHAT TO DO?

*“[T]he ability of states to serve as policy laboratories is a strength of federalism.”*¹⁴⁷

Experimental federalism is the process by which states serve as laboratories and experiment with new policies and laws.¹⁴⁸ Through this experimentation, states can share information that can lead to collective learning,¹⁴⁹ yielding a better picture of what was effective.¹⁵⁰ Consequently, states can build on one another’s successes and failures, “generat[ing] more effective and efficient policy approaches.”¹⁵¹ Former President Bill Clinton used Brandeis’ term “laboratories of democracy” to describe how state officials “learn from one another, borrowing, adapting, and improving on each other’s best efforts.”¹⁵²

It is generally believed that state governments are more adept at creating innovative laws or policies than the federal government because they are more flexible and responsive to an ever-changing electorate.¹⁵³

147. Srinivas C. Parinandi, *Policy Inventing and Borrowing among State Legislatures*, 64 AM. J. POL. SCI. 852, 866 (2020).

148. See *New State Ice Co. v. Liebmann*, 285 U.S. 262, 279–80 (1932); Doni Gewirtzman, *Complex Experimental Federalism*, 63 BUFFALO L. REV. 241, 242 (2015); Symposium, Richard H. Fallon, Jr., *The Future of Federalism: Federalism as a Constitutional Concept*, 49 ARIZ. ST. L.J. 961, 973 (2017); Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 430–31 (1998).

149. See Jenna Bednar, *Nudging Federalism Towards Productive Experimentation*, 21 REG’L & FED. STUDS. 503, 507–08 (2011). The collective learning can occur both horizontally across states and vertically to the federal government. See Myron T. Steele & Peter I. Tsoflias, *Realigning the Constitutional Pendulum*, 77 ALB. L. REV. 1365, 1369–70 (2014).

150. See J. William Futrell, *Law of Sustainable Development*, ENV’T. F., Mar.–Apr. 1994, at 16, 20 (“The prospects for early innovation and experimentation on the state level are better than in Washington.”); see also Steele & Tsoflias, *supra* note 149, at 1369–70.

151. Hannah J. Wiseman, *Regulatory Islands*, 89 N.Y.U. L. REV. 1661, 1666 (2014); see also Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-to-the-Bottom” Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1211–12 (1992).

152. ANDREW KARCH, *DEMOCRATIC LABORATORIES* 145 (2010) (quoting Bill Clinton in DAVID OSBORNE, *LABORATORIES OF DEMOCRACY* xii (1990)).

153. See David L. Markell, *States as Innovators: It’s Time for a New Look to our “Laboratories of Democracy” In the Effort to Improve our Approach to Environmental Regulation*, 58 ALB. L. REV. 347, 356 (1994); see also Paulette L. Stenzel, *Right To Act: Advancing the Common Interests of Labor and Environmentalists*, 57 ALB. L. REV. 1, 37 (1993) (“Individual states can choose varying mechanisms as the tools for achieving their goals. Then, those laws can be examined to see which options have proven to be the most effective.”); Matthew J. Parlow, *Progressive Policy-Making on the Local Level: Rethinking Traditional Notions of Federalism*, 17 TEMP. POL. & CIV. RTS. L. REV. 371, 371 (2008) (“[L]ocal governments may prove even more fruitful agents for social change

“[F]ederalism allows state governments, equipped with knowledge of their unique and very different communities, to make better policy choices than a ‘one size fits all’ approach imposed by a national government.”¹⁵⁴ Former President George H.W. Bush referred to the movement of power and decision-making to the states as being “closer to the people.”¹⁵⁵ Similarly, Ralph Nader has said, “Progressive groups and low and moderate income families and minorities are often finding state legislatures — and city councils — more responsive to their needs than the lawmakers in Washington.”¹⁵⁶ In addition to states, other subnational governments such as cities, localities, and Native American tribes also serve as laboratories and innovators of change.¹⁵⁷

and policy innovation than the state or federal levels of government.”). Additionally, tribes are also sovereigns and are well-placed to experiment. Elizabeth Ann Kronk Warner, *Justice Brandeis and Indian Country: Lessons from the Tribal Environmental Laboratory*, 47 ARIZ. ST. L.J. 857, 857 (2015) (“[G]iven their unique connection to the land and the intensified thread of some modern environmental challenges, many tribes are already engaged in regulatory innovation related to environmental law.”).

154. Gewirtzman, *supra* note 148, at 256–57; *see also* Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120 (1999).

155. President George Herbert Walker Bush, State of the Union Address (Jan. 29, 1991); *see also* Gregory v. Ashcroft, 501 U.S. 452, 457–59 (1991); Brian Galle & Joseph Leahy, *Laboratories of Democracy? Policy Innovation in Decentralized Governments*, 58 EMORY L.J. 1333, 1336 (2009); Randy E. Barnett, *The Ninth Amendment: It Means What It Says*, 85 TEX. L. REV. 1, 21 (2006); Erwin Chemerinsky, *The Assumptions of Federalism*, 58 STAN. L. REV. 1763, 1768 (2006); Hannah J. Wiseman, *Disaggregating Preemption in Energy Law*, 40 HARV. ENV'T. L. REV. 293, 293 (2016). The federal government has encouraged and respected the States' ability to innovate through their own lawmaking. An example lies in the “State Innovation Waivers” of the Patient Protection and Affordable Care Act (“PPACA”). State Relief and Empowerment Waivers, 83 Fed. Reg. 53,575 (Oct. 24, 2018) (to be codified at 31 C.F.R. pt. 33 and 45 C.F.R. pt. 155). The U.S. Secretary of Health and Human Services and the Secretary of the Treasury stated in guidance that they were “committed to empowering the states to innovate in ways that will strengthen their health insurance markets, expand choices of coverage, target public resources to those most in need, and meet the unique circumstances of each state.” *Id.* “States are better positioned than the federal government to assess and respond to the needs of their citizens with innovative solutions. We encourage states to craft solutions that meet the needs of their consumers and markets and innovate to the maximum extent possible under the law.” *Id.* at 53,577.

156. Ralph Nader, *State Legislatures as “Laboratories of Democracy”*, COMMON DREAMS (May 31, 2004), <https://web.archive.org/web/20080924115109/http://www.commondreams.org/cgi-bin/print.cgi?file=%2Fviews04%2F0531-12.htm>. Mr. Nader also quotes Tim McFeeley, who was the Executive Director of the Center for Policy Alternatives, as saying, “[t]oday, it is state legislators who are proposing the nation’s most far-reaching, proactive measures. They are making legislatures a testing ground for the newest political debates. For progressives, the action is in the states.” *Id.*

157. In seeking to protect app-based drivers, two cities recently enacted ordinances to provide for minimum pay for app-based drivers. *See* NEW YORK, N.Y., LOCAL LAW NO. 2018/150 (Aug. 14, 2018); SEATTLE, WASH., ORDINANCE 126,189 (Sept. 29, 2020); *see also* Kronk Warner, *supra* note 153, at 857; David A. Dana & Hannah J. Wiseman, *A Market Approach to Regulating the Energy Revolution: Assurance Bonds, Insurance,*

Subnational governments have not only been innovating in numerous areas of the law by choice,¹⁵⁸ but also by force.

“When federal inaction creates a policy vacuum, state policy experimentation may be the *only* available solution for solving difficult social problems.”¹⁵⁹ Inaction or ineffectual action at the federal level will ideally prompt state policymakers to experiment and endeavor to create optimal solutions. Accordingly, one would think that having fifty state legislatures that are essentially potential “innovation centers”¹⁶⁰ should provide opportunities to test a variety of approaches simultaneously or within a short amount of time.¹⁶¹ And this could be true if all or even a multitude of states were willing to engage in experimentation. However, not all states want, or have the resources, to experiment. Instead, these states may forgo conducting their own experiments, opting to free-ride on an experimenting state’s law or a pre-existing common law test, leading to under-experimentation and information deficits.¹⁶² Ultimately, free-riding can result “in a sub-optimal level of experimentation,” thereby reducing our chances of achieving the best policy.¹⁶³ Regardless, free riding occurs, and because some states are more prone to being first-movers than others, a free-

and the Certain and Uncertain Risks of Hydraulic Fracturing, 99 IOWA L. REV. 1523, 1587–88 (2014).

158. See Markell, *supra* note 153, at 355; see also Joel Eisen, Emily Hammond, Jim Rossi, David Spence, Jacqueline Weaver, & Hannah Wiseman, *Introduction: Themes in Energy Law* 1, 20 (Geo. Wash. Univ. L. School, Pub. L. & Legal Theory Paper No. 2014-38, 2014).

159. Gewirtzman, *supra* note 148, at 244; see KARCH, *supra* note 152, at 15 (“When national lawmakers could not agree on legislation or did not address specific topics, state officials sometimes developed innovated policy solutions on their own.”); see also Frances Stokes Berry & William D. Berry, *State Lottery Adoptions as Policy Innovations: An Event History Analysis*, 84 AM. POL. SCI. REV. 395 (1990).

160. While Professor Markell spoke specifically to environmental law innovation, his comments equally resonate in the employment law setting. See David L. Markell, *The Federal Superfund Program: Proposals for Strengthening the Federal/State Relationship*, 18 WM. & MARY J. ENV’T L. 1, 73 (1993).

161. See Markell, *supra* note 153, at 355; Gewirtzman, *supra* note 148, at 243; see also Rachael K. Hinkle & Michael J. Nelson, *The Transmission of Legal Precedent among State Supreme Courts in the Twenty-First Century*, 16 ST. POL. & POL’Y Q. 391 (2016); Michael C. Dorf, *The Supreme Court 1997 Term — Foreword: The Limits of Socratic Deliberation*, 112 HARV. L. REV. 4, 60–61 (1998); Benjamin K. Sovacool, *The Best of Both Worlds: Environmental Federalism and the Need for Federal Action on Renewable Energy and Climate Change*, 27 STAN. ENV’T L.J. 397, 434–36 (2008). But see Daniel Treisman, *THE ARCHITECTURE OF GOVERNMENT: RETHINKING POLITICAL DECENTRALIZATION* 229–35 (2007) (arguing that states acting as innovators does not necessarily lead to innovation); Hongbin Cai & Daniel Treisman, *Political Decentralization and Policy Experimentation*, 4 Q. J. POL. SCI. 35, 53 (2009) (noting that experimentation and innovation are not a foregone conclusion).

162. Gewirtzman, *supra* note 148, at 267.

163. *Id.* at 266.

riding state has one to follow.¹⁶⁴ California is one such recognized first-mover.

A. California — A Recognized First-Mover

California is a proven “first-mover” state in many instances.¹⁶⁵ For example, when former President Donald Trump announced that the United States was withdrawing from the 2015 Paris Agreement, California co-founded a 15-state alliance committed to upholding the Agreement’s objectives.¹⁶⁶ Further, when California increased its minimum wage, many states followed.¹⁶⁷

Gender diversity on public company boards is another example of California being first. On September 30, 2018, California passed a law that required public company boards to have a minimum number of women directors.¹⁶⁸ This policy diffused to Washington within eighteen months of

164. Some states are risk-seeking first movers or early adopters of innovative policies, whereas some are more risk-averse or late adopters (which can be the free riders). *See id.* at 270.

165. *See, e.g.,* David E. Adelman & Kirsten H. Engel, *Reorienting State Climate Change Policies to Induce Technological Change*, 50 ARIZ. L. REV. 835, 870 (2008) (noting California as a first mover in the area of solar technology research); Lauren Baron, *How to Avoid Constitutional Challenges to State Based Climate Change Initiatives: A Case Study of Rocky Mountain Farmers Union v. Corey and New York State Programs*, 32 PACE ENV’T. L. REV. 564, 565 (2015) (noting California as a first mover in reducing emissions from the transportation sector); Sharon B. Jacobs, *Bypassing Federalism and the Administrative Law of Negawatts*, 100 IOWA L. REV. 885, 905 (2015) (recognizing California as a first mover in the energy and environmental space by setting “a baseline calculation methodology for demand response by regulation”); Spencer Keller, *How Small Cannabis Businesses Can Survive the Hurdles of IP Protection*, 8 TEX. A&M L. REV. 199, 200 (2020) (finding California as a first-mover because it gave doctors the option to recommend medicinal marijuana to patients); Holning Lau, *Human Rights and Globalization: Putting the Race to the Top in Perspective*, 102 NW. U. L. REV. COLLOQUY 319, 327 (2008) (observing California as the first mover in same-sex marriage rights to non-residents); J. Haskell Murray, *The Social Enterprise Law Market*, 75 MD. L. REV. 541, 558 (2016) (identifying California as the first to depart from the Model Benefit Corporation Legislation and expressly require dissenter’s rights); Chiara Pappalardo, *What a Difference a State Makes: California’s Authority to Regulate Motor Vehicle Emissions Under the Clean Air Act and the Future of State Autonomy*, 10 MICH. J. OF ENV’T. & ADMIN. L. 169, 169 (2021) (noting California as a first mover and serving as a laboratory for the testing of “technological solutions and regulatory approaches to improve air quality”); Catherine Powell, *We the People: These United Divided States*, 40 CARDOZO L. REV. 2685, 2741 (2019) (mentioning that first mover states like California need to continue to lead in the area of climate change mitigation).

166. Felix von Meyerinck, Alexandra Niessen-Ruenzi, Markus Schmid, & Steven Davidoff Solomon, *As California Goes, So Goes the Nation? Board Gender Quotas and the Legislation of Non-economic Values* 1, 20 (ECGI Finance Working Paper No. 785/2021, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303798.

167. *Id.* at 6, 21–22.

168. *See* CAL. CORP. CODE §2115.5 (West 2019); *see also id.* §301.3. California was

California's adoption; Washington enacted a bill that requires either a gender-diverse board or specific disclosures to shareholders essentially as to why they did not meet the minimum number of women requirement.¹⁶⁹ While Norway was the true first to establish a corporate board quota,¹⁷⁰ California was the first-mover in the United States.¹⁷¹

Many political science scholars have investigated and attempted to rank which states are the most innovative and conducting more experiments.¹⁷² Regardless of what methodology is used to rank the states, California has consistently been on or near the top.¹⁷³

Probably every one of the fifty states can point to a few areas of law in which it developed new doctrine accepted by other states. But California has a record, probably unique in the number and subject-matter range, of legal innovations — instituted by the Legislature and the courts alike — that have broken new paths.¹⁷⁴

the first state to enact a law requiring gender-diversity. It was also the first state to act when it comes to non-binding resolutions, having adopted theirs in 2013. S. Con. Res. 62, 2013 Leg., 2013-2014 Sess. (Cal. 2013). The non-binding resolution, which was designed to encourage public company participation, diffused to other states: S. 1007, 2015 Leg., 189th Sess. (Mass. 2015); H.R. 0439, 2015 Leg., 99th Sess. (Ill. 2015); H.R. 273, 2017 Leg., 2017-2018 Sess. (Pa. 2017); H.R.J. Res. 17-1017, 2017 Leg., 2017 Sess. (Colo. 2017).

169. S. 6037, 66th Leg., Reg. Sess. (Wash. 2020). The Washington law requires companies who do not meet the minimum requirements to provide a “board diversity discussion and analysis” that discloses the company’s approach to creating board diversity. *Id.* Some answers that the company would provide in said discussion and analysis would include: how the board “considered the representation of any diverse groups in identifying and nominating” board candidates, or the reasons that diversity was not considered; any policies adopted to identify and nominate members of any diverse groups as board candidates, or the reasons for not adopting such a policy; and “mechanisms of refresh[ing] the board, such as term limits and mandatory retirement” of board members. *Id.*

170. See Darren Rosenblum, *Feminizing Capital: A Corporate Imperative*, 6 BERKLEY BUS. L.J. 55, 62–63 (2009); see also, Gwladys Fouche, *Exclusive: Norway Wealth Fund Tells Firms: Put More Women on Your Boards*, REUTERS (Feb. 15, 2021, 5:56 AM), <https://www.reuters.com/article/us-norway-swf-exclusive/exclusive-norway-wealth-fund-tells-firms-put-more-women-on-your-boards-idUSKBN2AF0TX> (“Norway’s \$1.3 trillion sovereign wealth fund, the world’s largest, wants the companies it invests in globally to boost the number of women on their boards and to consider setting targets if fewer than 30% of their directors are female . . .”).

171. See Darren Rosenblum, *California Dreaming?*, 99 B.U. L. REV. 1435 (2019) (arguing that California’s board diversity law may actually be successful and encourage other states to act).

172. See, e.g., Walker, *supra* note 4.

173. See *id.* at 883. But see Robert L. Savage, *Policy Innovativeness as a Trait of American States*, 40 J. POLITICS 212, 212 (1978) (“American political folklore is rich in suggesting that some states are innovators while others are laggards.”).

174. Harry N. Scheiber, *California — Laboratory of Legal Innovation*, 11 EXPERIENCE 4, 5 (2001).

What motivates California and other states to innovate or experiment? Other than simply trying to come up with the best solution to a problem, policy evangelism is posited as a reason that a state may be motivated to be more innovative. Elected officials are likely to “evangelize — to want to see their own ideas of the ‘best’ outcome enacted not only for themselves, but everywhere”¹⁷⁵ — because they believe they have the best idea how to tackle a problem — that their innovation improves society and should be as widely implemented as possible.¹⁷⁶ Additionally, politicians may be seeking nationwide attention and notoriety.¹⁷⁷ Aside from political reasons, higher levels of state innovation can be attributable to the availability of financial resources,¹⁷⁸ a larger population — particularly those residing in urban areas, and a higher percentage of the population being college graduates.¹⁷⁹

Not all states have the financial resources to experiment. “In a world where states have scarce resources, piggybacking on the efforts and insights of [others] seems sensible and even economically desirable.”¹⁸⁰ State policy innovation and experimentation is risky and costly.¹⁸¹ As such, states with more financial resources are more likely to experiment.¹⁸² “More populous

175. Galle & Leahy, *supra* note 155, at 1356; *see also* Steven Kelman, *Why Public Ideas Matter*, in *THE POWER OF PUBLIC IDEAS* 31, 46 (Robert B. Reich ed., 1988) (reporting surveys of officials).

176. Galle & Leahy, *supra* note 155, at 1363; *see* Cai & Treisman, *supra* note 161, at 53.

177. *See* Gewirtzman, *supra* note 148, at 268; *see also* Heather K. Gerken & Ari Holtzblatt, *The Political Safeguards of Horizontal Federalism*, 113 MICH. L. REV. 57 (2014); Galle & Leahy, *supra* note 155, at 1386–89.

178. *See* Thad Kousser, TERM LIMITS AND DISMANTLING OF THE LEGISLATIVE PROFESSIONALISM 177–79 (2005); Charles R. Shipan & Craig Volden, *The Mechanisms of Policy Diffusion*, 52 AM. J. POL. SCI. 840, 843 (Oct. 2008) (“Innovative leaders were found to be larger, wealthier and more cosmopolitan.”); *see also* Robert L. Crain, *Fluoridation: Diffusion of an Innovation among Cities*, 44 SOCIAL FORCES 467, 472 (1966); Fred W. Grupp, Jr. & Alan R. Richards, *Variations in Elite Perceptions of American States as Referents for Public Policy Making*, 69 AM. POL. SCI. REV. 850, 851 (1975); Walker, *supra* note 4, at 880.

179. *See* Andrew Karch, Sean C. Nicholson-Crotty, Neal D. Woods, & Ann O’M. Bowman, *Policy Diffusion and the Pro-innovation Bias*, 69 POL. RSCH. Q., Apr. 2016, at 83, 86.

180. Scott Dodson, *The Gravitational Force of Federal Law*, 164 U. PENN. L. REV. 703, 730 (2016). Dodson’s focus was on piggybacking on federal laws, but the premise is equally applicable to states.

181. *See* Galle & Leahy, *supra* note 155, at 1342; *see also* Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593, 594 (1980).

182. *See* Karch, Nicholson-Crotty, Woods & Bowman, *supra* note 179, at 83 (2016); Boehmke & Skinner, *supra* note 4, at 303; Gray, *supra* note 4, at 1174; Walker, *supra* note 4, at 880; *see also* Dodson, *supra* note 180, at 732; John B. Oakley & Arthur F. Coon, *The Federal Rules in State Courts: A Survey of State Court Systems of Civil Procedure*, 61 WASH. L. REV. 1367, 1426 (1986).

states with ample resources are better able to absorb the costs of experimen[tation] in one or two budget areas and can more easily diversify against the risk of failure.”¹⁸³ As the fifth-largest economy in the world, California is well poised to experiment and provide solutions to big problems.¹⁸⁴

B. Diffusion Mechanisms

“Diffusion is the process by which an innovation spreads.”¹⁸⁵ It transpires when state policymakers observe other states and implement the same solution.¹⁸⁶ Said another way, while some states serve as laboratories and experiment with new policies and laws, policymakers in states that are less likely to experiment can free-ride on an experimenting state’s law.

Some state legislatures will immediately adopt another state’s law because they want to *imitate* that state. Others will seek to *learn* from the first-moving state’s experiment’s results. Regardless, the decision to free-ride does not come easily. While political science scholars focus on four main mechanisms or ways that a policy or law can spread from one state to another: imitation, learning, economic competition, and coercion,¹⁸⁷ this Article focuses on the imitation and learning mechanisms because they are the most applicable here.

i. Mechanism: Imitation

Imitation as a mechanism focuses directly on emulating another state.¹⁸⁸ States that imitate often hope to “raise their profile and make them[selves] more attractive places to live,”¹⁸⁹ like the state they are choosing to emulate.

183. Galle & Leahy, *supra* note 155, at 1367 (citing Ken Kollman et al., *Decentralization and the Search for Policy Solutions*, 16 J. L. ECON. & ORG. 102, 102 (2000)); see also Koleman S. Strumpf, *Does Government Decentralization Increase Policy Innovation?*, 4 J. PUB. ECON. THEORY 207, 231 (2002).

184. See Frances Stokes Berry & William D. Berry, *Innovation and Diffusion Models in Policy Research*, in THEORIES OF THE POLICY PROCESS 169, 170, 176–77 (Paul A. Sabatier ed., 1999); Volden, *supra* note 1, at 301, 304; Shipan & Volden, *supra* note 178, at 843 (stating how large states are the primary sources of innovation).

185. EVERETT M. ROGERS, *DIFFUSION OF INNOVATIONS* 13 (1962).

186. GRAEME BOUSHEY, *POLICY DIFFUSION DYNAMICS IN AMERICA* 26 (2010).

187. See Shipan & Volden, *supra* note 178, at 840. “Economic diffusion forces occur on policies that involve competition between states over residents, payments, or revenues. Such competition is usually most acute between states with common borders because this facilitates less costly movement by individuals or capital across borders.” Boehmke & Skinner, *supra* note 4, at 320.

188. Shipan & Volden, *supra* note 178, at 842.

189. *Id.* at 843; see also KARCH, *supra* note 152, at 148; Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOCIO. REV. 147, 149 (1983).

Another way that imitation can fuel diffusion is through homogeneity or institutional isomorphism.¹⁹⁰ In other words, states that are homogeneous (resemble one another) are likely to imitate a state they are similar to by adopting its policy. While imitation often occurs based on close geographical proximity, the similarity can go beyond pure geography. For instance, states that are ideologically or politically homogenous are more likely to adopt one another's laws through imitation.¹⁹¹

A free-riding imitating state trusts, or seeks to emulate, the experimenting state regardless of the experiment's outcome.¹⁹² For some policymakers, the decision to imitate can be based in saving resources, luring new residents to their state, or alternatively, preventing the loss of their current residents to the experimenting state. Perhaps they want to appear united with the first-moving experimenting state.¹⁹³ Or perhaps the policy is one that most states can agree on, such as sex offender registries or the AMBER Alert system.¹⁹⁴ There could be numerous reasons that policymakers may find it valuable to imitate. However, there are drawbacks to imitation. Problematically, when policymakers imitate, they may not consider the unique preferences of their residents,¹⁹⁵ thus creating asymmetry between state law and the electorate.¹⁹⁶ Another problem is that free-riding imitating states are unlikely to undertake the investigations or develop and maintain the records commonly associated with experimentation, such as the debates and legislative or rulemaking history that courts use when interpreting the law.¹⁹⁷

If a state policymaker's impulse is to emulate a specific state, imitation as a process takes virtually no time at all. It can be essentially immediate. For example, recall Washington's adoption of California's gender-diverse board quota law within eighteen months.¹⁹⁸ While the Washington law's language is not verbatim, it is very similar and can still be considered as having imitated California's as it is common for a state to customize a law to fit its

190. KARCH, *supra* note 152, at 148; DiMaggio & Powell, *supra* note 189, at 149.

191. Daniel M. Butler, Craig Volden, Adam M. Dynes, & Boris Shor, *Ideology, Learning, and Policy Diffusion: Experimental Evidence*, 61 AM. J. POL. SCI. 37, 37 (2017); *see also* BOUSHEY, *supra* note 186, at 25 ("Rather than taking a comprehensive solution search for each . . . problem, governments borrow heavily from their neighbors or ideological peers."); Gewirtzman, *supra* note 148, at 293 (describing the idea of "homophily").

192. *See* Dodson, *supra* note 180, at 730 ("It is cognitively easier and simpler for states to follow a trodden path . . . than to blaze a new trail.").

193. *Id.* at 736.

194. BOUSHEY, *supra* note 186, at 1.

195. *See* Dodson, *supra* note 180, at 747.

196. *Id.* at 706.

197. *Id.* at 730.

198. *See supra* notes 168–69 and accompanying text.

jurisdiction.¹⁹⁹ Imitative adoption can happen quickly because there is no experimentation to wait for.

Lastly, consider the American proverb, “where California goes, so goes the nation” and how it applies to the imitation mechanism.²⁰⁰ “California has often been a leader in introducing new regulation, which is subsequently adopted by other states.”²⁰¹ As a matter of fact, California is a known bellwether in environmental, labor, privacy, and other causes.²⁰² Some states may want to imitate California because of its large economy, population, and innovative reputation, particularly in the labor law space. Are those attributes enough to promote adoption of the WCL by other states, or would other state policymakers prefer to learn from California’s experiment first?

ii. Mechanism: Learning

When states experiment with different policies, they can provide results of success and failure that other states can learn from.²⁰³ It is just as important to observe and analyze unsuccessful state laws and programs as it is the successful ones. The learning mechanism inherent in this scrutiny is crucial to a state’s decision on whether and when to adopt others’ laws.²⁰⁴ “When confronted with a problem, decision makers simplify the task of finding a solution by choosing an alternative that has proven successful elsewhere.”²⁰⁵ As such, learning as a diffusion mechanism depends upon the success, or perhaps the perceived success, of a policy or law. If a state’s policymakers determine or perceive that the experimenting state’s legal

199. KARCH, *supra* note 152, at 149. Perhaps Washington’s changes to California’s law helps to achieve a more optimal solution. See Dodson, *supra* note 180, at 746 (“For those convinced by the virtues of homogeneity, allowing temporary, controlled, and collaborative variation may help achieve uniformity in a better form.”). One can certainly view California’s carve-outs as modifications to a statute it adopted. See KARCH, *supra* note 152, at 149.

200. Meyerinck, Niessen-Ruenzi, Schmid, & Solomon, *supra* note 166, at 19 (stating that California led the nation in board gender quotas through imitation mechanism).

201. *Id.*

202. *Id.* at 20–22.

203. Gewirtzman, *supra* note 148, at 266 (noting that some states choose to do nothing and wait while other states undertake risky experiments that will produce information and results); see also Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422, 1464–67 (2011).

204. Markell, *supra* note 153, at 355–56, 355 n.23; see also Daniel A. Farber, *Environmental Protection as a Learning Experience*, 27 LOY. L.A. L. REV. 791, 801 (1994); Galle & Leahy, *supra* note 155, at 1354.

205. William D. Berry & Brady Baybeck, *Using Geographic Information Systems to Study Interstate Competition*, 99 AM. POL. SCI. REV. 505, 505 (2005); see Shipan & Volden, *supra* note 178, at 841; see also Boehmke & Skinner, *supra* note 4, at 320 (“Social learning describes a process whereby states look to the policies of other states, whether as a solution to a common problem or merely as a way to keep up with their peers.”).

experiment was a success, they are more likely to adopt it.²⁰⁶ While this makes sense in a vacuum, policymakers do not operate in such a space. State policymakers who are ideologically or politically against certain policies may be reluctant or unwilling to learn due to their own biases.²⁰⁷ Therefore, even if a law or policy is statistically beneficial, politics may prevent it from diffusing.

Learning as a process takes time. Allowing states to implement policy more gradually allows for feedback and improved institutional learning.²⁰⁸ State policymakers that are interested in knowing the political, economic, and overall consequences of a new law may take months if not years to observe and evaluate the law's effectiveness.²⁰⁹ This is one way that learning is contrasted with imitation. A state that utilizes the learning process patiently awaits the experiment's results. A state that utilizes the imitation process is not interested in waiting for results but is primarily interested in hopping on the bandwagon.²¹⁰

In learning, policymakers focus on the policy itself — how was it adopted, was it effective, what were its political consequences? In contrast, imitation involves a focus on the other government — what did that government do and how can we appear to be the same? The crucial distinction is that learning focuses on the *action* . . . while imitation focuses on the *actor*.²¹¹

206. Shipan & Volden, *supra* note 178, at 842. It is often difficult to compute the success of a policy or law. Sometimes shortcuts that are consistent with learning occur. By way of example, "policymakers may interpret the broad adoption of a policy without subsequent abandonment over time as evidence of the success of the policy, or at least as evidence of maintained political support." *Id.*; see also Gewirtzman, *supra* note 148, at 271.

207. See Butler, Volden, Dynes, & Shor, *supra* note 191, at 38–39.

208. Steele & Tsoflias, *supra* note 149, at 1369–70.

209. Shipan & Volden, *supra* note 178, at 844.

210. See BOUSHEY, *supra* note 186, at 2 ("Although the Amber Alert was exceptional in the sheer speed and scope of its implementation, such abrupt patterns of policy adoption are far from unique in American politics. The reenactment of the death penalty, prohibition, term limits, tax revolts, state auto lemon laws, English Only language legislation, 'three strikes' sentencing guidelines, mandatory child auto-restraint requirements, and sex-offender registries stand as prominent examples of policy innovations that moved rapidly and extensively throughout the nation. Most of these innovations were championed by well-organized interest groups, and appealed broadly to voters across the states. In many cases, the innovation was adopted by more than 30 states in fewer than six years.").

211. Shipan & Volden, *supra* note 178, at 842–43 ("[A] classic example of learning is avoiding touching the hot burner after observing someone doing so with bad effects, whereas imitation is jumping off the garage roof after observing your older brother doing so, without regard for the consequences. In the former case, it is the action that matters; in the latter, the actor. In the former, you learn about consequences; in the latter you simply aspire to be like the other actor.").

Brandeis recognized that when a state experiments, risk is minimized because if such an experiment fails, the damage is confined to that single state.²¹² This of course assumes that the policy or law does not diffuse rapidly via imitation.²¹³ If states adopt laws before the results are in, as is often the case with imitation, then Brandeis' hypothesis is not as confined. Conversely, if a state innovation provides a successful outcome, it should lead to diffusion of innovation among states.

Some state policymakers openly admit to waiting for the AB5 experiment to run its course before deciding whether to adopt it or a similar AB5-esque statute.²¹⁴

*C. Policymakers Seek to Learn the Experiment's Results
Before Free-Riding*

*"[T]here's an incentive for everyone [in New York] that comes up with a proposal that avoids the pitfalls in California — that means we don't have [a] daily running list of . . . exemptions or lawsuits."*²¹⁵

Since California created AB5, states that are seeking to codify a new worker classification law are watching and waiting for the experiment's results. This spectating exemplifies the learning mechanism of diffusion.²¹⁶

Illinois legislator Will Guzzardi openly admits to learning before free-riding on AB5.²¹⁷ "When we're not the first state to act, we get to reflect on the lessons of other states."²¹⁸ As of January 2020, his plan was to introduce legislation similar to AB5, but not until he spoke with labor advocates and

212. *New State Ice Co. v. Liebmann*, 285 U.S. 262, 310–11 (1932) (Brandeis, J., dissenting); see also Dodson, *supra* note 180, at 746; Gewirtzman, *supra* note 148, at 243; JENNA BEDNAR, *THE ROBUST FEDERATION: PRINCIPLES OF DESIGN* 31 (2009); Bednar, *supra* note 150; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 276 (1977).

213. See *infra* Part IV.B.i.

214. See *infra* Part IV.D.

215. Anna Gronewold, *Motive for Cuomo's Gig Economy Task Force Leaves Some Confused*, POLITICO (Jan. 22, 2020, 7:15 PM), <https://www.politico.com/states/new-york/albany/story/2020/01/22/motive-for-cuomos-gig-economy-task-force-leaves-some-confused-1253683> (quoting Staten Island Sen. Diane Savino). It can also lead to more experimentation if a state decides against adoption.

216. See *supra* Part IV.B.ii. Spectating can also lead to more experimentation if a state decides against adoption.

217. Mr. Guzzardi's comments were made prior to AB5's clarifying AB2257 enactment, but, presumably, his comments are applicable to the WCL and not just the initial iteration via AB5.

218. Eli Rosenberg, *Gig Economy Bills Move Forward in Other Blue States, After California Clears the Way*, WASH. POST (Jan. 17, 2020), <https://www.washingtonpost.com/business/2020/01/17/gig-economy-bills-move-forward-other-blue-states-after-california-clears-way/>.

workers.²¹⁹ In speaking to Eli Rosenberg of the Washington Post, Representative Guzzardi did not commit to an AB5-esque bill, stating it could be like AB5 or maybe the bill would create a new class of worker.²²⁰ As such, he is now waiting to see how California's AB5 experiment goes.

New Jersey passed several laws in 2019 to crack down on worker misclassification.²²¹ As of this writing, New Jersey bill S863 was proposed by Senator Stephen M. Sweeney.²²² Bill S863 would modify New Jersey's ABC test to mimic the version that California uses, as well as broaden its scope.²²³ New Jersey uses the ABC test solely for unemployment compensation purposes.²²⁴ If passed, the new law will modify the ABC test to mimic AB5's coverage and expand its application to wage and hour laws, wage payment laws, and wage collection laws in alignment with the New Jersey Supreme Court's 2015 decision in *Hargrove v. Sleepy's, LLC*.²²⁵ However, the legislation does not contain as long of a list of carve-outs, which has been cause for criticism by the U.S. Chamber of Commerce.²²⁶ In November 2019, Sean Redmond, Executive Director, Labor Policy, penned:

[B]ecause lawmakers in California realized just how sweeping it was, A.B. 5 also included numerous exemptions for employers in certain industries, something that [this bill] fails to do. Moreover, after passing it barely two months ago, the California legislature already realizes that it may need to further amend A.B. 5 in its upcoming session to address the predictably ill effects of the bill.²²⁷

Redmond also called for further discussions with Sweeney relative to exempting types of workers from the bill.²²⁸ Clarifying what he thinks about the gig economy, Redmond elaborated: "[E]xemptions must also include legitimate independent contractors working for app-based platforms who

219. *Id.*

220. *Id.*

221. Ryan T. Warden, *New Jersey Resumes Efforts to Amend ABC Test for Independent Contractor Status, Passes Slate of Laws Targeting Misclassification*, NAT'L L. REV. (Jan. 23, 2020), <https://www.natlawreview.com/article/new-jersey-resumes-efforts-to-amend-abc-test-independent-contractor-status-passes> (outlining the proposed legislation).

222. S. 863, 2019 Leg., Reg. Sess. (N.J. 2020).

223. *See id.*

224. *See* Gronewold, *supra* note 215.

225. 106 A.3d 449 (2015) (expanding the coverage of the ABC test beyond unemployment to purposes of resolving a wage-payment or wage-and-hour claim.); *see* Warden, *supra* note 221.

226. Letter from Sean P. Redmond, *supra* note 121.

227. *Id.*

228. *See id.* ("To the extent that there may have been discussions about exempting many types of workers from S. 4204, the U.S. Chamber is supportive of these discussions.").

provide their services while exercising a great deal of independence.”²²⁹

New York is also on the move. In 2019, numerous workplace protections were put into place.²³⁰ More on point to this Article, in the summer of 2019, a bill to create a new “dependent worker” classification was submitted; however, the bill has languished in committee for over a year and a half.²³¹ California’s adoption of AB5 may have provided more momentum for New York’s leaders evidenced by bill sponsors considering bills more like AB5.²³²

While many New Yorkers appreciate the innovation and services offered by a developing app-based economy, their fellow workers are unable to reap these benefits because the law is not aligned with existing economic and

229. *Id.* The question of independence leads back to control and whether app-based workers have sufficient independence to be classified as independent contractors. In *Lowman v. Unemployment Compensation Board of Review*, 235 A.3d 278 (Pa. 2020), the Pennsylvania Supreme Court held that an Uber driver was not free from Uber’s control and therefore was not self-employed. *Id.* at 281. The court did a lengthy analysis of all of the ways that Uber does and does not control its drivers. *See id.* at 295–308.

230. N.Y. LAB. LAW § 652 (McKinney 2021) (minimum wage increase); A.B. 10636, 2017–2018 Leg. Sess. (N.Y. 2017) (tip credit increase); N.Y. WORKERS’ COMP. LAW § 205 (McKinney 2021) (amending the workers’ compensation law to provide benefits for paid family leave); S.B. 6577 2019–2020 Leg. Sess. (N.Y. 2019) (strengthening and reforming the state’s anti-harassment and anti-discrimination laws); N.Y. LAB. LAW § 194 (McKinney 2021) (expanding pay equity protection for employees beyond gender-based pay differentials); N.Y.C. ADMIN. CODE § 8-107 (2016) (prohibiting employers from conducting pre-employment drug testing for marijuana; prohibiting employment discrimination based on an individual’s reproductive health choices); A.B. 2006 2019–2020 Leg. Sess. (N.Y. 2019) (amendment making discrimination based on gender identity of expression unlawful); N.Y. EXEC. LAW § 292 (McKinney 2021) (prohibiting discrimination based on traits historically associated with race, including hair texture and protective hairstyles, such as braids, locks, and twists); N.Y. EXEC. LAW § 296 (McKinney 2021) (prohibits employers from taking discriminatory action against an employee for wearing clothing, attire or facial hair associated with the requirements of the employee’s religion; amendment requiring employers to provide reasonable time off to allow employees who are domestic violence victims to participate in legal proceedings related to the offense or to obtain health or safety services); N.Y. ELEC. LAW § 3-110 (McKinney 2020) (revised election law to provide workers expanded time off to vote); A.B. 5501 2019–2020 Leg. Sess. (N.Y. 2019) (prohibits an employer from threatening to contact immigration authorities about an employee or an employee’s family member); WESTCHESTER CNTY., N.Y. CODE OF ORDINANCES § 586.04 (2022) (provides paid safe time leave to employees who are the victims of domestic violence or human trafficking).

231. S.B. 6583, 2019–2020 Leg. Sess. (N.Y. 2019), <https://www.nysenate.gov/legislation/bills/2019/s6538> (showing the current status of the bill).

232. Annie McDonough, *Will New York Follow California on Gig Worker Protections?*, CITY & STATE N.Y. (Sept. 11, 2019), <https://www.cityandstateny.com/articles/policy/technology/california-passed-ab5-what-does-mean-new-york.html> (“‘California does what they want,’ Savino said. ‘Sometimes California and New York are on the same page, and sometimes they’re in totally different places. I think New York is going to have the most comprehensive conversation about it. My goal is for us to put forward the best piece of legislation that becomes a model for the nation, regardless of what happens anywhere else.’”).

social changes. This asymmetry enables corporations to circumvent what would be considered fair pay and benefits in an app-based economy, thereby sacrificing the employee and taxpayer for increased profits.²³³ Former Governor Cuomo is quoted as having said about AB5: “I don’t want to lag California in anything, I don’t want to lag any other state.”²³⁴ In what could have been a step further, New York Senator John Liu considered a bill that is similar to AB5.²³⁵ He has said: “‘You know what, California, they are the first, and sometimes it’s good to be the second,’ he added. ‘We’ll figure out what has worked there, and we have the benefit of learning from someone with a little bit of experience.’”²³⁶

Clearly, policymakers are watching California’s AB5 and its aftermath to learn from California’s experiment.²³⁷ Will states adopt a similar approach? What do policymakers need to consider?

D. Applying the Galle and Leahy Diffusion Factors

Policymakers who seek to learn from another state’s experiment require focus and guidance to complete their learning process. As stated previously, some policymakers seek to get their name out and evangelize.²³⁸ But while political aspirations and views surely impact decisions to adopt another state’s laws,²³⁹ policymakers should look beyond politics and biases to consider laws more objectively, or at a minimum consider their political agenda within a certain scope of factors. More specifically, Professors Galle and Leahy outline three factors that policymakers can weigh when deciding whether to free-ride: “relevancy, information, and costs.”²⁴⁰ Said another way, these factors can help determine whether a policy or law will likely diffuse to another state.

i. Relevancy

The *relevancy* factor addresses whether a policy is useful (or applicable)

233. ANDREW CUOMO, NEW YORK STATE: 2020 STATE OF THE STATE 101 (2020), <https://www.governor.ny.gov/sites/default/files/atoms/files/2020StateoftheStateBook.pdf>.

234. McDonough, *supra* note 232.

235. Gronewold, *supra* note 215.

236. *Id.* New York uses a version of the ABC test for purposes of workers in the construction industry. N.Y. LAB. L. § 861-c(2) (McKinney 2022); *see In re Barrier Window Systems, Inc.*, 53 N.Y.S. 222, 226 (App. Div. 2017).

237. Note also that the U.S. Congress is considering the ABC test part of AB5 for use in determining classification for NLRA purposes under the PRO Act.

238. *See supra* note 175 and accompanying text.

239. *See supra* note 177 and accompanying text.

240. Galle & Leahy, *supra* note 155, at 1346.

to another state.²⁴¹ Relevancy is positively related to diffusion. Conversely, if a policy is not relevant to another state, it is negatively related to diffusion. Therefore, diffusion is likely to happen in cases where states are homogeneous with regard to institutional structures, physical resources, and demographics because similar states' laws will be pertinent.²⁴² States often tailor their policies or laws to their unique characteristics.²⁴³ As such there is a reduced likelihood of diffusion of the tailored policy or law to a state that is heterogeneous to the creating state.²⁴⁴

In applying the relevancy factor to potential diffusion of the WCL, policymakers should look beyond the scope of worker classification as a general proposition. Properly classifying workers is relevant to all states; however, the focus should be on the relevancy of the *statutory language itself*. California's WCL could very well fail to diffuse due to the under-inclusiveness created by the extensive number of carve-outs and retained use of the *Borello* test.²⁴⁵ Potential free-riders may view the WCL as being too customized or tailored to California, and therefore not relevant to their own state. If that is so, relevancy will be lacking, which disfavors diffusion. Conversely, it is possible that portions of California's approach will seem relevant enough for policymakers to consider adoption with some customization, which would favor diffusion.

ii. Information

The *information* factor addresses the ease of obtaining useful data from the first-mover state — whether such state will share information resulting from its experiment.²⁴⁶ “[G]ood information may often prove elusive. Innovators rarely have incentives to generate their own information, other actors may have limited knowledge about the most useful aspects of an

241. *Id.* at 1347; see also Robert L. Savage, *When a Policy's Time Has Come: Cases of Rapid Policy Diffusion, 1983-1984*, 15 *PUBLIUS* 111, 114 (1985) (stating that sometimes States emulate a policy on the basis of its virtue and adopt it regardless of whether there is a need).

242. Galle & Leahy, *supra* note 155, at 1347; Savage, *supra* note 241, at 114; see Volden, *supra* note 1, at 295; see also Sharun W. Mukand & Dani Rodrik, *In Search of the Holy Grail: Policy Convergence, Experimentation and Economic Performance* (John F. Kennedy Sch. Of Gov't, Harv. U., Faculty Rsch. Working Papers Series, Working Paper No. RWP02-027, 2002), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=329901.

243. See KARCH, *supra* note 152, at 149.

244. *Id.*

245. Consider the Department of Labor's comment in declining to adopt the ABC test to be used for FLSA purposes: “The fact that California recently enacted numerous exemptions to the ABC test highlights the test's limitations” Independent Contractor Status Under Fair Labor Standards Act, 85 Fed. Reg. 60,600, 60,636 (proposed Sept. 25, 2020) (to be codified at 29 C.F.R. pts. 780, 788, 795).

246. Galle & Leahy, *supra* note 155, at 1351.

experiment, and innovating jurisdictions may actually actively conceal information about their activities from outsiders.”²⁴⁷ Information availability (like an experiment’s results) is positively related to diffusion.²⁴⁸ Some scholars note that first-movers may be more forthright about sharing positive information about success than negative information indicating failure.²⁴⁹ Such outcome information is important for diffusion, but it may not be readily available or even measured unless the first-mover state benefits from it.²⁵⁰

Policymakers considering the adoption of the WCL can learn from the successes and failures associated with the AB5 experiment so long as the information is available to them. When analyzing whether obtaining information from the AB5 experiment will be easy, states can look to various sources. The first source should be California itself as it is in the best position to provide the results from this experiment.²⁵¹ However, will California be forthcoming with the data other states need? Does it benefit California to provide such information? While this information may not come from the state agencies directly, it could come from academic institutions or organizations within California such as the UC Berkeley Labor Center (“the Center”).²⁵² Professors from the Center research and report on a variety of labor issues including app-based work and independent contracting.²⁵³ The Center’s reports could be helpful to policymakers.

247. *Id.*; see Rose-Ackerman, *supra* note 181, at 611 (“[I]f innovations take time for other states to copy, [the first mover state] expects some net immigration of voters from other communities. Their immigration lowers tax bills and induces more migration.”). Some States may deliberately choose to withhold information to prevent other states from free-riding. This is problematic in that it “deprives the system of critical data that could help other states or the federal government identify the best available policy solution.” Gewirtzman, *supra* note 148, at 267.

248. See ROGERS, *supra* note 185, at 16 (“The easier it is for individuals to see the results of an innovation, the more likely they are to adopt.”); David Lazer, *Information and Innovation in a Networked World*, in DYNAMIC SOCIAL NETWORK MODELING AND ANALYSIS: WORKSHOP SUMMARY AND PAPERS 101 (Ronald Breiger, Kathleen Carley & Philippa Pattison, eds. 2003) (stating technology has made information gathering easier and cheaper which in turn makes it easier for states to free ride).

249. Galle & Leahy, *supra* note, 155, at 1354; Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927–39 (1998); see also Christopher Hood, *The Risk Game and the Blame Game*, 37 GOV’T & OPPOSITION 15, 33 (2002).

250. See Galle & Leahy, *supra* note 155, at 1353.

251. But see Wiseman, *supra* note 151, at 1164 (noting states do not always produce accurate or enough information about their experiments).

252. UC Berkeley Labor Center: *About Us*, U.C. BERKLEY LAB. CTR., <https://laborcenter.berkeley.edu/about/> (last visited Jan. 17, 2022).

253. E.g., Annette Bernhardt & Sarah Thomason, *What Do We Know About Gig Work in California? An Analysis of Independent Contracting*, UC BERKELEY LAB. CTR. (June 14, 2017), <https://laborcenter.berkeley.edu/what-do-we-know-about-gig-work-in->

Depending on the heterogeneity of the states involved, policy goals will vary, and therefore the information state policymakers will gather and analyze will vary.²⁵⁴

[V]ariations in the types of information that states produce can make it difficult to compare the effectiveness of policies from different states, or to aggregate information about policies implemented in multiple states. [P]referential differences can also make it more likely that a state will discount or ignore useful information from other states based on mistrust of its sources.²⁵⁵

Policymakers in states that have different goals and values than California's when it comes to worker protections may therefore mistrust California's data or discount it altogether. Their own ideological or political biases can get in the way of analyzing the data accurately.

The private sector — such as companies, interest groups, academics, and policy entrepreneurs — provide information as well, particularly when it comes to nationalized hot issues such as worker classification.²⁵⁶ But policymakers should be cautioned. Many of the private sector groups are not without motives that can skew data. For example, Uber has publicly provided driver compensation data, but Uber is an interested party, so policymakers should be careful how they read the data and should make efforts to determine its credibility or replicate it when possible.²⁵⁷ And while organizations and academics can generally be considered neutral researchers, free of conflicts of interest, policymakers should look at whether the research is funded by interested companies and take that into consideration.

Lawsuits emanating from AB5 or the WCL can also provide valuable information to policymakers that are considering adoption. Similarly, the public's reaction obtained via the media and social media can also be invaluable.²⁵⁸ California's AB5 stirred up a monumental amount of

california/.

254. Gewirtzman, *supra* note 148, at 274.

255. *Id.*

256. *Id.* at 288–89. Such groups can be considered “the primary providers of interstate linkages, facilitating the transfer of information about policy experiments across state borders and coordinating multi-state political efforts at policy innovation.” *Id.*; see BOUSHEY, *supra* note 186, at 29–30; Amanda C. Leiter, *Fracking as a Federalism Case Study*, 85 U. COLO. L. REV. 1123, 1126–29 (2014); Michael Mintrom, *Policy Entrepreneurs and the Diffusion of Innovation*, 41 AM. J. POL. SCI. 738, 739–41 (1997).

257. *Uber Drive: How Much Drivers Make*, UBER, <https://www.uber.com/us/en/drive/how-much-drivers-make/> (last visited Mar. 20, 2022).

258. See, e.g., Scott Rodd, *Uber, Lyft, Postmates Refuse to Comply With California Gig Economy Law*, NPR (Jan. 4, 2020), <https://www.npr.org/2020/01/04/793142903/as-california-tries-to-make-contract-workers-employees-industries-push-back> (showing the media's representation of how the public feels about AB5 lawsuits); Twitter: #AB5, https://twitter.com/search?q=ab5&src=typed_query (last visited July 24, 2021) (showing

controversy. Prop 22 added fuel to the media reactions and created greater national awareness.²⁵⁹ Free-riding states have been able to sit back and watch the media reaction unfold. Potential free-riders, in deciding whether to adopt the WCL, could find it helpful to gather data from the explosion of social media attention AB5 received. However, policymakers should exude caution in that some individuals are more vocal than others, particularly those that are solicited by lobbying groups. Other individuals may not be as forthcoming with their preferences or opinions.

Ultimately, policymakers may determine that it is too difficult to obtain information or at least information that is transferrable to their state's interests. The lack of ease of obtaining information or information they trust disfavors diffusion. If, however, policymakers perceive obtaining information as easy, then that could favor diffusion but only if the information is considered favorable.

iii. Costs

The last factor addresses the *costs* of adoption. Conservation of resources, particularly for resource strained states, is a priority, but “[i]f the costs of copying are comparable to, or even higher than, the costs of experiment, the jurisdiction might as well experiment.”²⁶⁰ Costs likely incurred in the diffusion process are associated with adoption, implementation, and enforcement. If putting the infrastructure in place is too complex and therefore costly, the policy is less likely to be adopted.²⁶¹ Moreover, costs pose an issue for free-riders who may not be able to afford them or evaluate their credibility. Therefore, high costs and complexity are negatively related to diffusion.

California's WCL is particularly complex and likely costly to administer, particularly when considering enforcement and education. It has been too responsive to pushback, risking chaos and disintegration — a sub-optimal result.²⁶² California has seen the chaos and disintegration first-hand, but perhaps the disintegration can be viewed as somewhat minimized by the WCL's use of the *Borello* test as a default for the carve-outs.²⁶³ Other states

the public's reaction on Twitter, one of the most used social media sites).

259. E.g., Tim Ryan, *Lyft, Uber Say Classification Rulings Can't Stand After Prop 22*, LAW360 (Nov. 9, 2021, 9:29 PM), <https://www.law360.com/articles/1327367/lyft-uber-say-classification-rulings-can-t-stand-after-prop-22>.

260. Galle & Leahy, *supra* note 155, at 1357. In fact, being true to experimental federalism, we want and need more experimentation to achieve the best policies.

261. See Rogers, *supra* note 185, at 252.

262. Gewirtzman, *supra* note 148, at 253; see also Doni Gewirtzman, *Lower Court Constitutionalism: Circuit Court Discretion in a Complex Adaptive System*, 61 AM. U. L. REV. 457, 508 (2012).

263. See Powell, *supra* note 82, at 481–82 (finding that following California's

may not have or want to maintain a pre-existing default test, and the costs associated with such are likely prohibitive. Additionally, some state legislatures may not have the resources (monetary and human time) to spend on carving out exceptions like California continues to do. One of the reasons policymakers prefer to free-ride is to save time and money. Revisiting or amending a law regularly would be costly.²⁶⁴ As such, it is possible that potential free-rider states will consider the costs of adopting, implementing, and enforcing AB5 as insurmountable.

E. Analyzing the Potential Diffusion of California's WCL

*"[S]tates with successful policies are more likely to be emulated than are those with failing policies."*²⁶⁵

Applying the Galle and Leahy diffusion factors: relevancy, information, and costs, it is questionable whether policymakers will decide that the WCL is relevant enough, that the data about the WCL's successes and failures is credible and readily obtainable, and that the costs justify the adoption of the WCL.²⁶⁶ After application of the three factors, policymakers will want to consider the successes and failures of the WCL before making the decision of whether to adopt it.

Circling back to experimental federalism and laboratories of democracy: States "can learn more when multiple governments try the policy, and even more when such policies affect larger segments of society."²⁶⁷ California's overall population is large, as is its independent contractor population.²⁶⁸ Given that the WCL directly affects (economically and socially) the entire populous of California, its workers and businesses, the WCL qualifies as affecting a "larger segment of society." Still, based on the results of the experiment, is it likely that the WCL could or should diffuse to other states?

Diffusion is more likely to occur when a state's experiment is viewed as

adoption of the *Borello* test, Uber drivers were classified by the law as employees instead of independent contractors).

264. Dodson, *supra* note 180, at 732.

265. Volden, *supra* note 1, at 294.

266. See Galle & Leahy, *supra* note 155, at 1346–60 (discussing the three factors).

267. Shipan & Volden, *supra* note 178, at 842.

268. As of July 1, 2019, California is the most populous state with 39,512,223 residents. 2019 U.S. Population Estimates Continue to Show the Nation's Growth Is Slowing, U.S. CENSUS BUREAU (Dec. 30, 2019), <https://www.census.gov/newsroom/press-releases/2019/popest-nation.html>. According to recent data, the ABC Test, which represents the new part of California's worker classification law (AB5), "will apply to [sixty-four] percent of workers who are independent contractors at their main job, [and] will apply except when strict criteria are met to [twenty-seven] percent" SARAH THOMASON, KEN JACOBS, & SHARON JAN., DATA BRIEF: ESTIMATING THE COVERAGE OF CALIFORNIA'S NEW AB5 LAW 2 (2019).

successful. In measuring success, the positive and negative results must be weighed. Given that the WCL is a merger of the ABC test and California's previous *Borello* test, and that it contains 109 carve-outs, it may be difficult to discern precisely which parts of the WCL are successes and which are failures. Case law and other political occurrences can also cause confusion as to success versus failure. For instance, in the California courts, Uber drivers were deemed employees under AB5 in *People v. Uber Technologies, Inc.*²⁶⁹ That is a significant success given the goal of protecting app-based drivers via reclassification as employees. However, despite the ruling in *Uber*, the passing of Prop 22 exempted the drivers from the coverage of the WCL and provided the drivers with fewer benefits. Since the goal was to provide safety net protections for the drivers and Prop 22 provides some of these protections, even if marginally, there will likely be mixed reactions as to the failure or success of this aspect of the WCL. In August 2021, a California court found Prop 22 to be unconstitutional,²⁷⁰ and if that holding is upheld, then the WCL lends itself to being more of a success regarding rideshare and delivery drivers since these workers were previously reclassified as employees entitled to full California labor protections. Ultimately the question becomes, how will the interaction between the WCL and Prop 22 be perceived?²⁷¹ Will policymakers in states that do not have broad voter initiative processes²⁷² like California see the WCL as a success when it comes to reclassifying app-based drivers or will they see it as an overall failure? Will policymakers in heterogeneous states determine that the marginal protections the rideshare companies offered their drivers were sufficient and allow them to do so in their states? Only time will tell.

The above stated successes and failures will yield valuable information for states that seek to "learn" from California's AB5 experiment. Policymakers will also be gaining important knowledge from both the public reactions as well as any empirical evidence of what are perceived as the successes and failures. Several industry groups rebuked using the ABC test to reclassify their workers as employees.²⁷³ California acquiesced and provided for carve-

269. *People v. Uber Techs., Inc.*, 56 Cal. App. 5th 266, 328 (Ct. App. 2020).

270. In August 2021, the Superior Court of California determined that Prop 22 was unconstitutional. What ultimately happens as the case makes it through the California court system could impact policymakers' decision making. See *supra* note 144.

271. Ryan, *supra* note 259 (noting that in light of Prop. 22's passage, Uber and Lyft have filed petitions to overturn earlier rulings which prevented them from classifying their gig workers as independent contractors).

272. California's initiative process exists so that Californians do "not have to rely only on lawmakers to make new laws. Propositions can create new laws, change or repeal existing laws, change the state constitution, and approve a bond measure." EASY VOTER GUIDE, FAST FACTS: STATE BALLOT MEASURES (2010), <http://www.easyvoterguide.org/wp-content/pdf/FastFacts-BallotMeasures.pdf>.

273. See JON O. SHIMABUKURO, CONG. RSCH. SERV., R46765, WORKER

outs in the WCL to accommodate these industries. However, hiring entities in non-exempt industries could be motivated to hire independent contractors from outside of California. States that cannot afford to have their workers unemployed, may be reluctant to adopt an AB5-like statute. Additionally, politicians seeking reelection will not want to be responsible for putting workers in the unemployment line.

States seeking to learn from California's AB5 experiment could adopt the ABC test and customize it to fit their needs like California has been doing.²⁷⁴ Such states can learn from the pushback by certain industries when they consider enacting similar legislation and decide whether to expand or take a more restrictive approach.²⁷⁵

California's reputation of being larger and more "cosmopolitan" could also influence states, who aspire to be like it.²⁷⁶ Some states may feel an urgency now that California has moved in the worker classification space and that may promote diffusion. Or, policymakers may believe that the controversies surrounding the WCL may die down and once all is quiet they may decide it is safe to adopt.²⁷⁷

Further, homogenous states may be more inclined to imitate or adopt the WCL. Conversely, ideological and political bias that likely exists in heterogeneous states may foreclose diffusion of the WCL to them.²⁷⁸ This has possibly already proven true with recent changes in classification laws that could be based on ideological or political bias. Certain heterogeneous states have abandoned the use of the ABC test in favor of another test (Arkansas, Oklahoma, Tennessee) or voted to choose a test instead of the ABC test (Virginia). Ideological and political bias aside, potential free-riders may conclude that the WCL is not relevant to their state, the information/results may be too difficult to obtain and verify as credible, and that it will be too costly to adopt, implement, and enforce a statute like the WCL.²⁷⁹ Such states may determine that there must be a better way to

CLASSIFICATION: EMPLOYEE STATUS UNDER THE NATIONAL LABOR RELATIONS ACT, THE FAIR LABOR STANDARDS ACT, AND THE ABC TEST (2021) (stating that because the ABC test creates an employee-employer relationship that has not previously existed, the test will discourage certain industries from hiring freelance or for contract workers).

274. See KARCH, *supra* note 152, at 149 ("Early adopters' experiences . . . may provide administrative lessons that also enable [free-riders] to develop [more] expansive programs.").

275. *Id.* at 150 ("Early adopters' experiences might generate a political backlash that limits the acceptability of an innovation, causing late adopters to take a more cautious approach.").

276. See Shipan & Volden, *supra* note 178, at 843.

277. See KARCH, *supra* note 152, at 149.

278. Prince, *supra* note 35, at 161–63 (showing that certain politically conservative states are abandoning the ABC test).

279. See KARCH, *supra* note 152, at 150.

experiment or innovate on their own, while others may prefer the notoriety that comes with innovation. In either case, diffusion is not likely to occur.

Overall, if the rate of diffusion is low, perhaps another state will be an experimenter in this space by providing a better, more effective worker classification test or approach. Even if the diffusion rate is somewhat high (as it appears to be with the ABC test generally), one should question whether the WCL or the ABC test is the best path forward for classifying workers. When states free-ride, they rob us of the benefits of experimental federalism — the more states that experiment and compare results, the more optimal the resulting policy should be.²⁸⁰ This holds true particularly for heterogenous states that analyze information differently and bring different values, ideas, and foci to the process.²⁸¹ Homogenous states and free-riding in general result in sub-optimal policies because they do not bring different values, ideas, and foci to the process. Instead, they create the problem of premature convergence which can result in a broad adoption of a sub-optimal test or policy.²⁸² If states latch on to the WCL rather than experiment, we miss out on a potentially better approach to worker classification.²⁸³

V. CONCLUSION

California's worker classification law is developing. It is a true experiment in that it started with a sort of "idea" (from *Dynamex*) and moved into an experimental phase with the enactment of AB5. AB5 was a merger of new law (the ABC test) and old law (the *Borello* test). Upon receiving industry and worker pushback, within a year AB5 was repealed (or replaced) with AB2257, a law designed to clarify AB5's provisions. AB2257 also expanded the law's exemptions to 109. These changes show that the experiment is still ongoing in that results are analyzed and California's legislature acts on those results. Once the acting (or *reacting*) occurs, the experiment starts again. As such, California's WCL is complicated and continues to evolve, which can be a good thing and aligns with the overarching theory of experimental federalism. But for the purposes of diffusion among states, one may question whether it is adequately meeting its goals.

280. Gewirtzman, *supra* note 148, at 258 ("[M]any of federalism's experimental benefits are dependent upon states having different policy preferences and approaching problems in materially different ways.").

281. *Id.* at 270.

282. *Id.* at 269–70.

283. Galle & Leahy, *supra* note 155, at 1368. Although, "[i]t is possible that instead of experiments, states [will] all simply pluck what seem to them to be the lowest hanging new fruits, rather than sorting among all of the available alternatives to select the most appealing." *Id.*

Many state policymakers look to California for innovative legislation that they can adopt. Some states imitate other states when it comes to adopting laws, but others prefer to learn from the results of the first-mover state's experiment. As shown, state policymakers in numerous states like New York, New Jersey, and Illinois (and likely others) are awaiting the ultimate results of the AB5 experiment. California's WCL may or may not diffuse to other states depending on whether states determine it is relevant to their residents, the information (results) are easy to obtain and credible, and the costs to adopt, implement and enforce are feasible. In part because of the numerous carve-outs in California's WCL, it is not likely that many states will adopt it as is. The law is too customized to California and the 109 carve-outs will likely be considered unmanageable. Measuring the successes and failures is also difficult.

Overall, it appears that the AB5 experiment should not diffuse to other states or the federal government. The continued experimentation through repeated amendments, while well-intentioned, has gone beyond providing an adoptable statute for other states. To maximize the benefits of experimental federalism, a group of states, both homogenous and heterogenous to California, should experiment and work toward a more optimal solution to worker (mis)classification. This collective learning will benefit not just one state's residents and businesses, but all.

Workers need protections but California's worker classification law does not sufficiently satisfy this need.

APPENDIX A — LIST OF THE 109 EXEMPTIONS FROM THE ABC TEST
PORTION OF CALIFORNIA’S WORKER CLASSIFICATION LAW.²⁸⁴

- [1] Bona fide business-to-business contracting relationship – previously contained in AB 5
- [2] Relationship between a referral agency and a service provider
- [3] Graphic design [for referrals] – previously contained in AB 5
- [4] Web design – previously contained in AB 5
- [5] Photography – previously contained in AB 5
- [6] Tutoring – previously contained in AB 5
- [7] Consulting
- [8] Youth sports coaching
- [9] Caddying
- [10] Wedding planning
- [11] event planning – previously contained in AB 5
- [12] Services provided by wedding and event vendors
- [13] Minor home repair – previously contained in AB 5
- [14] Moving – previously contained in AB 5
- [15] Errands – previously contained in AB 5
- [16] Furniture assembly – previously contained in AB 5
- [17] Animal services – previously contained in AB 5
- [18] Dog walking – previously contained in AB 5
- [19] Dog grooming – previously contained in AB 5
- [20] Picture hanging – previously contained in AB 5
- [21] Pool cleaning – previously contained in AB 5
- [22] Yard cleanup – previously contained in AB 5
- [23] Interpreting services
- [24] ”Professional services”
- [25] Marketing – previously contained in AB 5
- [26] Administrator of human resources – previously contained in AB 5
- [27] Travel agent services – previously contained in AB 5
- [28] Graphic design – previously contained in AB 5
- [29] Grant writer – previously contained in AB 5
- [30] Fine artist – previously contained in AB 5
- [31] Services provided by an enrolled agent – previously contained in AB 5
- [32] Payment processing agent through an independent sales organization – previously contained in AB 5
- [33] Still photographer – previously contained in AB 5
- [34] Photojournalist – previously contained in AB 5
- [35] Videographer

284. Source: AB5, AB2257 & Chris Micheli, *AB 5 ‘Fix:’ New Exemptions Added to California’s Independent Contractor Law*, CAL. GLOBE (Sept. 14, 2020), <https://californiaglobe.com/section-2/ab-5-fix-new-exemptions-added-to-californias-independent-contractor-law/>.

- [36] Photo editor who works under a written contract
- [37] Digital content aggregator
- [38] Freelance writer – previously contained in AB 5
- [39] Translator
- [40] Editor – previously contained in AB 5
- [41] Copy editor
- [42] Illustrator
- [43] Newspaper cartoonist – previously contained in AB 5
- [44] Content contributor
- [45] Advisor
- [46] Producer
- [47] Narrator
- [48] Cartographer
- [49] Licensed esthetician – previously contained in AB 5
- [50] Licensed electrologist – previously contained in AB 5
- [51] Licensed manicurist – previously contained in AB 5
- [52] Licensed barber – previously contained in AB 5
- [53] Licensed cosmetologist – previously contained in AB 5
- [54] A specialized performer
- [55] Services provided by an appraiser
- [56] Registered professional foresters
- [57] A real estate licensee – previously contained in AB 5
- [58] A home inspector
- [59] A repossession agency – previously contained in AB 5
- [60] Relationship between two individuals wherein each individual is acting as a sole proprietor or separate business entity
- [61] Recording artists
- [62] Songwriters
- [63] Lyricists
- [64] Composers
- [65] Proofers
- [66] Managers of recording artists
- [67] Record producers
- [68] Directors
- [69] Musical engineers
- [70] Mixers engaged in the creation of sound recordings
- [71] Musicians engaged in the creation of sound recordings
- [72] Vocalists
- [73] Photographers working on recording photo shoots, album covers, and other press and publicity purposes
- [74] Independent radio promoters
- [75] Any other individual engaged to render any creative, production, marketing
- [76] Musician
- [77] Musical group
- [78] An individual performance artist performing material that is their

original work and creative in character

[79] Relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry – previously contained in AB 5

[80] Relationship between a data aggregator and an individual providing feedback

[81] A person or organization who is licensed by the Department of Insurance pursuant to Chapter 5 (commencing with Section 1621) – previously contained in AB 5

[82] A person or organization who is licensed by the Department of Insurance pursuant to Chapter 6 (commencing with Section 1760) – previously contained in AB 5

[83] A person or organization who is licensed by the Department of Insurance pursuant to Chapter 8 (commencing with Section 1831) of Part 2 of Division 1 of the Insurance Code – previously contained in AB 5

[84] A person who provides underwriting inspections

[85] A person who provides premium audits

[86] A person who provides risk management

[87] A person who provides loss control work for the insurance and financial service industries

[88] A physician and surgeon – previously contained in AB 5

[89] Dentist – previously contained in AB 5

[90] Podiatrist – previously contained in AB 5

[91] Psychologist – previously contained in AB 5

[92] Veterinarian – previously contained in AB 5

[93] Lawyer – previously contained in AB 5

[94] Architect – previously contained in AB 5

[95] Landscape architect

[96] Engineer – previously contained in AB 5

[97] Private investigator – previously contained in AB 5

[98] Accountant – previously contained in AB 5

[99] A securities broker-dealer – previously contained in AB 5

[100] Investment adviser – previously contained in AB 5

[101] Agents and representatives of securities brokers and investment advisory – previously contained in AB 5

[102] A direct sales salesperson – previously contained in AB 5

[103] A manufactured housing salesperson

[104] A commercial fisher working on an American vessel – previously contained in AB 5

[105] A newspaper distributor

[106] A newspaper carrier

[107] An individual who is engaged by an international exchange visitor program

[108] A competition judge with a specialized skill set or expertise

[109] Relationship between a motor club holding a certificate of authority – previously contained in AB 5

TAKING MISAPPROPRIATION SERIOUSLY: STATE COMMON LAW DISGORGEMENT ACTIONS FOR INSIDER TRADING

JEANNE L. SCHROEDER*

I. Introduction	98
A. Background	98
B. Advantages of Taking Appropriation Seriously	105
II. Current Law	107
A. Federal Insider Trading Jurisprudence	107
i. Texas Gulf Sulphur	107
ii. The Common Law of Insider Trading	110
iii. Purpose Of Restricting Insider Trading	111
iv. Classic Insider Trading	118
B. Misappropriation	120
C. Tipper-Tippee Liability	127
III. The State Law Disgorgement and Breach of Fiduciary Duty	129
A. Origins	129
B. Reception	130
C. Temporary Doubts About the Continued Relevance of Brophy in Delaware	136
D. Revival	138
IV. Restitution and Property	142
A. Common Law of Property	142
i. Theft	144
ii. Fraud	146
B. The Supreme Court's Misappropriation Analysis	147
C. The Logic of Misappropriation	151

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V. The Restatement (Third) of Restitution and	
Unjust Enrichment	152
A. Introduction.....	152
B. Restitution and Misappropriation of Property	
(Generally).....	155
C. Restitution and Property in Information	
(Specifically)	158
D. Fiduciary and Similar Duties	160
VI. Application of Taking Misappropriation Seriously	162
A. Duties.....	163
B. Measure of Liability.....	168
C. Tippee Liability.....	168
D. Tippee Liability for the Profits of a Tippee.....	175
E. “Solving” Dorozhko.....	177
F. The Brazen Misappropriator.....	179
G. Permitted Trading	180
VII. Conclusion	184

I. INTRODUCTION

A. Background

In two recent cases, the U.S. Supreme Court substantially diminished the Securities and Exchange Commission’s (“SEC”) ability to deprive persons who violate the federal securities laws of their ill-gotten gains. In the 2017 case of *Kokesh v. SEC*,¹ a unanimous opinion penned by Justice Sonya Sotomayor held that disgorgement actions were subject to the five-year statute of limitations for penalties imposed by U.S.C. § 2462.² In a notorious

1. 137 S. Ct. 1635 (2017).

2. 28 U.S.C. § 2462 governs any “action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise.” As Urska Velikonja points out, this is particularly significant since the five-year statute of limitations would almost certainly start to run from the time of the fraud, not the time of the SEC’s discovery of the fraud. Urska Velikonja, *Public Enforcement After Kokesh: Evidence from SEC Actions*, 108 GEO. L.J. 389, 391 (2019). Her examination of 8,000 cases from 2010 (the year the SEC sued the defendant in *Kokesh*) to 2018 (the year *Kokesh* was decided) suggests that, depending on how courts interpret *Kokesh*, between 20% and 80% of SEC disgorgement actions might be at risk. *Id.* at 395.

One reason for this is that, unlike private litigants who file complaints before discovery, the SEC generally does not bring actions until its investigation is completed, which often take years. *Id.* at 398. One suspects that one of the effects of *Kokesh* might be that the SEC will change its practice and commence actions earlier. *Id.* at 431–32. Velikonja also suggests that the reduced statute of limitations might have a lesser effect on insider trader enforcement actions than for actions for other violations because they are easier to detect than large, on-going, frauds like Ponzi schemes. *Id.* at 411–13, 415–

footnote, the Court stated that it was leaving the question as to whether the SEC had the authority to seek disgorgement at all to another day,³ implying that the writing was on the wall.

Three years later, in *Liu v. SEC*,⁴ in an 8-1 opinion once again authored by Justice Sotomayor, the Court held that the SEC could continue to seek disgorgement in judicial actions as an equitable remedy adjunct to its statutory authority to seek injunctions under §21(d)⁵ of the Securities Exchange Act of 1934 (the “Exchange Act”), but its practice had exceeded the bounds of equity.⁶ Consequently, the Court imposed substantial limitations on disgorgement going forward.⁷ Disgorgement orders must be limited to the defendant’s net profits, after deducting legitimate expenses.⁸ Rejecting a theory of joint and several liability, it ruled that in most cases a defendant can be forced to disgorge only his own profits, not those of third parties.⁹

Perhaps most important, the Supreme Court held that disgorged funds must be distributed to the victims of the defendant’s fraud.¹⁰ In the past, the SEC often turned disgorged funds over to the U.S. Treasury. In so holding, the Supreme Court rejected the SEC’s argument that it is enough that the

16.

3. *Kokesh*, 137 S. Ct. at 1642 n.3.

4. 140 S. Ct. 1936 (2020).

5. 15 U.S.C. § 78u(d).

6. In fact, as the Restatement (Third) of Restitution and Unjust Enrichment (the “R3RUE”) makes clear, the modern law of “restitution” (which includes what federal securities law calls disgorgement) does not easily fit into equity. Rather, it has grown to encompass a wide variety of legal and equitable doctrines including contract, tort, and most relevant to securities regulation, principal-agency and property principles. As such, courts impose both legal and equitable remedies in the name of restitution. Consequently, the R3RUE takes the position that it would not try to shoe-horn restitution into a legal/equitable dichotomy because most state common law courts today have both legal as well as equitable jurisdiction. Nevertheless, this distinction remains significant for federal purposes since the SEC does not have the express statutory authority to seek disgorgement, only the general authority to seek equitable remedies auxiliary to its statutory authority. The lingering significance of the distinction at the state level is whether the defendant has a Constitutional right to trial by jury when a plaintiff seeks restitution. Restatement (Third) of Restitution and Unjust Enrichment § 4 cmts. 1, b (AM. L. INST. 2011) [hereinafter R3RUE]; see also Douglas Laycock, *Restoring Restitution to the Canon*, 110 MICH. L. REV. 929, 930–31 (2012). However, in Delaware, restitution actions to recover profits from classic insider traders are implicitly considered equitable as they are adjudicated before chancellors without juries. See *infra* text at notes 68–70, 218–47.

7. 140 S. Ct. 1936 (2020).

8. *Id.* at 1940.

9. *Id.* at 1949. It did, however, note there might be exceptions in some cases, such as in the case of *Liu*, where the two defendants were spouses or where there is, in effect, a partnership. See *id.*

10. *Id.* at 1940.

enforcement action benefits the public generally.¹¹ Only subsequent cases will tell us under what circumstances and to what extent payments to the Treasury can be made if it is not feasible to distribute funds to victims.¹²

The holdings of *Liu* and *Kokesh* are in tension. Among the Court's rationales in *Kokesh* for finding that disgorgement was a penalty was that defendants were often required to disgorge profits earned by others (such as tippees in insider trading cases) and sometimes disgorged funds were paid to the U.S. Treasury.¹³ But in *Liu*, the Court imposed limitations on the SEC's disgorgement powers because equitable remedies must not be punitive. This suggests that it was the SEC's improper wielding of its disgorgement powers that was punitive and perhaps implies that disgorgement *properly* applied would *not* be a penalty. This raises the question, assuming that the SEC follows the restrictions imposed by *Liu*, will the practice cease to be a penalty such that the five-year statute of limitations of 28 U.S.C. § 2462 will cease to apply? If so, *Kokesh* might retroactively become irrelevant — a curious historical footnote.

In the meanwhile, the Supreme Court has been developing a largely property-based theory of insider trading. Why is insider trading evil? Because material nonpublic information is property that the trader has fraudulently obtained and must not use for his own purposes.

In this Article I bring these thoughts together. I examine the restitutionary remedy of disgorgement and connect it to the specific context of insider trading. I argue that disgorgement can and should be sought in *private* rights of actions brought under *state* common law rather than by the SEC under the federal securities laws.¹⁴ Delaware and New York already permit issuers to

11. *Id.*

12. Velikonja estimated that “between 2004 and 2012, the SEC used fair funds to distribute more than 75% of all collected monetary penalties,” including disgorgement. Urška Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Funds Distributions*, 67 STAN. L. REV. 331, 334 (2015). Velikonja's data suggests that during the period from 2010 to 2018, disgorgement was obtained in approximately 96.6% of SEC insider trading actions (including those that are settled). Velikonja, *supra* note 2, at 425–26.

13. *Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2020).

14. As early as 1984, Robert Thompson suggested that, at least in some cases, restitution based on unjust enrichment policies might be the appropriate remedy for insider trading. Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984). One of two problems he identifies is that, following *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969), the appropriate party to seek restitution in the case of what we now call classic insider trading would be the issuer of the securities but, as I will discuss (*see infra* text at notes 130–32) it will rarely have standing under federal law. *Id.* at 395.

Second, Thompson finds “it provides little deterrence to an insider. The defendant knows that if he is caught, he simply must hand back what he gained, and that if he is not caught, he will make a handsome profit.” *Id.* at 396 (citations omitted). Of course, this assumes that the purpose of disgorgement is deterrence, not corrective

do so in the context of what is known as classic insider trading. If one takes the Supreme Court's insider trading jurisprudence seriously, other owners of information should also be able to do so under the alternate misappropriation theory of insider trading. Such cases would not be subject to the limitations imposed by *Kokesh* and *Liu*. More importantly, they would avoid many of the doctrinal quandaries that have arisen under the notoriously problematic federal caselaw.

Private disgorgement actions under state law would be a supplement to, not a replacement of, SEC civil actions for injunctions and fines¹⁵ or Department of Justice ("DOJ") criminal actions. Indeed, private actions will probably be largely parasitic on federal actions because insider trading is typically only revealed through government investigation.¹⁶ And there are reasons to expect that relatively few state disgorgement actions will be brought, if for no other reason than the profits most insider traders make (or losses avoided) are typically quite modest.¹⁷ Nevertheless, I argue that by the logic of the Supreme Court's jurisprudence, the owners of the material nonpublic information would be the appropriate parties to bring such litigation. Indeed, part of my impetus for writing this Article is to illustrate how the Supreme Court's approach which combines property, fiduciary duty, and fraud elements is inadequate for addressing the public policy issues regarding insider trading as a federal offense.

I will not offer a detailed analysis of the *Kokesh* and *Liu* decisions, merely noting in passing, that the Supreme Court's understanding of restitution is flawed. In her short opinion in *Kokesh*, Justice Sotomayor partly based her holding on the assertion that disgorgement was a penalty because in practice it was intended to deter wrongdoing rather than to compensate victims. As

justice. *See infra* text at notes 25–31. Moreover, this is less an argument as to who should be the appropriate plaintiff in a private right of action as one suggesting that the state should be able to bring civil or criminal enforcement actions.

For others who have suggested that insider trading might be analyzed as a form of unjust enrichment under state law, see, e.g., James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345 (2010); WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 3.5.2 (2d ed. 1996); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 26 (1982); and Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1500 (1999).

15. Verity Winship's analysis of SEC actions for insider trading for fiscal years 2005 through 2015 might suggest that it has been over-reliant on disgorgement, as opposed to fines. Verity Winship, *Disgorgement in Insider Trading Cases: FY2005-FY2015*, 71 SMU L. REV. 999 (2018). Although the SEC has the authority to seek penalties of up to triple profits in addition to disgorgement, in fact, it has not typically sought the maximum it could. *Id.* at 1009–10.

16. *See infra* text at note 143.

17. *See infra* text at note 148.

such, she stated, it addresses a public rather than an individual harm.¹⁸

This presumes that law falls into a rigid punitive v. compensatory dichotomy. This is a category mistake, but confusion about restitution is common. Indeed, Andrew Kull, the Reporter on the Restatement (Third) of Restitution and Unjust Enrichment (“R3RUE”) has asked rhetorically whether the “law of restitution in this country has been neglected so long that it is already past resuscitation.”¹⁹ I, like the drafters of the R3RUE and the American Law Institute, answer “no.” It ought to be resuscitated.

The R3RUE insists that restitutionary remedies — which include disgorgement²⁰ — are neither compensatory nor punitive, but fall within a third category: unjust enrichment.²¹ As Doug Rendleman, a member of the R3RUE advising committee explains “The . . . baseline guide to restitution is the defendant’s gain, not the plaintiff’s loss,”²² a simple point that many courts do not internalize.²³

18. *Kokesh*, 137 S. Ct. at 1635, 1643.

19. Andrew Kull, *Three Restatements of Restitution*, 68 WASH. & LEE L. REV. 867 (2011). Professor Kull suggests that one reason why knowledge and scholarship of remedies generally, and restitution specifically, has languished in the United States, even as it has flourished in other common law jurisdictions, is that since the 1960s, U.S. law schools have become academies for the study of public law. *Id.* at 870 (citing John Langbein, *The Later History of Restitution*, in *RESTITUTION: PAST, PRESENT, AND FUTURE* 57, 61 (W.R. Cornish et al. eds., 1998)). Even American private law scholarship tends to be focused on “‘instrumental’ or policy-based analysis,” whereas restitution rarely extends beyond the relative rights of the litigants. *Id.* at 871. He notes that he once heard Ernest Weinrib refer to restitution as the “private parts of private law.” *Id.*; see also Laycock, *supra* note 6, at 930.

Justice Sotomayor does not mention the R3RUE in *Kokesh* in which she makes this distinction, although she does discuss it in *Liu* to justify her limitations on disgorgement.

20. James Edelman limits the term “restitution” for remedies designed to return a transfer of property or its traceable proceeds to its owner, JAMES EDELMAN, *GAIN-BASED DAMAGES: CONTRACT, TORT, EQUITY AND INTELLECTUAL PROPERTY* 66 (2002), and disgorgement for remedies that seek to recover profits from a wrongdoer, whether or not a transfer has been made. *Id.* at 72. Nevertheless, as the R3RUE does not make this distinction, I will generally not do so either.

21. Brief of Remedies and Restitution Scholars as Amici Curiae in Support of Neither Side at 12, *Liu v. SEC*, 140 S. Ct. 1936 (2020) (No. 18-1501), https://www.supremecourt.gov/DocketPDF/18/18-1501/126519/20191223115738971_18-1501%20Liu%20v%20SEC%20Restitution%20Scholars%20Brief.pdf; see also Doug Rendleman, *Measurement of Restitution: Coordinating Restitution with Compensatory Damages and Punitive Damages*, 68 WASH. & LEE L. REV. 973, 975 (2011). Rendleman notes, however, that in practice although the policies favoring punitive damages and restitution “are not identical[,] . . . the policies are unclear and may overlap, leading an observer to remark or a defendant to argue that disgorgement has a punitive quality.” *Id.* at 980.

22. Rendleman, *supra* note 21, at 975–76.

23. *Id.* at 977–79. However, as I discuss (see *infra* text at notes 184, 194–97, 215, 228, 237–43), some courts, reflecting the ignorance that Kull, Rendleman, and Laycock lament, have incorrectly refused to order disgorgement in private rights of actions for

Although, the R3RUE agrees with the Supreme Court that the goal of restitutionary remedies is to deter bad action, it denies the Supreme Court's assertion that restitution seeks to do this by punishing the defendant. Rather, restitution un-does the bad act.²⁴ That is, we are not *punishing* a thief when we make him give back stolen goods (or pay damages for the tort of conversion). We are recognizing the property rights of the owner of the goods and re-establishing the *status quo ante*. We penalize the thief when we prosecute him.

Accordingly, Ernest Weinrib argues that restitution should not be viewed through the instrumental lens of deterrence at all, but through a Kantian one of correlative rights and duties.²⁵ When a defendant interferes with certain rights of the plaintiff, corrective justice demands that we make the defendant reverse this interference by, in appropriate circumstances, ceding her profits earned (or losses avoided) to the plaintiff.²⁶

While I am sympathetic with Weinrib's analysis, as a practical matter, the difference between a deterrence and a corrective justice rationale for remediating insider trading law might lie in the questions of who should bring a cause of action and who should receive the disgorged profits. If we are only concerned with deterrence, then it would be appropriate for the state to bring the cause of action because, as Justice Sotomayor suggested in *Kokesh* in finding that disgorgement is a penalty, it would be addressing a

insider trading on the mistaken grounds that the issuer does not suffer harm.

24. Justice Sotomayor recognizes this in *Liu* when she insists that to come within the SEC's statutory authority to seek equitable remedies, disgorgement cannot be punitive. *Liu v. SEC*, 140 S. Ct. 1936, 1942 (2020). As mentioned, this is in tension with her opinion in *Kokesh* holding that it is a penalty.

25. Ernest Weinrib states:

[R]ights and their correlative duties imply a conception of the parties as persons who interact with each other as free and equal agents, without the law's subordinating either of them to the other. Accordingly, as an instantiation of corrective justice, liability for unjust enrichment should exhibit the correlative structure of the parties' relationship, vindicate the plaintiff's rights as against the defendant, and affirm the parties' freedom and equality.

ERNEST J. WEINRIB, *CORRECTIVE JUSTICE* 188 (2012).

26. That is:

Just as the owner's rights to set the terms on which property is used or transferred implies a correlative duty on others to abstain from using it . . . , so the owner's right to the profits from the use or transfer of the property imports a correlative duty on others to abstain from such profits. [] The gain is the continuing embodiment of this injustice, and the injustice is undone when the gain is restored to the owner of the object from which the gain accrued. Gain-based damages reverse the wrong by showing, through the return of the benefits, that the law considers the defendant's implicit assertion of ownership to be a nullity whose consequences are to be undone.

Id. at 126.

public, not an individual, harm.²⁷ Moreover, at least in those cases where the “victim” has not suffered out-of-pocket damages, it should not matter whether disgorged funds are distributed to the issuer, to investors, or kept by the state.²⁸ Nevertheless, despite finding in *Kokesh* that disgorgement is a penalty, Justice Sotomayor also insists in *Liu* that disgorged funds be distributed to victims, suggesting that the remedy is compensatory, not punitive.²⁹

If, however, one adopts the corrective justice theory of restitution, then the person whose rights have been violated (i.e., the issuer in the case of classic insider trading or some other source of the information, in the case of the misappropriation theory) would be both the appropriate plaintiff and the recipient of the disgorged amount. This would seem to be consistent with Justice Sotomayor’s rejection in *Liu*, of the SEC’s argument that it is enough if enforcement actions benefit the public generally even if disgorged funds are not distributed to victims³⁰ — which, of course, is inconsistent with her previous holding in *Kokesh* that disgorgement, being deterrent in nature, serves a public, rather than a private, purpose. It is, however, consistent with Andrew Kull’s assertion that restitution policy rarely extends beyond the relative rights of private litigants.³¹

This is the approach that Delaware has taken with respect to the classic theory of insider trading. I argue that if we were to take the Supreme Court’s insider trading jurisprudence seriously, which is based both on breach of fiduciary-type duties and the conceptualization of material nonpublic information as property, then the owner of the information should have a private right of action for “disgorgement.”³² Moreover, based on basic principles of unjust enrichment the plaintiff should be entitled to the funds regardless of whether she suffered an out-of-pocket loss.³³

Unfortunately, under the Supreme Court’s standing requirements for

27. *Kokesh v. SEC*, 137 S. Ct. 1635, 1643 (2020).

28. This was the SEC’s position prior to *Liu*. See Roberta S. Karmel, *Will Fifty Years of the SEC’s Disgorgement Remedy Be Abolished?*, 71 SMU L. REV. 799, 806 (2018).

29. See *Liu*, 140 S. Ct. at 1945–46 (explaining the importance of distributing disgorged funds to victims).

30. See *supra* text at notes 10–12.

31. See *supra* note 19.

32. Similarly, Andrew Marrero has argued that the Supreme Court’s logic suggests that the SEC should disburse amounts disgorged by insider traders under the misappropriation theory to the defrauded source, not to investors. Andrew W. Marrero, *Insider Trading: Inside the Quagmire*, 17 BERKELEY BUS. L.J. 234, 290 (2020). I agree.

33. As Graham Virgo says in his treatise on restitution, its function is “to deprive the defendant of a gain rather than to compensate the claimant for loss suffered.” GRAHAM VIRGO, *THE PRINCIPLES OF THE LAW OF RESTITUTION* 3 (2d ed. 2006) (citations omitted); see also *infra* text at notes 167–68, 320–23.

Exchange Act § 10(b)³⁴ and Rule 10b-5 promulgated under it,³⁵ it will usually be difficult if not impossible for the owner to have standing to seek disgorgement under the federal securities laws.³⁶ This is one of the many reasons I suggest that such actions should instead be brought under state law.

B. Advantages of Taking Appropriation Seriously

As I discuss in the last section of this Article,³⁷ taking the Supreme Court's insider trading jurisprudence seriously, applying the common principles of restitution, and bringing the action in state, rather than federal, court would go far towards solving some of the most vexing issues that have arisen in the law of insider trading. This is so for seven reasons.

First, one reason the federal law of insider trading law is so complex is that the Supreme Court requires not just that the defendant breach a fiduciary or similar duty and misappropriate material nonpublic information, but that, in doing so, she must *also* commit actual fraud. That is, although all fraud might be wrongful, not all wrongful acts are fraudulent. The confluence of these three necessary elements (fraud, fiduciary duty, and misappropriation of property) into one cause of action has become cacophonous. In contrast, under state law, although fraud can be grounds for restitution, breaches of fiduciary duty and misappropriation standing alone can each be an independent ground for restitution.³⁸

Second, there is ample confusion over the requisite relationship between the information owner and the information trader as well as the latter's duties that would make trading based on the information actionable. There is also disagreement with whether this duty comes from state law or federal common law. This has resulted in inconsistent and ad hoc rulings.³⁹ It also raises significant *Erie* questions that are rarely addressed in the caselaw and are beyond the scope of this Article.⁴⁰ When presented with these actions, state courts would merely be applying their own common law of fiduciary duties, property, and fraud, and they have much experience in deciding these issues.

Third, it would simplify the rules as to when a tippee inherits the tipper's duty not to trade on material nonpublic information. Under the federal law

34. 15 U.S.C. § 78j(b).

35. 17 C.F.R. § 240.10b-5 (2021).

36. *See infra* text at notes 130–32, 292–93.

37. *See infra* text at notes 376–483.

38. *See infra* text at notes 331–75.

39. *See infra* text at notes 378–413.

40. In *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), the Supreme Court held that in diversity jurisdiction cases federal courts are not entitled to create their own general common law for issues that properly fall within state law.

of tipping, the party bringing the cause of action has the burden of proving that the tippee knew, or had reasonable grounds to believe, that the tipper was violating a duty to the owner of the information exploited and that the tipper received a personal benefit from the tip.⁴¹ In contrast, if we take seriously the Supreme Court's theory that material nonpublic information is *property* of the issuer or other source of the information, then under state common law of property, the *tippee* as transferee of misappropriated property should have the burden of showing that he was a good faith purchaser for value who *lacked* knowledge when he learned and used the information.

Fourth, it provides justification for one aspect of SEC disgorgement that most concerned the Supreme Court in *Koresch* and *Liu*. That is, in the past, tippers were made to disgorge an amount of money equal to the profits made by tippees even when the tipper did not share directly in that profit.⁴² Justice Sotomayor viewed this as an impermissible imposition of joint and several liability.⁴³ However, if we take seriously the Supreme Court's tipping jurisprudence that passing information as a gift constitutes *value to the tipper*, then under the principles of unjust enrichment the tipper, who must account to the owner for his ill-gotten gains, should have to disgorge an amount equal to the value of the gift. This most reliable measure of the value of the gift, in turn, should be measured by the tippee's profits earned (or loss avoided) in trading on the information. This would be the direct, not the vicarious or joint and several, liability of the tipper.

Fifth, the law of restitution provides an appropriate measure of recovery in misappropriation cases. If we considered the market to be injured by insider trading so that all contemporaneous traders could recover out-of-pocket damages, then the potential liability for misappropriation would be disproportionate.⁴⁴ However, if we take the Supreme Court seriously that in misappropriation it is the owner of the information that is defrauded, then a disgorgement action by the owner would result in the more appropriate remedy of depriving the disloyal confidant of the fruits of his misdeeds.

Sixth, it would eliminate the embarrassment identified by the Second Circuit Court of Appeals in *SEC v. Dorozhko*,⁴⁵ which suggested that insider trading on the basis of *stolen* as opposed to fraudulently obtained material

41. *Dirks v. SEC*, 463 U.S. 646, 661–62 (1983).

42. See *infra* text at notes 435–37.

43. *Liu v. SEC*, 140 S. Ct. 1936, 1949 (2020).

44. William K.S. Wang, *Measuring Insider Trading Damages for a Private Plaintiff*, 10 U. CAL. DAVIS BUS. L.J. 1, 3 (2009). This is why, of course, Section 20A caps damages at the defendant's profits earned or losses avoided. See *infra* text at notes 135–42.

45. 574 F.3d 42 (2d Cir. 2009).

nonpublic information does not violate the federal securities laws. However, if we conceptualize such information as property, then any non-permitted use should be grounds for restitution under state common law.

Finally, and following from the last point, eliminating the necessary element of fraud in insider trading law and looking to the broader law of restitution would do away with perhaps the most unsatisfying aspect of *United States v. O'Hagan*,⁴⁶ the case in which the Supreme Court adopted the misappropriation theory. This is the possibility that a so-called brazen misappropriator could get away with her ill-gotten gains.⁴⁷

II. CURRENT LAW

A. Federal Insider Trading Jurisprudence

In this Article, I do not directly address the SEC's right to obtain disgorgement in civil actions. Rather, I argue that if one takes the Supreme Court's insider trading law jurisprudence seriously, then "disgorgement" should be available in private rights of action under state law.

I will also not purport to give a detailed account of federal case law for two reasons. First, in my experience, almost every academic article on insider trading does so and I probably would have little to add to this well-trodden field. I assume anyone who is reading this Article already has a passing knowledge of the law. Second, and more importantly, I am advocating an expansion of the state common law regime precisely to avoid the inadequacy of federal law.

i. Texas Gulf Sulphur

The *Liu* case should be read in the context of the Supreme Court's forty-five year attempt to curtail the expansion of the securities law which began in the 1960's when the SEC and the lower federal courts were in effect seeking to federalize what would today be considered the bailiwick of state corporate law.⁴⁸ Disgorgement of profits for securities fraud is generally considered to originate in the Second Circuit case *SEC v. Texas Gulf Sulphur*,⁴⁹ decided at the height of the expansionary era. Although *Texas Gulf Sulphur* heralded the modern era of insider trading enforcement and private rights of action against issuers,⁵⁰ the Supreme Court long rejected

46. 521 U.S. 642 (1997).

47. See *infra* text at notes 462–66.

48. For an argument that insider trading law could have been developed as state rather than federal law, see Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998).

49. 401 F.2d 833 (2d Cir. 1968).

50. Although the case was an SEC enforcement action, it was the basis for the

many elements of the Second Circuit's analysis.⁵¹ *Liu* is yet another bullet in this zombie case that will not die.

First, in *Santa Fe Industries Inc. v. Green*⁵² the Supreme Court rejected the Second Circuit's holding that Rule 10b-5 encompasses constructive, as opposed to actual, fraud. Consequently, under modern securities law, breach of fiduciary duty *standing alone* is not supposed to constitute securities fraud, although (confusingly) it remains as an element in insider trading cases.⁵³

Second, in *Chiarella v. United States*⁵⁴ the Supreme Court rejected the Second Circuit's holding that the federal securities laws mandate parity of information. Consequently, today the mere possession of material non-public information standing alone does not impose the so-called *Cady, Roberts*⁵⁵ duty to "disclose or abstain" before trading securities.⁵⁶ Reading

explosion of private causes of action for securities fraud because it established that a plaintiff need not have privity with the issuer. *Id.* at 862; see Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, 71 SMU L. REV. 835, 836–37 (2018) [hereinafter Langevoort, *Duties*]; A.C. Pritchard & Robert B. Thompson, *Texas Gulf Sulphur and the Genesis of Corporate Liability Under Rule 10b-5*, 71 SMU L. REV. 927 (2018).

51. James Cox says that he continues to teach *Texas Gulf Sulphur* even though little of it remains because "[w]hat truly sets *TGS* apart is its opacity on the core of the case: why insider trading is proscribed. Its vagueness naturally invites conjecture on how its carefully developed record overcomes that weakness to divine a solid foundation for regulating insider trading." James D. Cox, *Seeking an Objective for Regulating Insider Trading Through Texas Gulf Sulphur*, 71 SMU L. REV. 697, 700 (2018). Onnig Dombalagian argues that, although some of its specific elements have been overruled, *Texas Gulf Sulphur* continues to influence the SEC's decisions on how issuers make disclosure and its vision of parity of information still captures the popular imagination. Onnig H. Dombalagian, *Texas Gulf Sulphur and Information Disclosure Policy*, 71 SMU L. REV. 713 (2018). Marc Steinberg emphasizes that *Texas Gulf Sulphur* continues to influence insider trading law in other countries. Marc I. Steinberg, *Texas Gulf Sulphur at Fifty — A Contemporary and Historical Perspective*, 71 SMU L. REV. 625, 638–40 (2018).

52. 430 U.S. 462 (1977).

53. As I discuss (*see infra* text at notes 114–19) fiduciary or similar duties impose the duty to speak that will establish omission as an element of fraud.

54. 445 U.S. 222 (1980). Langevoort suggests that in application, the Second Circuit's egalitarian parity-of-information principle was "long gone by the time Justice Powell wrote the Court's opinion in *Chiarella*." Langevoort, *Duties*, *supra* note 50, at 847.

55. *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961). As has been oft noted (*see, e.g.*, STEPHEN BAINBRIDGE & WILLIAM D. WARREN, *INSIDER TRADING LAW AND POLICY* 33–34 (Found. Press, 1st ed. 2014) [hereinafter BAINBRIDGE, *INSIDER TRADING*]), because the insider will rarely have the right to disclose the information, this is tantamount to an "abstain" rule.

56. As Stephen Bainbridge discusses in his essay on the silver anniversary of *TGS*, two of the problems of the Second Circuit's analysis are that it applied to *anyone* in possession of material nonpublic information (i.e., not just to traditional insiders or others having fiduciary or similar duties), and material nonpublic information was implicitly

Santa Fe Industries together with *Chiarella*, it also clear that, federal insider trading law rejects the *Cady, Roberts* notion that the federal law of insider trading is intended to prevent some vague notion of “unfairness” to investors.⁵⁷

Third, in *TSC Industries, Inc. v. Northway, Inc.*,⁵⁸ the Court rejected the Second Circuit’s definition of materiality as that which *might* reasonably affect an investment decision in favor of a *would* standard.⁵⁹

Fourth, in *Ernst & Ernst v. Hochfelder*,⁶⁰ the Supreme Court rejected the Second Circuit’s holding that one can negligently violate Rule 10b-5 in favor of a scienter standard. In light of this quadruple repudiation of the Second Circuit’s overly expansive holdings in *Texas Gulf Sulphur*, perhaps what should be surprising is not that the Supreme Court also at least partially rejected its broad remedial provisions, but how they survived this long.

defined to include market information not received from the issuer or from another person having a proprietary relationship to the information. Stephen M. Bainbridge, *Equal Access to Information: The Fraud at the Heart of Texas Gulf Sulphur*, 71 SMU L. REV. 643 (2018). As Justice Powell was concerned in *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983), such an expansive rule would actually discourage market analysis. See A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Law*, 52 DUKE L.J. 841, 931 (2003). Bainbridge is particularly scathing in his review of the *TGS* court’s mischaracterization of precedent and legislative history. See Bainbridge, *supra* note 56, at 648–52.

57. *Cady, Roberts & Co.*, Exchange Act Release No. 6668, at 912.

58. 426 U.S. 438 (1976), *rev’g* 512 F.2d 324 (1985).

59. In *TSC Industries* the Supreme Court stated, “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in [making an investment decision]” 426 U.S. at 449. However, the Supreme Court would eventually adopt the *Texas Gulf Sulphur* magnitude versus probability test for the materiality of contingent events in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

60. 425 U.S. 185 (1976).

ii. *The Common Law of Insider Trading*

It is almost *de rigeur* in academic literature to bemoan the sorry state of insider trading law.⁶¹ In Donald Langevoort's term, it is a "crazy-quilt."⁶² One reason for this is that no statutory provision defines it. Even in 1988, when Congress amended the Exchange Act to add §§ 20A⁶³ and 21A⁶⁴ authorizing private rights of action for contemporaneous traders and SEC actions for penalties, respectively, against "[a]ny person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information,"⁶⁵ it notoriously did not define *when* or *how* such purchasing and selling violates the law. Consequently, except for insider trading in the context of a tender offer, which is governed by the prophylactic provisions of Rule 14c-3,⁶⁶ to be unlawful, insider trading must contravene the anti-

61. For an introduction to the voluminous literature bewailing the chaotic "quagmire" of insider trading law, see DONALD C. LANGEVOORT, 18 INSIDER TRADING: REGULATION, ENFORCEMENT, & PREVENTION § 1.6, Westlaw (May 2021 update); see also Marrero, *supra* note 32, at 250–01.

As always, there are exceptions. Relying on Michal Shur-Ofry and Ofer Tur-Sinai's concept of "constructive ambiguity," Jill Fisch argues that what others, such as myself, see as incoherent insider trading jurisprudence in fact has the advantage of allowing judicial lawmaking to be "flexible and incremental." Jill E. Fisch, *Constructive Ambiguity and Judicial Development of Insider Trading*, 71 SMU L. REV. 749, 757, 764 (2018).

As a former transactional attorney, I agree that constructive ambiguity is often both intentional and beneficial in contract drafting. See Jeanne L. Schroeder, *Sense, Sensibility and Smart Contracts: A View From a Contract Lawyer*, 49 U.C.C. L.J. 251 (2020). However, although Professor Fisch mentions it in passing, Fisch, *supra* note 61, at 770, I do not think she gives sufficient concern to the fact that there is criminal as well as civil liability for insider trading. Indeed, Langevoort suggests that courts often apply the law too narrowly in civil cases precisely because of the concern of a broad interpretation in criminal cases. Donald C. Langevoort, *Watching Insider Trading Law Wobble: Obus, Newman, Salman, Two Martomas, and a Blaszczak*, 89 FORD. L. REV. 507, 526–27 (2020) [hereinafter Langevoort, *Wobble*]. For a recent critique of the common law aspect of criminal insider trading law and argument for an insider trading criminal statute, see Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J.F. 129 (2017), <http://www.yalelawjournal.org/forum/insider-tradings-legality-problem>.

62. Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scierter Requirement* [hereinafter Langevoort, *What Were They Thinking?*], in RESEARCH HANDBOOK ON INSIDER TRADING 52 (Stephen M. Bainbridge ed., 2013) [hereinafter, HANDBOOK].

63. 15 U.S.C. § 78t-1.

64. *Id.* § 78u-1.

65. *Id.* § 78t-1(a).

66. 17 C.F.R. § 240.14c-3 (2021). In *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court confirmed that prophylactic rules were permitted under Exchange Act § 14(e), 15 U.S.C. § 78n(3), because its language is broader than that of § 10(b) which is limited to actual fraud. See *id.* 672–73.

fraud provision of Exchange Act § 10(b) as developed in caselaw. However, as Justice Powell stated in *Chiarella*, “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”⁶⁷

iii. Purpose Of Restricting Insider Trading

Another reason for the chaotic state of insider trading law is that there is little consensus as to what, if anything, is wrong about insider trading and how this relates to federal securities law policy.⁶⁸ The commentary on this issue is voluminous. Many who argue insider trading should be unlawful tend to do so on the grounds that it is unfair.⁶⁹ Another rationale for a ban is

67. *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980).

68. Fisch identifies the problem of seeking a statutory solution to the inconsistency in the caselaw, reflecting the fact that there is no consensus on the purpose of the ban on insider trading. Fisch, *supra* note 61, at 751. One commentator has noted:

Manifesting the extent to which even authorities on the subject are unable to articulate a compelling legal theory of what insider trading is and why the conduct it encompasses should be declared unlawful, a large body of case law and commentary, for instance, variously portrays insider trading doctrine as based on principles drawn from or analogous to the law of fraud, breach of fiduciary duty, agency, theft, conversion, embezzlement, trusts, property, contracts, corporations, confidential relationships, unjust enrichment, lying, trade secrets, and corruption.

Marrero, *supra* note 32, at 254–55 (citations omitted). This is somewhat of an overstatement since many of these categories (for example, fiduciary duty and agency) substantially overlap. Nevertheless, he is correct that overall, the law is a quagmire and the jurisprudence that requires us to combine both fiduciary and property concepts to produce fraud is unsatisfying.

Bainbridge, writing in 1995, identifies three rationales in the academic literature. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1228–41 (1995) [hereinafter Bainbridge, *Incorporating*]. First, it is an adjunct to the mandatory disclosure system. *Id.* Second, it protects investors. *Id.* Third, it is necessary for confidence in the markets. *Id.* Richard W. Painter, Kimberly D. Kwawiec & Cynthia A. Williams list among the various purposes attributed to insider trading regulation objectives of promoting information symmetries, market confidence, disclosure, fraud prevention, protection of proprietary material, and enforcement of fiduciary obligations. Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998). For another good introduction to the policy debate pro and con regulation, see Steven M. Bainbridge, *An Overview of Insider Trading Law and Policy: An Introduction to the Research Handbook on Insider Trading*, in HANDBOOK, *supra* note 62, 1, 19–30 [hereinafter, Bainbridge, *Overview*].

69. This is best expressed by the title of Kim Scheppele's classic article “*It's Just Not Right*”: *The Ethics of Insider Trading*, 56 L. & CONTEMP. PROBS. 123 (1993). See also the dyspeptic comments of Judge Richard Howell when sentencing Raj Rajaratnam for insider trading that “insider trading is an assault on the free markets . . . his crimes reflect a virus in our business culture that needs to be eradicated.” quoted in Alexandre Padilla, *Insider Trading: What is Seen and What is Not Seen*, in HANDBOOK, *supra* note 62, at 251 [hereinafter Padilla, *Insider Trading*]. This begs the question that our free-market system allows the buying and selling of property on the basis of material nonpublic information in almost every context other than the securities markets. See

that insider trading makes markets less efficient because the market does not have full information relevant to the correct pricing of securities.⁷⁰ However, there are others who argue the opposite and believe that it should be permitted as it enhances market efficiency.⁷¹ That is, trading by insiders puts the market on notice of nonpublic information and is a substitute for affirmative disclosure of the substance of that information.⁷² Richard Epstein takes both sides, arguing that sometimes insider trading is efficient and sometimes it isn't.⁷³ Consequently, he would prefer that restrictions be left to the private ordering of contract.⁷⁴

Related to both the fairness and efficiency arguments is the assertion that permitting insider trading would negatively affect the securities markets. For example, in *O'Hagan*, the case in which the U.S. Supreme Court adopted the misappropriation theory of insider trading, Justice Ruth Bader Ginsberg included investor confidence as one of her rationales for adopting the misappropriation theory.⁷⁵ Tamar Frankel suggests that, based on 1929 and "to some extent" 2008, "when trust is undermined, the securities markets

infra text at notes 89–94. In a relatively early article written before the Supreme Court adopted the misappropriation theory, James Cox notes that "American jurisprudence abhors insider trading with a fervor reserved for those who scoff at motherhood, apple pie, and baseball." James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628, 628 [hereinafter Cox, *Insider Trading*]. He raises questions about the usual rationales including fairness, "arguments explaining how insider trading impacts the corporation's operation, investor behavior, and the allocational efficiency of capital, markets," *id.* at 628–29, as well as the Supreme Court's fiduciary principal.

Peter Molk suggests that some:

Justify [the ban on insider trading] as protecting the capital markets, safeguarding ordinary investors and their companies from opportunism. Others characterize insider trading restrictions as preventing the "inherent unfairness" that would result from insiders systematically trading with superior information. Still others focus on preventing share price distortions that could arise from legalized insider trading.

Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1693 (2020) (citations omitted).

70. See, e.g., Cox, *Insider Trading*, *supra* note 69, at 630.

71. See, e.g., *id.* at 635–37.

72. For a quick survey of the economic arguments for and against insider trading, see Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 227–37 (2008) and BAINBRIDGE, *INSIDER TRADING* *supra* note 55, at 175–86.

73. Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482, 1491–94 (2016).

74. *Id.*

75. *United States v. O'Hagan*, 521 U.S. 643, 658–59 (1997). In doing so she cited the classic article for this proposition, Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979).

will dry up.”⁷⁶ One commentator has gone so far as to suggest that if insider trading were legalized “[s]tock markets would drastically shrink if not disappear.”⁷⁷

These are empirical assertions that have been challenged since the 1960’s.⁷⁸ Henry Manne argues that there is an easy way to test which side is correct in the case of classic insider trading.⁷⁹ That is, we could allow a publicly traded company to give its management and employees permission to engage in classic insider trading so long as the company publicly disclosed this policy.⁸⁰ If investors react by “dumping” said company’s stock, we have evidence that the net effect of allowing insider trading does hurt market confidence and that Congress should consider banning this practice. However, arguably this might not be necessary because if such a policy does depress stock prices, one would expect management would not adopt it or face stockholder ire. If they don’t, it would suggest that the current ban is unnecessary and perhaps inefficient.⁸¹ Moreover, at least some studies have indicated that the “general public [is] fully aware that insider trading laws are ineffective in discouraging insider trading, but they are still investing despite knowing that they are at risk of trading with insiders.”⁸²

Underlying many of these arguments is the belief that, despite the Supreme Court’s holdings to the contrary, the federal securities laws should

76. Tamar Frankel, *Insider Trading*, 71 SMU L. REV. 783, 789 (2018).

77. George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 248 (2013).

78. See, e.g., Henry G. Manne, *INSIDER TRADING AND THE STOCK MARKET* (1966).

79. Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 555–57 (1970).

80. *Id.*

81. *Id.* For two recent discussions suggestions that insider trading has negative effects on markets, see Michael A. Perino, *The Lost History of Insider Trading*, 2019 U. ILL. L. REV. 951 (2019) and David Rosenfeld, *The Impact of Insider Trading on the Market Price of Securities: Some Evidence from Recent Cases of Unlawful Trading*, 44 J. CORP. L. 65 (2018). For a recent article questioning the market-confidence argument, see John P. Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. U. J.L. & POL’Y 1 (2018). For a cogent overview of the debate and how it ignores modern high-frequency trading practices, see Yesha Yadav, *Insider Trading and Market Structure*, 63 UCLA L. REV. 968 (2016) [hereinafter Yadav, *Market Structure*]. For a more recent skeptical view of the market-confidence argument, see John P. Anderson, *Insider Trading and the Myth of Market Confidence*, 56 WASH. U. J.L. & POL’Y 1 (2018).

Epstein makes a more subtle form of this argument. He does not think that we can conclude that insider trading is always either efficient or inefficient. Rather, some forms of insider trading might be efficient, while others might be detrimental to a corporation and its shareholders. Accordingly, rather than adopting a blanket rule by regulation or case law, we should apply classic insider trading policy to an issuer’s board of directors so long as it discloses its decision and reasoning to the stockholders. Epstein, *supra* note 73, at 1493–94.

82. Padilla, *supra* note 69, at 251, 257.

favor parity of information among market participants, the policy behind *Cady, Roberts*, and *Texas Gulf Sulphur*.⁸³ The classic argument for parity of information (published one year before *Chiarella*) is Victor Brudney's suggestion that prohibitions on trading based on nonpublic information should depend on whether the trader's informational advantages are erodable (such that others could theoretically obtain the information) or unerodable.⁸⁴ Others have argued that this distinction is unworkable either in practice or theory.⁸⁵ As Jonathan Glater notes, informational asymmetries are just one of the many inequalities that exist between and among market participants.⁸⁶

Yesha Yadav has noted that high-speed traders have strong structural advantages in obtaining and trading on non-fully market information over other traders.⁸⁷ She suggests that regulators should consider "what counts as a harmful and unfair allocation of informational privileges — in other words, clarifying what should fall within the prohibition against insider trading and why."⁸⁸ It is not clear why informational advantages are more unfair than

83. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir. 1971) ("Either the transactions so traded could be concluded by a relative or an acquaintance of the insider.").

84. Brudney, *supra* note 75, at 361–67. More recently, Bruce Klaw argues for a statutory ban on insider trading based on an equality of access of information principle that he derives from the ethical theories of John Rawls and Immanuel Kant. Bruce W. Klaw, *Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory*, 7 WM. & MARY BUS. L. REV. 275, 298, 313 (2016). In doing so, however, he does not address why what he sees as a universal ethical principle does not apply generally to economic behavior and relies largely on arguments based on negative effects on securities markets.

85. For three very different critiques of this distinction, see Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313 (2002); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443 (2001); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

86. He states:

Some have more experience, some have more wealth, which enables the purchase of advice from others with more experience or with better information. Given the cost of compensating for such diversity and the dubious normative case for trying to, there is a strong argument that capital market regulation should strive for allocative efficiency. Yet this is conspicuously not the approach taken by securities regulation.

Jonathan D. Glater, *Insiders, Outsiders, & Fair Access: Identifying Culpable Insider Trading*, 83 BROOK. L. REV. 1393, 1394–95 (2018).

87. Yesha Yadav, *Insider Information and the Limits of Insider Trading*, 56 WASH. U. J.L. & POL'Y 135 (2018).

88. *Id.* at 137 (continuing "[s]hould confidential, corporate information merit different legal treatment than data from exchanges and trading venues that is not-fully-public? If confidential corporate information is different, then why?"); see also Yadav,

these and other structural inequalities inherent in our capitalist economy — including, without limitations, educational, wealth, and social conditions.

Moreover, one may legally buy and sell almost any other type of property based on informational advantages, as the Second Circuit Court of Appeals noted without irony in *Texas Gulf Sulphur*.⁸⁹ In that case, the nonpublic information concerned a valuable mineral strike on the issuer's land.⁹⁰ The Second Circuit noted that the issuer had a "legitimate corporate objective" in concealing this information — i.e., it wanted to surreptitiously buy adjoining land from neighboring property owners.⁹¹ In other words, parity of information counts for nothing in the commercial real estate market. And yet it found that it was unlawful for insiders to buy securities based on the same information because of a lack of parity of information between the insiders and the sellers.⁹² As Andrew Verstein notes, if instead of buying stock based on the material nonpublic information concerning Texas Gulf Sulphur's mineral strike, the insiders had

[S]hort[ed] copper and zinc futures, [they] could have reaped similar fortunes, but without the legal problems. For while insider trading in securities has long been illegal, the same behavior has been entirely legal in the commodities and futures markets.⁹³

In the words of Jamie Boyle, why do we have this enigmatic "island of egalitarianism" in the otherwise individualistic ocean that is capitalism?⁹⁴ Indeed, the misappropriation theory of insider trading is based on the proposition that the source of information has a property interest in it with the right to exploit it for its own financial advantages.

Of course, the difference between the two fact patterns in *Texas Gulf Sulphur* is the identity of the persons exploiting material nonpublic information and their relationship to the source of the information. If the issuer's insiders bought the land, instead of stock, without the prior approval of the issuer's disinterested directors after full disclosure this, no doubt, would have been an improper taking of a corporate opportunity from the issuer. That is, if the hypothetical purchase of the land by the insiders on inside information would have been wrongful, it is not because the lack of parity of information between the sellers and the buyers was *unfair to the*

Market Structure, *supra* note 81.

89. 401 F.2d 833, 848–49 (2d Cir. 1968).

90. *Id.* at 839–42.

91. *Id.* at 848.

92. *See id.* at 849–50.

93. Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 448 (2016) (citations omitted). Verstein calls for more coordination between the two legal regimes. *Id.* at 450.

94. James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413, 1491 (1992).

sellers (who would have no cause of action against the buyers). The wrongfulness would be the insiders' breach of their fiduciary duty of loyalty to the issuer. As such, it is the issuer who should have a cause of action against the insiders, not the sellers of the land. As I discuss, this is the position that Delaware has taken in finding that there is a derivative action on behalf of an issuer to sue insiders for disgorgement of profits for insider trading.⁹⁵

Nevertheless, the biggest *doctrinal* problem for those who favor a parity-of-information rationale for a ban on insider trading is that, as discussed below,⁹⁶ the Supreme Court expressly rejected such reasoning in *Chiarella*.⁹⁷ Moreover, whatever goals one thinks insider trading law should serve, the Supreme Court reads the language of Exchange Act Sec. 10(b) and Rule 10b-5 as being limited to *actual* fraud.⁹⁸ This causes a mismatch because, as Langevoort has correctly stated, "relatively little" about insider trading "can fairly be considered deceptive."⁹⁹

To complicate things even more, the Supreme Court has found that violations of fiduciary duties are not fraudulent *per se*.¹⁰⁰ Nevertheless, breaches of duty are necessary to establish when insider trading is fraudulent. The SEC and the courts have twisted themselves into pretzels trying to fit their policy concerns into the Supreme Court's Procrustean doctrinal bed. Consequently, it is both refreshing and distressing that Langevoort asserts "[t]he robust persistence of insider trading enforcement (criminal and civil) is based as much on politics as coherent policy."¹⁰¹ More cynically, some

95. See *infra* text at notes 166–68, 229–46.

96. See *supra* note 54 and *infra* text at notes 107–18.

97. 445 U.S. 222 (1980).

98. In the early retrenchment case of *Ernst & Ernst v. Hochfelder*, the Supreme Court stated that "despite the broad view of [Rule 10b-5] advanced by the Commission . . . its scope cannot exceed the power granted the Commission by Congress under § 10(b)." 425 U.S. 185, 212–14 (1976). Since the Supreme Court previously found that § 10(b) is limited to actual fraud — an intentional tort — scienter is an element of a private right of action under Rule 10b-5. *Id.*; see also *United States v. O'Hagan*, 521 U.S. 642, 651 (1997) (stating that "precedent indicates [that liability under Rule 10b-5] does not extend beyond conduct encompassed by § 10(b)'s prohibition").

99. Langevoort, *What Were They Thinking*, *supra* note 62, at 52.

100. See *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 480 (1977) ("We thus adhere to the position that 'Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.'").

101. Unfortunately, this language which appeared in an earlier version of Langevoort, *Wobble*, *supra* note 61, did not make it to the final published version. See Donald C. Langevoort, *Watching Insider Trading Law Wobble: Obus, Newman, Salman, Two Matromas and a Blaszcak*, (Jan. 8, 2019) (unpublished draft) <https://ssrn.com/abstract=3490636> at 8 [hereinafter, Langevoort, *Wobble (draft)*]. In the earlier version he continued:

Insider trading enforcement has become a recognizable brand symbol for American-style securities regulation, touching on some deep-seated public

suggest that, during the great recession, regulators and politically ambitious prosecutors wanted to be seen doing something by bringing civil and criminal actions against easy targets rather than the more difficult or impossible task of pursuing the structural causes of the crisis.¹⁰²

I do not attempt to solve the problem of the *federal* insider trading policy, other than to note that there does seem to be strong revulsion against insider trading by the public generally.¹⁰³ Moreover, Congress has expressed its displeasure with insider trading by enacting legislation providing for private rights of action as well as penalties for it, without defining what it is.¹⁰⁴ So it would seem to be appropriate for Congress to take the next step and enact legislation to clarify its contours.¹⁰⁵

fascination, envy and distaste for the arrogance of economic elites and others who exploit some undeserved edge in the stock markets. [] The campaign against abusive trading generates public support for the complex mission of investor protection more generally, which is consequential whether or not we have a coherent theory of how and why it constitutes securities fraud.

Id. at 8 (citations omitted). I have similarly, but not as graciously, suggested that envy plays a large part in the public distaste for insider trading. Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005) [hereinafter, Schroeder, *Envy*].

102. A.C. Pritchard, *Insider Trading Law and the Ambiguous Quest for Edge*, 116 MICH. L. REV. 945, 951 (2018) [hereinafter, Pritchard, *Edge*]. Roberta Karmel, a former SEC commissioner, alleges that “blockbuster cases are used to prop up the SEC’s image as a tough cop on Wall Street,” that the “number and types of insider trading cases currently being brought” are a “misallocation of enforcement resources,” and is concerned that “it is wrong for a person to be jailed for an undefined crime.” Roberta S. Karmel, *The Law on Insider Trading Lacks Needed Definition*, 68 SMU L. REV. 757, 758 (2015) [hereinafter, Karmel, *Definition*]. Nevertheless, Karmel believes that “a ban on insider trading is necessary to the SEC’s disclosure system.” *Id.* at 768 (citations omitted).

Another variation on this is the “public choice” theory that insider trading regulation is an attempt by the SEC “to enlarge its jurisdiction and enhance its prestige” as well as to “maximize [administrators’] salaries, power and reputation by maximizing the size of their agency’s budget.” Bainbridge, *Overview*, *supra* note 68, at 27; *see also* M. Todd Henderson, *The Changing Demand for Insider Trading Regulation*, in HANDBOOK, *supra* note 62, at 230. The public choice theory of regulation (based on agency capture) is probably most closely, but not exclusively, associated with Jonathan Macey. JONATHAN MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* (1991).

103. One study indicates that the public is equally confused about the rationale for a ban. They don’t like insider trading, but they are not sure why. Stuart P. Green & Matthew B. Kugler, *When is it Wrong to Trade Stocks on the Basis of Non-Public Information?: Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 484 (2011).

104. *See infra* text at notes 63–65.

105. One relatively recent, and in my mind, unsuccessful attempt by Congress to clarify insider trading was the Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291. This was supposed to eliminate a non-existent loophole that supposedly exempted Representatives and Senators from

Rather, I am taking the Supreme Court's insider trading jurisprudence seriously that, whether it constitutes fraud for the purpose of the federal securities laws, it does constitute violation of fiduciary duties and misappropriation of information. If so, under basic restitutionary principles of common law it is the person to whom the duty is owed or the owner of the information who should have a cause of action against the trader for disgorgement and that right of action does not require a proof that the plaintiff was defrauded or that it suffered economic harm.

iv. Classic Insider Trading

"Classic insider trading" involves the purchase or sale of equity securities (or options on equity securities) by traditional insiders owing a fiduciary duty to the issuer — directors, officers and perhaps employees and major stockholders — based on material nonpublic information learned from the issuer.¹⁰⁶ Classic insider trading has also been extended to so-called temporary or constructive insiders such as outside counsel who take on fiduciary or equivalent duties in the context of specific transactions.¹⁰⁷ Consequently, in *Chiarella*,¹⁰⁸ the Supreme Court found that the defendant, who bought shares in the targets of unannounced tender offers based on information he learned at his job working at a financial printing house

insider trading liability. Of course, there never was such a loophole, legislators were subject to the same rules as everyone else. What was true was that it was unclear how to apply the misappropriation theory of insider trading to legislators with respect to material nonpublic information they learned in performing their official duties. However, the operative portion of the STOCK Act merely states:

[S]olely for the purposes of the insider trading prohibitions arising under this Act, . . . each Member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the solely United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.

Id. § 4(b)(g)(1). As I have shown elsewhere, this language does not address the many other ambiguities of the law. Jeanne L. Schroder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159 (2014) [hereinafter, Schroeder, *Taking Stock*]. As confusion as to whether certain senators who traded in securities after a private briefing on the dangers of the Coronavirus early in the outbreak shows, the STOCK Act seems to have done little to clarify the law. See, e.g., Rachel Sandler, *Senate Ethics Panel Drops Insider Trading Probe Into Kelly Loeffler*, FORBES (June 16, 2020, 8:13 PM), <https://www.forbes.com/sites/rachelsandler/2020/06/16/senate-ethics-panel-drops-insider-trading-probe-into-kelly-loeffler/?sh=2bd20363416c>.

106. See Zachary Gubler, *A Unified Theory of Insider Trading Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 30, 2016), <https://corpgov.law.harvard.edu/2016/09/30/a-unified-theory-of-insider-trading-law/>.

107. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997); *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); see Bainbridge, *Overview*, *supra* note 68, at 11–12.

108. See 445 U.S. 222, 231–37 (1980).

producing documentation for the bidder, did *not* violate the law because he had no fiduciary duty to the *target* or its stockholders.

The Supreme Court has never expressly set forth every step in its reasoning in *Chiarella*, perhaps because it is largely written in the negative — finding that *Chiarella* did *not* violate the law because he had no fiduciary or similar duty rather than explaining *when and why* such a duty would have made his trading fraudulent.¹⁰⁹ Justice Powell seems implicitly to be relying on the common law doctrine that self-dealing — a fiduciary's use of the assets of the beneficiary for the fiduciary's own benefit — is a breach of fiduciary duty.¹¹⁰ Moreover, material non-public information is implicitly conceptualized as property of the issuer, a conception made express in *Carpenter v. United States*¹¹¹ and *O'Hagan*.¹¹² However, as discussed,¹¹³ the Court had previously found that mere breach of fiduciary duty standing alone does not constitute securities fraud. Fraud requires either the misstatement of a material fact or the omission to state a material fact when under a duty to disclose.¹¹⁴ Insider trading cases are almost always omission cases. But silence can only be fraudulent if there is a duty to speak. Justice Powell noted that the common law imposes duties on fiduciaries to speak to their beneficiaries.¹¹⁵ Accordingly, in *Chiarella*, (and subsequently in *Dirks v. SEC*)¹¹⁶ the Supreme Court held that this implies that the possession of material nonpublic information by a person who does not have a fiduciary or similar duty to the issuer does *not* impose the *Cady, Roberts* duty to disclose or abstain from trading.¹¹⁷

Justice Powell also assumed that the classic insider's duty to disclose or abstain runs not just to the corporation, but directly to its stockholders as well.¹¹⁸ He also suggested that this fiduciary duty runs not merely to existing shareholders (in which case only purchases of securities would also be unlawful) but also to future shareholders (so that sales of securities can also

109. Marrero asserts that insider trading law is based on five fictions: fiction of the insider, fiction of fiduciary duty, fiction of disclosure, fiction of personal benefit, and fiction of deception. Marrero, *supra* note 32, at 262. I agree that the last one (deception) is fictional. I think that it is more accurate to say with respect to the others that sometimes courts stretch them to near their breaking points.

110. RESTATEMENT (THIRD) OF AGENCY §§ 8.02, 8.05 (AM. L. INST. 2006).

111. 484 U.S. 19, 25–26 (1987).

112. *O'Hagan*, 521 U.S. at 653–54.

113. See *supra* text at notes 53 and 100.

114. Interestingly, the Supreme Court has held that material misstatements or omissions are not necessary elements for fraud under bankruptcy law. *Husky Int'l Elec. v. Ritz*, 136 S. Ct. 1581, 1586 (2016).

115. *Chiarella v. United States*, 445 U.S. 222, 228–29 (1980).

116. See *infra* text at notes 160 and 374.

117. *Chiarella*, 445 U.S. at 230–32.

118. *Id.* at 228–30.

be unlawful).¹¹⁹ This means that the *Cady, Roberts* duty is to disclose information to the market generally.

Finally, there is an assumption that the information that must be disclosed under the *classic* theory (in contradistinction to the misappropriation theory) is the material information itself rather than the insider's intent to trade. As others have noted, this was not, in fact, the state corporate law of fiduciary duties with respect to insider trading at the time *Chiarella* was decided.¹²⁰ Despite the doctrinal issues with this analysis, however, the boundaries of classic trading are fairly clear.¹²¹ This cannot be said about the misappropriation theory and the extension of liability to tippees.

B. Misappropriation

The Supreme Court adopted the misappropriation theory of insider, or more accurately outsider, trading in *O'Hagan*.¹²² Under this theory, the

119. In a footnote, Justice Powell cites with approval an opinion by Judge Learned Hand that it would be a "sorry distinction" to find that a director or officer did not have a fiduciary duty to a future shareholder who purchased stock sold by that person, when he had a duty to the present shareholder from whom he purchased stock. *Id.* at 227 n.8 (quoting *Cady, Roberts*, 40 SEC at 914 n.23).

As sorry as this distinction might seem to Justice Powell and Judge Hand, state corporation law makes a sharp distinction between current and potential stockholders. For example, derivative actions can only be maintained by persons who are stockholders of the nominal plaintiff at the time of the alleged wrong and throughout the pendency of the case. *Kahn v. Kohlberg, Kravis, Roberts & Co.*, 63 A.3d 831, 836 (Del. 2011).

120. For discussions of how *Chiarella* differs from state precedent, see Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225 (2017); Adam C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 22–26 (1998); Harry S. Gerla, *Confidentiality Agreements and the Misappropriation Theory of Insider Trading: Avoiding the Fiduciary Duty Fetish*, 39 U. DAYTON L. REV. 331, 333–34 (2015); Bainbridge, *Overview*, *supra* note 68, at 9–10. Bainbridge correctly points out that there is a tension in Powell's holdings in *Chiarella* and *Dirks* that insider trading involves breaches of fiduciary duties with the Supreme Court's holding in *Santa Fe Industries* that breaches of fiduciary duty standing alone do not constitute fraud under Rule 10b-5. Bainbridge, *Overview*, *supra* note 68, at 9–10; *see also* Stephen M. Bainbridge, *Regulating Insider Trading in the Post-Fiduciary Duty Era: Equal Access or Property Rights*, in HANDBOOK, *supra* note 62, at 80, 81–83 [hereinafter, Bainbridge, *Post-Fiduciary Duty*].

121. In an interesting recent article, Peter Molk considers the implications for insider trading law of the fact that increasingly businesses, including publicly traded ones, are not being organized as corporations or limited partnerships, but as limited liability companies, which are permitted to eliminate management fiduciary duties in their organizational charters. Does this imply that classic insider trading by L.L.C. managers might be permitted under federal law? *See* Molk, *supra* note 69.

122. *United States v. O'Hagan*, 521 U.S. 642 (1997). In *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court previously adopted the misappropriation theory in the context of wire and mail fraud, but split 4-4 on its application to securities fraud, leaving in place the Second Circuit's opinion adopting a version of the misappropriation theory. *See infra* text at notes 275–93.

source of the information does not have to be the issuer of the securities being traded. Moreover, the trader need not be a traditional insider of the source, but can be anyone who has, to quote Justice Ginsberg in *O'Hagan*, a “*fiduciary* or similar duty of trust *and* confidence” to the source¹²³ which, as I discuss below,¹²⁴ the SEC has by regulation tried to vitiate as a “duty of trust *or* confidence.” As Donna Nagy has accurately and powerfully argued, the actions by the SEC and certain courts should be seen as a surreptitious attempt to repudiate the Supreme Court’s fiduciary principle and to reinstate the parity of information standard.¹²⁵

The theory is that material nonpublic information is property of the source

123. *O'Hagan*, 521 U.S. at 670 (emphasis added). At a number of points in *O'Hagan*, Justice Ginsburg describes the deception required for misappropriation in terms of a violation of a duty of “trust and confidence.” See, e.g., *id.* at 643, 645, 652. However, most of her discussion refers to the duties of fiduciaries. See, e.g., *id.* at 652 (emphasis added) (“[A] *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.”); see also *id.* (emphasis added) (“[T]he misappropriation theory premises liability on a *fiduciary-turned-trader*’s deception of those who entrusted him with access to confidential information.”). Justice Thomas, in his dissent, agrees with Justice Ginsburg’s characterization that misappropriation involves a breach of a fiduciary duty. *Id.* at 680–81 (Thomas, J., dissenting) (emphasis added) (“I do not take issue with the majority’s determination that the undisclosed misappropriation of confidential information by a *fiduciary* can constitute a ‘deceptive device’ . . .”). Elsewhere, Justice Ginsburg quotes the government’s brief with approval, which describes the theory as being based on the “common law rule that a trustee may not use the property that [has] been entrusted [to] him.” *Id.* at 654. Moreover, the two examples she gives of persons who have the type of duties necessary for insider-trading liability are traditional fiduciaries — i.e., officers and directors of corporations under the classic theory, and *O'Hagan* himself who, as an attorney, has a fiduciary duty to his firm and client. *Id.* at 644.

Similarly, in *Carpenter*, in which the Supreme Court adopted a misappropriation theory in the context of wire and mail fraud, Justice White, applying New York law, found that R. Foster Winans violated his *fiduciary* duty to his employer — *The Wall Street Journal* — when he used its confidential, proprietary information for his own purposes, without disclosing this intention. Justice White stated:

[In an earlier case] we noted the similar prohibitions of the common law, that “even in the absence of a written contract, an employee has a *fiduciary* obligation to protect confidential information obtained during the course of his employment.” As the New York courts have recognized: “It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or *fiduciary* relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.

Carpenter v. United States, 484 U.S. 19, 27–28 (1987) (emphasis added) (citing *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (1969); RESTATEMENT (SECOND) OF AGENCY §§ 388 cmt. c, 396(c) (AM. L. INST. 1958)).

124. See *infra* text at notes 360–63.

125. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009); see also Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 83–88.

of the information. When the source discloses the information to a confidant having the requisite duty, the confidant makes an implied representation of loyalty she will not engage in self-dealing by using the information for her own profit. If she does so, she is defrauding the source out of its possessory right in the property understood as the exclusive control of its use.¹²⁶ Misappropriation of information is akin to the embezzlement of money.¹²⁷ This fraud is “consummated” as *securities* fraud when the disloyal confidant uses the information to purchase or sell securities.¹²⁸ Although *O’Hagan* involved a defendant who was a lawyer with fiduciary duties to his partners and a former client by virtue of partnership law and legal ethics, there is no logical or doctrinal reason why confidants should not be able to accept similar duties by contract or why misrepresentations of fidelity could not be express, rather than implied. Consequently, the caselaw leaves the scope of the misappropriation theory unclear.¹²⁹

It is also unclear who, other than the SEC and the DOJ, can bring a cause of action for misappropriation insider trading under § 10(b) and Rule 10b-5. In *Blue Chip Stamps v. Manor Drug Stores*,¹³⁰ the Supreme Court held that, to have standing to bring a private right of action under Rule 10b-5, the plaintiff must itself purchase or sell securities. This means that, even though the source is deemed defrauded under the misappropriation theory, in most cases the source will be precluded from bringing a cause of action against the inside trader in federal court.¹³¹ Accordingly, state common law might be able to remediate some of the well-known paradoxes and analytical problems of the Supreme Court’s analysis of the misappropriation theory of insider trading.

It is generally thought that persons who buy or sell securities during the period that *classic* insider trading occurs should have a cause of action for

126. See *O’Hagan*, 521 U.S. at 651.

127. *Id.* at 654.

128. *Id.* at 655–56.

129. The federal courts in general are surprisingly lax in their discussions of the law of the requisite duty, typically merely stating that duty either does or does not exist. See *infra* text at notes 379–412. Although I, like Bainbridge, Bainbridge, *Incorporating*, *supra* note 68, prefer incorporating state law on federalism grounds, the resolution of this issue is beyond the scope of this Article.

130. 421 U.S. 723 (1975).

131. For example, in *Daividge v. White*, 377 F. Supp. 1084, 1088–90 (S.D.N.Y. 1974), the District Court for the Southern District of New York dismissed a derivative Rule 10b-5 action for insider trading against a former director on the grounds that the company did not itself purchase or sell securities. It allowed a claim brought under Delaware law to proceed. Similarly, over 35 years ago Robert Thompson, citing *Diamond* as well as some largely pre-*Blue Chip Stamps* scholarship, suggested that the issuer (in the case of classic insider trading) might be the more appropriate plaintiff in insider trading litigation, based on an unjust enrichment theory but for the standing requirement of federal law. Thompson, *supra* note 14, at 395.

fraud, although there are questions as to how to prove causation and the measure of damages. In a securities fraud cause of action, a plaintiff must prove both transaction causation (roughly, but-for causation) through reliance on the misstatement or omission,¹³² as well as loss causation (similar to proximate causation).¹³³ Since insider trading cases usually involve omissions, not misstatements, the plaintiffs can probably invoke the presumption of reliance and transaction causation established in *Affiliated Ute Citizens of Utah v. United States*.¹³⁴

However, with respect to loss causation there is an argument that the plaintiff's loss is not caused by defendant's *trade*, but the non-disclosure of the material nonpublic information.¹³⁵ Indeed, if the insider observed the *Cady, Roberts* "disclose or abstain" rule by *abstaining* from trading, the plaintiff would have incurred the same loss when the issuer subsequently disclosed the information.¹³⁶ Alternately, if the insider fulfilled the rule by disclosing the information immediately before trading, most traders would have suffered the same loss a little earlier than they did. Moreover, for every investor who, for example, "lost" money by selling at a low price before positive information was released, there will be another investor who fortuitously gained by buying before the release. Nevertheless, it is generally assumed that the measure of damages for private rights of action under Rule 10b-5 is out-of-pocket losses.¹³⁷ This could, however, result in aggregate damages to a plaintiff class disproportionate to the defendant's wrongdoing.

132. *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 267 (2014).

133. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

134. 406 U.S. 128 (1972).

135. See Bainbridge, *Overview*, *supra* note 68, at 23–24. This assumption that a contemporaneous trader is hurt by the insider's trading seems to be based on a "day trader" mentality where investors are trying to beat the market. For long term investors like myself (and Warren Buffett to whom I unfairly compare myself), I invest on what I think the future financial results of issues will be. Long-term traders do not view trading as a zero-sum game where some investors do better than others by making short-term bets.

136. As Robert Thompson has noted (in arguing, as I do, for a restitutionary approach to insider trading):

Those traders on the other side of the transaction from the insider may have sustained losses, but given the anonymous nature of the market few, if any, can show that their trading was induced by defendant's fraudulent conduct. In almost all cases plaintiffs made decisions to trade that were independent of the defendant; these plaintiffs would have suffered the same losses had the defendant simply not traded and not disclosed- action that would not have been a breach of defendant's rule 10b-5 duty.

Robert Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 391 (1984) (citations omitted); see also, Cox, *Insider Trading*, *supra* note 69, at 635.

137. See Wang, *supra* note 44.

Moreover, the logic of *O'Hagan* suggests that such investors would not have a cause of action for securities *fraud* under the misappropriation theory because the duty to speak runs to the source of the information, not the investment public.¹³⁸

In 1988 Congress addressed these concerns by enacting Exchange Act Section 20A giving contemporaneous traders a statutory cause of action against “any person who violates any provision of [the Exchange Act] . . . by purchasing or selling a security while in possession of material, nonpublic information.”¹³⁹ Unfortunately, this section does not specify when such trading violates the Exchange Act.

It is sometimes said that Section 20A is an action for disgorgement of profits.¹⁴⁰ This is not technically correct. The rule merely establishes a cause of action but does not set forth the measure of recovery. It does, however, *limit* the maximum recovery in two ways. First, Section 20A(b)(1) provides that “[t]he total amount of damages imposed . . . shall not exceed the profit gained or loss avoided in the transaction or transactions that are subject of the violation.”¹⁴¹ That is, disgorgement is the ceiling, not the measure, of damages. Second, Section 20A(b)(2) provides “the total amount of damages imposed against any person under [this section] shall be diminished by the amounts if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the [SEC] . . . relating to the same transaction or transactions.”¹⁴²

It is not clear how helpful Section 20A actually is to contemporaneous traders. As an empirical matter, a contemporaneous trader will probably only learn of the insider trading because the SEC has already brought an action seeking disgorgement,¹⁴³ in which case it might be too late for the plaintiff to obtain meaningful damages.¹⁴⁴ The Supreme Court’s holding in *Liu* that, in most cases, disgorgement is proper only if the SEC uses it to compensate victims may or may not change this.

Another reason might be that recovery under Section 20A is limited by the

138. See *Moss v. Morgan Stanley*, 719 F.2d 5, 10–12, 15 (2d Cir. 1982).

139. 15 U.S.C. §78t-1(a).

140. See, e.g., STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION CASES AND ANALYSIS* 469–70 (5th ed. 2019).

141. 15 U.S.C. § 78t-1(b)(1).

142. *Id.* §78t-1(b)(2).

143. Bainbridge notes that “[v]irtually all private party insider trading lawsuits are parasitic on SEC enforcement efforts, which is to say that the private party suit was brought only after the SEC’s proceeding became publicly known.” Bainbridge, *Incorporating*, *supra* note 68, at 1263 (citations omitted).

144. Where the SEC has obtained disgorgement in a settlement, however, courts have permitted plaintiffs to try to prove that the actual profits reaped by the defendant exceeded the settled amount. See, e.g., *Kaplan v. S.A.C. Cap. Advisors, L.P.*, 40 F. Supp. 3d 332, 338 (S.D.N.Y. 2017).

defendant's gains or avoided losses.¹⁴⁵ This is in contrast to a private class action under Sec 10(b) where the presumed damages are the aggregate out-of-pocket losses of the entire plaintiff class.¹⁴⁶ Except for a few high profile cases, the amount of profits disgorged in insider trading actions tends to be relatively moderate and probably would not support the legal fees of complex securities litigation if recovery must be shared among a plaintiff class.¹⁴⁷ Consequently, trading by insiders is commonly raised as evidence of the *issuer's* scienter in class actions for fraud under Rule 10b-5 where the plaintiff class can seek out-of-pocket damages (that is, the traditional insiders' guilty state of mind as evidenced by their trading on material nonpublic information will be attributed to the corporation in an allegation that the corporation's failure to disclose constitutes securities fraud).¹⁴⁸

The interrelationship between breach of fiduciary or other duties on the one hand and the fraud requirement for Rule 10b-5 liability is strained. Both the classic and misappropriation theories conceptualize material nonpublic information as property — implicitly, of the issuer under the classic theory and expressly of the source under the misappropriation theory. Classic insider trading is analogous to self-dealing by a fiduciary. Misappropriation is akin to embezzlement by an unfaithful confidant.¹⁴⁹ However, neither self-

145. See William K.S. Wang, *ITSFEA's Effect on Either an Implied Cause of Action for Damages by Contemporaneous Traders or an Action for Damages or Rescission by the Party in Privity with the Inside Trader*, 16 J. CORP. L. 445, 454 (1991).

146. *Id.*

147. The SAC Capital Advisor's insider trading settlement where the defendant paid fines and disgorgement in over a billion dollars is the exception. See Nate Raymond & Emily Flitter, *SAC Capital Agrees To Pay \$1.8 Billion In Largest Insider Trading Settlement In History*, BUS. INSIDER (Apr. 10, 2014, 10:24 PM), <https://www.businessinsider.com/sac-capital-settlement-2014-4>.

Verity Winship's analysis of SEC insider trading actions from fiscal years 2005–2015 indicate that, although disgorgement was ordered in 93% of the cases:

[T]he median disgorgement amount was \$62,756, which is indicative of the concentration of awards at the low end of the range. Although the overall average disgorgement ordered was \$1,567,232, more than half of the awards were under \$100,000 and only 12% were \$1 million or above. Moreover, the range was enormous: from \$1 to approximately \$275 million.

Winship, *supra* note 15, at 1008 (citations omitted).

148. One report written in 1999 showed that a significant majority of cases brought after the adoption of the enhanced scienter pleadings standards of the Private Securities Litigation Reform Act four years earlier alleged insider trading as evidence of senior management's knowledge of material nonpublic information compared to just over 1/5 before the passage of the Act. Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 94 (citing John L. Latham & Todd R. David, *Compliance Programs Risk of Insider Trading*, NAT'L L.J. June 28, 1999, B8).

149. In the words of Judge Rakoff of the Southern District of New York who has decided many noted insider trading cases (including the lower court opinion in *Salman*, discussed *infra* in text at notes 448–49):

Essentially, insider trading is a variation of the species of fraud known as

dealing nor embezzlement standing alone constitutes fraud. Consequently, the Supreme Court must add the additional step of arguing that the duties under both theories of insider trading create implied representations so that silence constitutes securities fraud.

This has led Bainbridge to argue that insider trading law can more coherently be read as a de facto federal common law of property rights in information.¹⁵⁰ Consequently, we could simplify the caselaw as applied if we just admit this and drop the extra step of a fraud analysis entirely.

There is great merit with Bainbridge's argument from a practical and policy matter. However, even ignoring the *Erie* question of the propriety of a federal common law of property, unless the Supreme Court were to overrule its own precedents construing the language of Section 10(b) as being limited to actual fraud or Congress amends the law, Bainbridge's suggestion is highly unlikely in the foreseeable future.¹⁵¹ This is why I argue that if we take the misappropriation theory seriously, we should look to state law under which fraud, breaches of fiduciary duty, and violations of property rights are independent grounds for restitutionary remedies.

embezzlement, which is defined in Black's Law Dictionary as "[t]he fraudulent taking of personal property with which one has been entrusted, especially as a fiduciary." [] If the embezzler, instead of trading on the information himself passes on the information to someone who knows it is misappropriated information but still intends to use it in connection with the purchase or sale of securities, that "tippee" is likewise liable, just as any knowing receiver of stolen goods would be.

United States v. Pinto Thomaz, 352 F. Supp. 3d 287, 295–96 (S.D.N.Y. 2018). However, he also believes that "[t]he crime of insider trading is a straightforward concept that some courts have somehow managed to complicate." *Id.*

Judge Rakoff, despite his criticism of other judges in fact, misstates the law of property. A good faith recipient of *stolen* goods is not entitled to retain the goods and must disgorge profits. However, embezzled property is obtained by fraud not theft; a thief has void title, while an embezzler has voidable title. A good faith purchaser of value can take fraudulently obtained property free of the true owner's adverse claim. A recipient of stolen property, however, always takes subject to the adverse claim regardless of his knowledge lack thereof. *See infra* text at notes 266–68, 271–74.

150. Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 91–98; Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644 (1999) [hereinafter, Bainbridge, *Path Dependent*]. He states "[t]he Court should again explicitly acknowledge that it is making common law. The rules it announces should be based on the protection of property rights, not on inapt securities fraud concepts." *Id.* at 1651.

151. As Karmel states, "[t]he trouble with [the misappropriation] theory is that the federal securities laws are concerned with fairness and the protection of investors, not the protection of business property rights in information." Karmel, *Definition*, *supra* note 102, at 768. She is, of course, ignoring the Supreme Court's holdings to the contrary.

C. Tipper-Tippee Liability

The third form of liability for insider trading is for tippers and tippees. This rule is articulated by the Supreme Court in *Dirks*.¹⁵² Although the tipper in *Dirks* was a classic insider, the rule of *Dirks* seems also to apply to misappropriators.¹⁵³

In *Dirks*, Ronald Secrist, a former officer of a publicly traded insurance company, contacted the defendant, Raymond Dirks, a broker-dealer who specialized in the insurance industry after failing to get regulators to investigate his allegation that the company was engaged in fraudulent practices that inflated its earnings.¹⁵⁴ After investigation, Dirks determined that the tipper's allegations were true and tried to spread word of the fraud by contacting, among others, *The Wall Street Journal*, which initially refused to publish this information.¹⁵⁵ Although he and his firm did not trade in the issuer's securities, Dirks did disclose the information to some of his clients who sold their stock in the company.¹⁵⁶ When the market learned of the fraud, largely because of Dirks's activities, the price dropped, the New York Stock Exchange suspended trading, and the California insurance regulator started an investigation.¹⁵⁷ Only then did the SEC deign to investigate the company. Rather than thanking Dirks for his service in helping to bring the fraud to light, it brought an enforcement action against him for insider trading.¹⁵⁸ The SEC argued that when "tippees" — regardless of their motivation or occupation — come into possession of material 'information that they know is confidential and know or should know came from a

152. 463 U.S. 646 (1983).

153. The Second Circuit Court of Appeals once suggested that the *Dirks* analysis did not apply in misappropriation cases. See *United States v. Falcone*, 257 F.3d 226, 230–31 (2d Cir. 2001). As its opinions in *Newman* and *Martoma II*, discussed *infra* in text at notes 417–21 show, it no longer takes this position. I will argue that one of the advantages of seeking disgorgement under state law is that it does not require the *Dirks* test for tippees.

As Langevoort notes, however, in the more recent case of *United States v. Blaszcak*, 947 F.3d 19, 19 (2d Cir. 2019), the Second Circuit found that *Dirks* does not apply to wire fraud or the criminal securities fraud action added as part of Sarbanes-Oxley (18 U.S.C. § 1348). Langevoort, *Wobble*, *supra* note 61, at 525–26. Karen Woody accurately argues that this interpretation of § 1348 results in "an inversion of civil and criminal standards as related to insider trading," in which the standards for prosecuting a criminal case against an alleged trader is lower than those for an SEC civil action. Karen E. Woody, *The New Insider Trading*, 52 ARIZ. S. L. REV. 594, 644 (2020).

154. *Dirks*, 463 U.S. at 649.

155. *Id.* at 649–50.

156. *Id.* at 649.

157. *Id.* at 650.

158. *Id.*

corporate insider,' they must either publicly disclose that information or refrain from trading."¹⁵⁹

Justice Powell, the author of the majority opinion in *Chiarella*, reconfirmed its holding that mere possession of material nonpublic information does not impose liability absent a breach of fiduciary duty.¹⁶⁰ A tippee could, however, in certain cases inherit her tipper's duties. But to do this, not only must the tipper violate a duty to the issuer or other source when he made the tip, but the tippee must know or should have known of the tipper's violation.¹⁶¹ Moreover, for a tipper to violate his duty to the issuer or other source, he must make the tip with the intent of obtaining a financial benefit.¹⁶² This benefit can take the form of an expectation of receiving a quid pro quo from the tippee.¹⁶³ But the tipper is also deemed to receive a benefit if he intended to make a gift to the tippee.¹⁶⁴ As I discuss below,¹⁶⁵ this will provide a state law theory as to why a tipper may have to disgorge an amount equal to the profits earned (or losses avoided) by his tippee that does not invoke joint and several liability.

159. *Id.* at 651.

160. *Id.* at 654–55.

161. *Id.* at 660.

162. *Id.* at 662. This part of the *Dirks* test is odd because, as I emphasize throughout this Article, personal benefit by a beneficiary is not a necessary element of self-dealing as Justice Powell, a former corporate lawyer, must have known. As Langevoort discusses, A.C. Pritchard's examination of Powell's notes show that the language of the case was the result of a compromise between Justice Powell and Justice O'Connor. This helps explain why it is so confusing. Langevoort, *Wobble*, *supra* note 61, at 512–13; see A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015).

Consequently, Merritt Fox and George Tepe agree with me that the personal benefit test, which was developed in the context of the classical theory and fiduciary type duties owed to the issuer and its shareholders, has no place in tipping of misappropriated material nonpublic information. Merritt B. Fox & George N. Tepe, *Personal Benefit Has No Place in Misappropriation Tipping Cases*, 71 SMU L. REV. 767, 770–71 (2018). They believe, however, that it has a role to play in classic insider trading under the rationale suggested by Justice Powell in *O'Hagan* — we don't want to "chill" legitimate research including interviews with analysts. *Id.* at 778–79.

Jonathan Macey defends the personal benefits test at least in the context of classic insider trading as consistent with the property theory of information on efficiency grounds. Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018) [hereinafter Macey, *Martoma II*]. To simplify, if information is property of an issuer, then its management should be able to use it as it sees fit to further valid corporate purposes. *Id.* at 873–77. This means that tipping should be permitted if it serves valid corporate purposes, such as making the market for an issuer's securities by giving information to professional securities analysts and others. *Id.* If the insider obtains a personal benefit from the tip, this is evidence that he was not using the information for a corporate purpose. *Id.*

163. *Dirks*, 463 U.S. at 663–64.

164. *Id.* at 664.

165. See *infra* text at notes 445–51.

III. THE STATE LAW DISGORGEMENT AND BREACH OF FIDUCIARY DUTY

In this section, I introduce the state law that has recognized that a corporation has the right to sue a traditional insider for trading on the basis of material insider information about the corporation learned through her position, i.e., classic insider trading. I then explore the basic rules of property law which suggests that, if we take the Supreme Court's misappropriation theory seriously, there should also be a state common law cause of action for the source of information to sue for trading on the basis of its material non-public information. I then turn to the R3RUE to examine the common law support for my proposal. I end with a discussion as to how such an approach would simplify and rationalize insider trading law.

A. Origins

In the 1949 case of *Brophy v. Cities Services Co.*,¹⁶⁶ the Delaware chancery recognized that a corporation has a restitutionary claim to recover the profits in what we would today call classic insider trading — that is trading by officers and directors of a corporation in securities issued by the corporation based on material non-public information belonging to the corporation.¹⁶⁷ In *Brophy*, Chancellor Harrington recognized that the concern of unjust enrichment is not loss to the plaintiff, but gain by the defendant, stating:

In equity, when the breach of confidential relation by an employee is relied on and an accounting for any resulting profit is sought, loss to the corporation need not be charged in the complaint. [] Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss.¹⁶⁸

New York followed suit 30 years later in *Diamond v. Oreamuno*.¹⁶⁹ This was also a derivative action against certain officers and directors for an accounting of profits received from the sale of corporate stock allegedly on the basis of material nonpublic information.¹⁷⁰ The defendant argued that the case should be dismissed because the harm of insider trading was unfairness to shareholders, but there was no damage to the corporation itself.¹⁷¹ Like the Delaware Supreme Court, the New York Court of Appeals ruled that the purpose behind a suit for breach of fiduciary duty is not

166. 70 A.2d 5 (Del. Ch. 1949).

167. *Id.* at 7–8.

168. *Id.* at 8. (citing *Loft, Inc. v. Guth*, 2 A.2d 225 (Del. Ch. 1939), *aff'd* 5 A.2d 503 (Del. 1939); *Lutherland, Inc. v. Dahlen*, 53 A.2d 143 (Pa. 1947)).

169. 248 N.E.2d 910 (N.Y. 1969).

170. *Id.* at 911.

171. *Id.* at 912.

compensation, but the recovery of ill-gotten profits, i.e., unjust enrichment.¹⁷²

As a *secondary* grounds for finding a cause of action, the Court of Appeals noted that, although the defendants' actions almost certainly violated Exchange Act §10(b) and Rule 10b-5, at that time the federal remedies were inadequate — being basically limited to the SEC's ability to obtain injunctive relief.¹⁷³ The Court of Appeals stated that a "class action under the federal rule might be a more effective remedy but the mechanics of such an action have, as far as we have been able to ascertain, not yet been worked out by the federal courts and several questions relating thereto have never been resolved."¹⁷⁴ Some later courts would rely on this secondary rationale, coupled with subsequent developments in federal caselaw and amendments to the Exchange Act, as a reason to reject the *Brophy/Diamond* rule on the grounds that it was outdated.¹⁷⁵

B. Reception

Since then, the reception in other states has been patchy. It is frequently said¹⁷⁶ that Florida rejected the *Diamond* rule in *Schein v. Chasen*.¹⁷⁷ This is not quite correct because that case does not even consider the applicability of this rule to classic *insiders*.

172. It stated:

Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation. The primary concern, in a case such as this, is not to determine whether the corporation has been damaged but to decide, as between the corporation and the defendants, who has a higher claim to the proceeds derived from the exploitation of the information. In our opinion, there can be no justification for permitting officers and directors, such as the defendants, to retain for themselves profits which, it is alleged, they derived solely from exploiting information gained by virtue of their inside position as corporate officials.

Id. at 912. The court did, however, entertain the possibility that a corporation might suffer reputational damage if the public learned that its insiders were trading on non-public information. *Id.* at 912.

The court also rejected the defendant's arguments that the short-swing profit rule of Exchange Act Section 16(b), 15 U.S.C. § 78p(b), was exclusive and that permitting a state cause of action might result in double liability. *Id.* at 914.

173. *Id.* at 914–15.

174. *Id.*

175. See *infra* text at notes 212–15, 218–19.

176. For example, it is cited for this proposition in the influential case of *Freeman v. Decio*, 584 F.2d 186, 189 (7th Cir.1978), discussed *infra* text at notes 203–13.

177. 313 So. 2d 739 (Fla. 1975); see, e.g., Thompson, *supra* note 14, at 395.

In *Schein*, the Florida Supreme Court considered an issue of Florida law certified by the Second Circuit Court of Appeals.¹⁷⁸ Unlike in *Brophy* and *Diamond*, the defendants were *not* insiders of the titular corporate plaintiff because they had not been validly served under New York law.¹⁷⁹ Rather, the defendants were alleged direct and remote tippees of the corporation's president.¹⁸⁰ In this pre-*Dirks* case, the Florida Supreme Court found that the plaintiff failed to plead a cause of action under Florida law. In doing so it rejected three theories: 1) that possession of material insider information imposes a fiduciary duty on a tippee, 2) that a tippee has joint and several liability with his tipper because tippers and tippees are involved in a common enterprise, and 3) that tippees are aiders and abettors of tippers.¹⁸¹ In other words, the Florida Supreme Court did not even consider, let alone reject, the *Brophy/Diamond* rule that issuers can sue *insiders* who commit classic insider trading. Rather, it rejected the plaintiff's allegation that the tippees' activity was unlawful. Indeed, in doing so, the *Schein* court anticipated some aspects of federal jurisprudence of tippee liability. As discussed,¹⁸² in *Dirks*, the Supreme Court rejected the SEC's position that mere possession of material nonpublic information imposes fiduciary duties on tippees. Moreover, in *Liu*, the U.S. Supreme Court expressly rejected the concept of joint and several liability of tippers and tippees in most cases.¹⁸³ The Florida Supreme Court did, however note, in addition to its primary argument that a

178. *Schein*, 313 So. 2d at 739.

179. *Id.* at 741.

180. *Id.* at 740–41.

181. The District Court for the Southern District of New York originally granted the defendant's motion to dismiss on the grounds that Florida law requires damage to the corporation. In this opinion, however, the District Court went on to say that derivative actions were designed to enforce proper behavior of corporate officials and cannot be extended "to cover outside individuals, corporations, or institutions." *Id.* at 742. It also held that the issue as to whether Florida would adopt *Diamond* with respect to the insider was not before the court. *Id.*

This holding was reversed by a two to one Second Circuit Court of Appeals decision. *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973). That was, in turn, vacated by the Supreme Court of the United States on April 29, 1974, in an opinion reported at *Schein v. Chasen*, 416 U.S. 386 (1974), leading to the certification of the question by the Second Circuit.

In its opinion the Florida Supreme Court quoted at length the dissent of Judge Kaufman in the earlier Second Circuit case to the extent that outside tippees are not fiduciaries with liability for trading on the basis of material nonpublic information. *Schein*, 313 So. 2d at 743–46. The Florida Supreme Court explained that it "quote[d] the dissent of Judge Kaufman and [held] it to be responsive and to be dispositive of the certified questions." *Id.* at 746.

182. See *supra* text at notes 160–64.

183. See *supra* text at note 9. As I discuss below, see *infra* text at notes 445–61, I argue that under some circumstances, tippers should have to disgorge an amount measured by her tippee's profits, but under a different theory of direct liability.

tippee has no duty not to trade, that it was adhering to Florida precedent “that actual damage to the corporation must be alleged . . . to substantiate a stockholders’ derivative action.”¹⁸⁴ This is consistent with the proposition that, if the issue were raised in the future, it might also require a showing of harm in a *Brophy/Diamond* derivative action against an insider.

Most other cases finding that states either do or do not adopt the *Brophy/Diamond* rule are, in fact, federal court decisions making “*Erie* guesses” as to what a state court would do. A number of federal decisions have concluded that New Jersey would follow *Brophy*.¹⁸⁵ Conversely, two other federal courts suggested that absent controlling state law, Connecticut¹⁸⁶ and Nevada¹⁸⁷ would look to Delaware for guidance and adopt the *Brophy* rule.

The federal courts in Ohio have been inconsistent. In 2007, in *In re Goodyear Tire & Rubber Co. Derivative Litig.*¹⁸⁸ the district court for the Northern District of Ohio expressed skepticism as to whether *Brophy* was the rule in Ohio, noting that some Delaware lower courts questioned its continued applicability. Nevertheless, it decided that the defendants would, in any event, not be liable under a *Brophy* analysis.¹⁸⁹ However, in 2014, in *In re Gas Natural, Inc.*,¹⁹⁰ the federal court for the Northern District of Ohio noted that some federal courts had held that, in the absence of any Ohio precedent on point, Ohio state courts would probably look to Delaware for guidance. Consequently, the court ruled that *Brophy* was the Ohio rule.¹⁹¹ As I will discuss,¹⁹² in the interim, in *Kahn v. Kohlberg, Kravis and Roberts L.P.*,¹⁹³ the Delaware Supreme Court dismissed the qualms of some Delaware chancellors relied on by the *Gas Natural* court and clarified that *Brophy* is alive and well.

184. *Schein*, 313 So. 2d at 746.

185. *Nat’l Westminster Bancorp v. Leone*, 702 F. Supp. 1132 (D.N.J. 1988); *see also In re ORFA Sec. Litig.*, 654 F. Supp. 1449 (D.N.J. 1987) (holding that New Jersey would adopt the *Brophy/Diamond* rule); *Frankel v. Slotkin*, 984 F.2d 1328, 1336–37 (2d Cir. 1993) (applying New Jersey law); *In re Cendant Corp. Derivative Action Litig.*, 189 F.R.D. 117, 130 (D.N.J. 1999) (holding that there was no conflict of law between New Jersey and Delaware, although the court seemed to assume that harm to the issuer was an element in a *Brophy* cause of action).

186. *In re Coleco Secs. Litig.*, 591 F. Supp. 1488, 1495 (S.D.N.Y. 1984). The court also thought that a Connecticut court would look to *Diamond* for guidance.

187. *In re Jackpot Enterprises Sec. Litig.*, No. CV-S-89-805, 1991 U.S. Dist. LEXIS 16287, at *7 (D. Nev. Mar. 28, 1991).

188. No. 5:03CV2180, 2007 U.S. Dist. LEXIS 1233 (N.D. Ohio Jan. 5, 2007).

189. *Id.* at *25–26.

190. No. 1:13-CV-02805, 2014 U.S. Dist. LEXIS 184046 (N.D. Ohio Sept. 24, 2014).

191. *Id.* at *68.

192. *See infra* text at notes 229–46.

193. *Kahn v. Kohlberg Kravis Roberts & Co.*, 23 A.3d 831 (Del. 2011).

Nevertheless, one year after *Gas Natural* (and four years after *Kahn*), in *Brosz v. Fishman*,¹⁹⁴ the district court for the Southern District of Ohio, without citing *Brophy*, *Natural Gas*, or *Kahn*, dismissed a derivative action brought on behalf of a corporation against a classic insider trader on the grounds that Ohio law requires that the plaintiff show harm to the nominal corporate plaintiff.¹⁹⁵ The court expressly found that there were no grounds for an unjust enrichment claim against the officers who traded on material nonpublic information: holding that “the profit generated by the alleged insider trading of the individual Defendants cannot be considered a benefit conferred on them by” the corporate plaintiff.¹⁹⁶ As I will show,¹⁹⁷ this ignores the Delaware Supreme Court holding in *Kahn* and reveals that the district court fundamentally misunderstands common law principles of restitution.

Probably the most influential anti-*Brophy* opinion is another *Erie* guess of state common law by a federal court. In the 1978 case of *Freeman v. Decio*,¹⁹⁸ the Seventh Circuit Court of Appeals decided, in the absence of relevant Indiana precedent, Indiana courts were *unlikely* to adopt the *Brophy/Diamond* rule. Despite its influence, the reasoning in *Freeman* is in many ways out of step with both state common law and subsequent federal securities law. As G.W.F. Hegel said of Immanuel Kant’s theory of the four antinomies, it is “a whole nest . . . of faulty procedure.”¹⁹⁹

Citing *Cady, Roberts*, the Seventh Circuit noted that the harm of insider trading is not to the corporate source of information but unfairness to stockholders.²⁰⁰ This is, of course, inconsistent with subsequent Supreme Court jurisprudence which would reject the fairness justification for insider trading liability in favor of an actual fraud theory involving a breach of a fiduciary or similar duty to the issuer and its shareholders (under the classic theory) or the source of the information (under the misappropriation theory).²⁰¹

The Seventh Circuit noted, and rejected, *Diamond*:

[T]he New York Court of Appeals in *Diamond* . . . engineer[ed] an innovative extension of the law governing the relation between a corporation and its officers and directors. The court held that corporate officials who deal in their corporation’s securities on the basis of non-

194. 99 F. Supp. 3d 776 (E.D. Ohio 2015).

195. *Id.* at 787–88.

196. *Id.* at 788.

197. See *infra* text at notes 229–46.

198. 584 F.2d 186 (7th Cir. 1978).

199. G.W.F. HEGEL, HEGEL’S SCIENCE OF LOGIC 195 (A.V. Miller trans. 1969).

200. *Freeman*, 584 F.2d at 189.

201. See *supra* text at notes 54–57, 106–29.

public information gained by virtue of their inside position commit a breach of their fiduciary duties to the corporation. *This holding represents a departure from the traditional common law approach, which was that a corporate insider did not ordinarily violate his fiduciary duty to the corporation by dealing in the corporation's stock, unless the corporation was thereby harmed.*²⁰²

The Seventh Circuit also dismissed *Brophy* as a “significant departure from the traditional common law.”²⁰³ To say that *Brophy* was a deviation from traditional common law is, of course, absurd since by the time that *Freeman* was written, thirty-year-old *Brophy* was the traditional common law of fiduciary duty of the most significant state governing corporate law.²⁰⁴ It also reflects the traditional rule of principal-agency law that an agent must account to her principal for profits earned from the abuse of her position even if the principal is not harmed.²⁰⁵ The R3RUE of Restitution agrees.²⁰⁶

The Seventh Circuit also rejected the New York Court of Appeals finding in *Diamond* that inside information is a corporate asset, asserting that this position is inconsistent with the law of corporate opportunity.²⁰⁷ In doing so, it ignored the fact that the highest courts in New York and Delaware determined that this was their common law of fiduciary duty, although as the Delaware Court would clarify, *Brophy* is not grounded in corporate opportunity.²⁰⁸ The Seventh Circuit also did not anticipate that the Supreme Court would later cite with approval *Diamond's* holding that material nonpublic information is property of the issuer in finding that insider trading constituted wire and mail fraud.²⁰⁹ The Supreme Court subsequently

202. *Freeman*, 584 F.2d at 191–92 (emphasis added).

203. *Id.* at 192.

204. In 2011, before *Kahn*, in which the Delaware Supreme Court confirmed that *Brophy* was still controlling, the Alabama Supreme Court, applying Delaware law, upheld a \$147,450,000 judgment against Richard Scrushy in a derivative action for insider trading in the stock of HealthSouth Corporation expressly rejecting the argument that *Brophy* was no longer valid law because it was anachronistic and/or had been preempted by changes in federal law. *Scrushy v. Tucker*, 70 So. 3d 289 (Ala. 2011). The court cited Vice Chancellor Laster's opinion in *Pfeiffer* (see *infra* text at notes 224–27) that its continued existence was the cornerstone of federal insider trading law, and stated that “*Brophy* has been a part of the warp and woof of Delaware securities laws for more than 60 years.” *Id.* at 309.

205. RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (AM. L. INST. 1958). Many law students are familiar with this principle from the British case of *Reading v. Regem*, 2 KB 268 (1948), often included in business associations and agency casebooks because of its colorful yet easy to understand facts reminiscent of *Masterpiece Theater Series* of shows such as *The Jewel in the Crown*.

206. See *infra* text at notes 362–72.

207. *Freeman*, 584 F.2d at 193–94.

208. *Kahn v. Kolberg Kravis Roberts & Co.*, 23 A.3d 831, 840 (Del. 2011).

209. *Carpenter v. United States*, 484 U.S. 19, 27–28 (1987).

extended this principle to securities fraud as well.²¹⁰ That is, *Freeman* is inconsistent with the shift in insider trading law from a fairness rationale to one based on breaches of duty and violations of proprietary rights in material nonpublic information.

The Seventh Circuit was also wrong about state common law of insider trading. The early 20th century rule was that in the absence of special facts, *shareholders* had no *direct* private right of action against insiders for insider trading on impersonal public markets (as opposed to face-to-face transactions) — a principle that Justice Powell notoriously misstated in *Chiarella* when he asserted that an insider's fiduciary duties with respect to insider trading ran directly to the issuer's current and potential future stockholders.²¹¹ This is, however, irrelevant to the question of whether in classic insider trading cases, the *issuer* of the securities (to whom insiders *do* owe a direct duty of loyalty) or the *source* of the information, in the case of the misappropriation, has a cause of action.

Most important, the Seventh Circuit seized on the New York Court of Appeals *secondary* justification for its opinion in *Diamond*, namely the inadequacy of remedies for insider trading under federal law.²¹² It held, by negative pregnant, that since federal remedies had improved, there was no longer a rationale for a state law remedy.²¹³

Nevertheless, despite its many doctrinal errors of state common law, its failure to anticipate the trend in federal law, and the fact that since the late 1970's when *Freeman* was decided, both federal case and statutory law have significantly cut back on private class actions for securities fraud, some federal courts have continued to adopt the *Freeman* rationale for

210. See *supra* text at notes 109–17, 126–28, 149–50.

211. See Manning G. Warren III, *A Birthday Toast to Texas Gulf Sulphur*, 71 SMU L. REV. 987, 988 (2018); Gubler, *supra* note 120, at 1228, 1241–42; CHOI & PRITCHARD, *supra* note 140, at 411.

212. See *Freeman*, 584 F.2d at 191–92.

213. It stated:

Since the *Diamond* court's action was motivated in large part by its perception of the inadequacy of existing remedies for insider trading, it is noteworthy that over the decade since *Diamond* was decided, the 10b-5 class action has made substantial advances toward becoming the kind of effective remedy for insider trading that the court of appeals hoped that it might become. Most importantly, recovery of damages from insiders has been allowed by, or on the behalf of, market investors even when the insiders dealt only through impersonal stock exchanges, although this is not yet a well-settled area of the law. In spite of other recent developments indicating that such class actions will not become as easy to maintain as some plaintiffs had perhaps hoped, it is clear that the remedies for insider trading under the federal securities laws now constitute a more effective deterrent than they did when *Diamond* was decided.

Id. at 195–96.

Erie guessing that state courts would reject *Brophy*. In *Daisy Systems Corp. v. Finegold*,²¹⁴ the federal court for the Northern District of California dismissed a cause of action by guessing that a California court would not follow *Brophy/Diamond* on a *Freeman* analysis. In *In re Cray Inc. Derivative Litig.*,²¹⁵ the district court for the Western District of Washington, relying heavily on *Freeman*'s reasoning that *Brophy* may no longer be good law, guessed that Washington State would require a showing of damage to the corporation for a derivative action for insider trading. Although, this might be dictum since the court dismissed the case on the grounds that the plaintiff did not show that the defendants traded on the basis of material nonpublic information.

However, in *Arlia v. Blankenship*,²¹⁶ the federal court for the Southern District of West Virginia, while acknowledging the *Freeman* line of precedents, without clear, on point state precedent was not willing to find that West Virginia courts would reject *Brophy* or that a *Brophy* claim must be removed to federal court under SLUSA. Even some federal courts prior to *Kahn* applying New York law questioned, on *Freeman* grounds, whether they should consider the continued validity of *Diamond*.²¹⁷

C. Temporary Doubts About the Continued Relevance of Brophy in Delaware

The Delaware chancery was not immune from doubt about the propriety of disgorgement for insider trading. Notably, in *In re Oracle Corp. Derivative Litig.*,²¹⁸ then Vice Chancellor Strine seemed open to the argument that *Brophy* should no longer be part of Delaware common law given subsequent developments in federal securities laws. However, because he found that the plaintiff failed to prove two elements of a *Brophy* action — namely that the defendants sold securities while in possession of material non-public information and did so with scienter — he

[D]ecline[d] their invitation . . . to conclude that *Brophy* is an outdated precedent that ought to be abandoned. The important policy question the defendants have raised can be left to a later case in which the answer to

214. No. C 86-20719, 1988 U.S. Dist. LEXIS 16765, at *14–15 (N.D. Cal. Sept. 20, 1988).

215. 431 F. Supp. 2d 1114, 1132–33 (W.D. Wash. 2006).

216. 234 F. Supp. 2d 606, 611 (S.D.W. Va. 2002).

217. See, e.g., *In re Symbol Tech. Sec. Litig.*, 762 F. Supp. 510, 517–18 (E.D.N.Y. 1991) (noting how in the time since *Diamond* was decided, the Rule 10b-5 class action has become the sort of federal remedy the court in *Freeman* envisioned); *Frankel v. Slotkin*, 795 F. Supp. 76, 81 (E.D.N.Y. 1992) (“Under these circumstances a common law claim to recover profits from insiders presents an actual, and needless, risk of double liability.”).

218. See 867 A.2d 904, 930 (Del. Ch. 2004) (hesitating to strengthen *Brophy*).

that question is outcome-determinative. Because the defendants prevail under a reasoned application of *Brophy*, it is unnecessary to make a broad ruling with sweeping effect.²¹⁹

Doubts about *Brophy* started changing in 2010 with *Pfeiffer v. Toll*.²²⁰ Vice Chancellor Travis Laster refused to grant a Special Litigation Committee's ("SLC") motion to dismiss a *Brophy* derivative claim against a corporation's directors for allegedly selling their stock on the basis of material non-public information concerning the company's business.²²¹ He expressly rejected the defendants' argument that *Brophy* is "a persistent anachronism from a time before the current federal insider trading regime, when this Court felt compelled to address insider trading because of the absence of any other remedy."²²² Rather, *Brophy* is firmly located in Delaware duty-of-loyalty jurisprudence. That is, *Pfeiffer* is a rebuke to the *Freeman* misunderstanding that *Brophy* is a deviation from the common law. Rather, it *is* Delaware's common law.²²³

Moreover, far from being redundant to, or in conflict with, federal law, it is not merely complementary, but necessary, to federal law. That is, the classic theory of insider trading requires that a trader violate a fiduciary or similar duty of trust and confidence to the issuer of the securities, and by extension its stockholders.²²⁴ As Bainbridge persuasively argues, although the federal courts have been unfortunately unclear about the source of this duty (at least in the case of misappropriation), the better view is that they should incorporate state common law.²²⁵ This would seem to be the case for the classic theory which is based on duties that insiders owe to issuers and their shareholders. Consequently, for Delaware to overturn *Brophy*, it would indirectly destroy the federal cause of action as well in the case of classic insider trading of the securities of Delaware corporations. Chancellor Laster

219. *Id.* at 929.

220. 989 A.2d 683 (Del. Ch. 2010).

221. *Id.* at 685.

222. *Id.* at 695.

223. Or, Laster states:

If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.

Id.

224. See *supra* text at notes 118–19.

225. See *supra* note 129.

states:

[T]he federal approach to insider trading . . . depends on the existence of a fiduciary relationship or similar relationship of trust and confidence. Federal law does not give rise to or establish the fiduciary duties of directors or officers. Those matters are governed by state law. Thus the federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties. If Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the cornerstone of the federal system would be removed.²²⁶

He continues:

I cannot foresee what might happen were a Delaware court to hold, as the defendants ask, that insiders do not breach any fiduciary duty to the corporation they owe by engaging in insider trading. Such a holding would take [classic] insider trading outside the fiduciary relationship of trust and confidence that has formed the basis for the federal approach since *Chiarella*. Arguably the private right of action for [classic] insider trading under Rule 10b-5, which depends on a breach of fiduciary duty, would no longer function.²²⁷

Nevertheless, he did not order disgorgement but declared that the plaintiff's recovery would be limited to actual damages to the corporate plaintiff²²⁸ — a position that seems at odds with his analysis that he is following *Brophy*.

D. Revival

In *Kahn*²²⁹ the Delaware Supreme Court, in reaction against Vice Chancellor Laster's confusion about damages in *Pfeiffer*, confirmed that the traditional understanding of *Brophy* is alive and well. In *Kahn*, Primedia Inc, the nominal plaintiff, sought the disgorgement of profits made by its controlling shareholder when it purchased preferred stock allegedly on the basis of material nonpublic information it obtained from the plaintiff corporation.²³⁰ Primedia's board members (who were also defendants) appointed an SLC which decided the action should be dismissed.²³¹ In the lower court's opinion, then Chancellor (later Chief Justice) Strine granted the SLC's motion applying the two part test of *Zapata v. Maldonado*.²³² The Delaware Supreme Court took the plaintiff's appeal because of the

226. *Pfeiffer*, 989 A.2d at 704.

227. *Id.* at 706.

228. *Id.* at 699–700.

229. 23 A.3d 831 (Del. 2011).

230. *Id.* at 835.

231. *Id.* at 834–35.

232. *Id.* at 835; *see also Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del.1981).

significance of the issue despite its potential mootness,²³³ precisely to clarify the continued viability of *Brophy*.²³⁴

The appeal concerned the application of the second prong of *Zapata*.²³⁵ That is, if a chancellor finds that an SLC met its burden of the first prong — i.e., that the SLC made a fair and thorough investigation in deciding to dismiss the case — the chancellor must then apply his own business judgment to the decision to dismiss.²³⁶ Vice Chancellor Strine’s decision was reversed and remanded because he followed Vice Chancellor Laster’s incorrect holding in *Pfeiffer* that the plaintiff must show harm to the corporate plaintiff to maintain a *Brophy* action.²³⁷

The Delaware Supreme Court emphasized that the *Brophy* court correctly applied the common law of restitution, citing the First Restatement of Restitution.²³⁸

[F]or the proposition that a fiduciary cannot use confidential corporate information for his own benefit. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit.²³⁹

Although it praised Vice Chancellor Laster’s analysis as “thoughtful,”²⁴⁰ the Delaware Supreme Court rejected his holding that a *Brophy* claim requires harm to the corporation in most cases.²⁴¹ The Vice Chancellor was

233. A derivative action can only be brought by a person who is stockholder of the nominal plaintiff corporation throughout the course of the litigation. Because of a pending cash-out merger, the individual bringing the derivative action would soon cease to be a stockholder and would no longer have standing.

234. It stated:

This Court may, however, invoke the exception to mootness doctrine for matters of public importance that are capable of repetition yet may evade review. We find that this case falls within the public importance exception because other litigants have raised the *Brophy* issue in actions now pending before the Court of Chancery. For that reason, we will resolve the legal issue concerning available disgorgement remedies for a *Brophy* claim.

Kahn, 23 A.3d at 836 (citations omitted).

235. *Id.*

236. *Id.* at 836–37.

237. *See id.* at 837 (holding that *Pfeiffer* cannot be considered Delaware law).

238. The R3RUE was not published until later in the year in which *Khan* was decided. Oddly, there is no Second Restatement of Restitution. *See infra* note 344.

239. *Kahn*, 23 A.3d at 837–38 (citing RESTATEMENT OF THE LAW OF RESTITUTION § 200, cmt. a (AM. L. INST. 1937)).

240. *Id.* at 840.

241. That is

To that end, the Vice Chancellor concluded that in the context of a *Brophy* claim, disgorgement is “theoretically available” in two circumstances: (1) “when a fiduciary engages directly in actual fraud and benefits from trading

incorrect because a *Brophy* action is restitutionary. As such, it is not designed to remedy harm to the corporate plaintiff but to prevent unjust enrichment of a disloyal fiduciary:

We decline to adopt *Pfeiffer*'s interpretation that would limit the disgorgement remedy to a usurpation of corporate opportunity or cases where the insider used confidential corporate information to compete directly with the corporation. *Brophy* was not premised on either of those rationales. Rather, *Brophy* focused on the public policy of preventing unjust enrichment based on the misuse of confidential corporate information.²⁴²

A Delaware corporation has a right to recover profits earned by officers, directors and controlling stockholders who trade on its securities on the basis of inside information. Since this right sounds in unjust enrichment, it is not necessary for the plaintiff to show it was harmed.²⁴³ Note, the *Kahn* court never expressly refers to information as property, but its statement that trading by the insider was a "misuse of confidential corporate information"²⁴⁴ implies that it is.

The problems of derivative actions are well known. Since the corporation whose securities are being traded is the nominal plaintiff, recovery is in most cases paid to the corporation rather than the stockholder bringing the case in the corporation's name. Moreover, the requirement that the stockholder make demand on the corporate board to sue its fellow directors or officers, or show that demand would have been futile (the subject of much post-*Kahn*

on the basis of the fraudulent information;" and (2) "if the insider used confidential corporate information to compete directly with the corporation." *Brophy*, in the Vice Chancellor's view, was an example of the second circumstance where disgorgement is an appropriate remedy. But, in most circumstances a corporation would only be able to recover for "actual harm causally related (in both the actual and proximate sense) to the breach of the duty of loyalty" — for example "costs and expenses for regulatory proceedings and internal investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation.

Id. at 839–40 (citations omitted).

242. *Id.* at 840 (citations omitted).

243. *Id.* The transaction leading to the *Kahn* opinion, eventually resulted in a settlement of \$39 million payable to the former stockholders of Primedia, but not directly on the *Brophy* claim. *KKR Gets Approval to Pay \$39M to End Class Action Over Primedia-TPG Merger*, BLOOMBERG L. (May 28, 2015, 12:00 AM), https://www.bloomberglaw.com/document/X5OTPDS000000?bna_news_filter=class-action&jcsearch=BNA%2520000001607239dc0fa5f0f239060f0000#jcite. Rather, the plaintiffs argued in a related class action that one of the reasons why the compensation paid to the stockholders in the cash-out merger (i.e., that should have rendered the *Kahn* opinion moot) was that the board did not consider the value of the *Brophy* claim against KKR when valuing the corporation. *In re Primedia, Inc. S'holder Litig.*, 67 A.3d 455, 484 (Del. Ch. 2013).

244. *Kahn*, 23 A.3d at 840.

litigation), can be prohibitive.²⁴⁵ Finally, the ability of the board of directors' of the formal plaintiff corporation to appoint an SLC that is likely to decide to dismiss an action against its fellow directors — the issue in *Kahn* — may make *Brophy* litigation unattractive. Moreover, as discussed, with a few notable exceptions, the profits gained, or losses avoided in typical insider

245. Nevertheless, numerous *Brophy* suits have been attempted in the context of classic insider trading since *Kahn*. See, e.g., *Sandys v. Pincus*, No. 9512, 2016 Del. Ch. LEXIS 43 (Del. Ch. Feb. 29, 2016) (finding demand not futile in a *Brophy* action because there are directors who are not defendants); *Silverberg v. Gold*, No. 7646, 2013 Del. Ch. LEXIS 312 (Del. Ch. Dec. 31, 2013) (finding demand would be futile); *Tilden v. Cunningham*, No. 2017-0837, 2018 Del. Ch. LEXIS 510 (Del. Ch. Oct. 26, 2018) (stating failure to plead demand futility with particularity); *In re Facebook, Inc.*, 922 F. Supp. 2d 445, 466, 469, 474–75 (S.D.N.Y. 2013) (finding failure to plead demand futility with particularity, derivative plaintiffs did not have standing to bring derivative action because they did not own stock on the day of the alleged wrong; claims not ripe); *Davis v. Gutierrez*, No. 17-cv-147, 2018 U.S. Dist. LEXIS 50135, at *47–48 (D.N.H. Mar. 27, 2018) (concluding the *Brophy* claim was adequately pleaded); *Heartland Payment Sys., LLC v. Carr*, No. 3:18-cv-9764, 2020 U.S. Dist. LEXIS 15302 (D.N.J. Jan. 27, 2020) (concluding the claim that tippee aided and abetted a *Brophy* claim was properly pleaded; disgorgement of profits to SEC does not preclude *Brophy* action); *Scrushy v. Tucker*, 70 So. 3d 289, 307 (Ala. 2011) (affirming that *Brophy* is still a valid claim under Delaware law); *Dollens v. Zions*, No. 01 C 2826, 2002 U.S. Dist. LEXIS 13511 (N.D. Ill. July 22, 2002) (finding demand would be futile); *In re Fossil, Inc.*, 713 F. Supp. 2d 644, 656 (N.D. Tex. 2010) (*Brophy* claim asserted with particularity); *In re Symbol Tech. Sec. Litig.*, 762 F. Supp. 510, 517 (E.D.N.Y. 1991) (applying Delaware law, the plaintiff did not adequately plead demand futility, but is permitted to replead; the fact that there might be a private or SEC action under Rule 10b-5 does not preclude *Brophy* claim, but there should not be double recovery; damages awarded to the extent actual injury to the issuer is not proven, will be held in trust pending the resolution of federal proceedings); *In re Taser Int'l S'holder Derivative Litig.*, No. CV-05-123, 2006 U.S. Dist. LEXIS 11554, at *48 (D. Ariz. Mar. 17, 2006) (*Brophy* claim sufficiently pleaded); *Rosky v. Farha*, No. 07-cv-1952-T-26MAP, 2009 U.S. Dist. LEXIS 107531, at *27 (M.D. Fla. Mar. 30, 2009) (*Brophy* claim sufficiently pleaded); *Spiegel v. Buntrock*, No. 8936, 1988 Del. Ch. LEXIS 149, at *12 (Del. Ch. Nov. 17, 1988) (demand not excused); *In re Wells Fargo & Co. Auto Ins. Derivative Litig.*, 2018 Cal. Super. LEXIS 2388, at *30 (Cal. Super. Ct., S.F. Cnty. May 8, 2018) (applying Delaware law, found that demand futility not pleaded with particularity).

In addition, a number of derivative cases have recently been brought seeking, among other things, disgorgement in connection insider trading, (although not all of the complaints cite *Brophy*. See *Rhodes v. Milton*, No. 2022-0023 (Del. Ch. Jan. 7, 2022); *Reiter v. Fairbank*, No. 2021-1117 (Del. Ch. Dec. 29, 2021); Compl. at 96, *Atchison v. Hernandez*, Docket No. 2020-0655-JTL (Del. Ch. filed Aug. 12, 2020), <https://www.bloomberglaw.com/document/X6EK9NA60058IIRLFCSU7LV2UU9?fmt=pdf>; *Cambridge Ret. Sys. v. McBride*, Docket No. 2019-0658-AGB (Del. Ch. filed Aug. 22, 2019), <https://www.bloomberglaw.com/product/blaw/document/X4NBD3ULB5K9UR9TVNGATG2DB9S?fmt=pdf>; Compl. at 51, *Equity-League Pension Tr. Fund v. Great Hill Partners, L.P.*, Docket No. 2020-0992-SG (Del. Ch. filed Nov. 23, 2020), <https://www.bloomberglaw.com/document/X71T4JR3TKA85BP517UHB7VDJ20?fmt=pdf>).

trading tend to be modest and may not justify the expense of complex litigation.²⁴⁶

Nevertheless, expanding *Brophy* to its logical extreme under the U.S. Supreme Court's misappropriation theory of information as property, could breathe life into it precisely because the defendants would not be officers and directors of the source. For example, in *Carpenter*, the *Wall Street Journal* might well have been willing to sue Winans and seek disgorgement because of the damage he and his co-conspirators might have done to its journalistic reputation.²⁴⁷ As such, it is more likely that state law misappropriation cases might be more attractive, in that the plaintiff — the source of the information — may be more inclined to want to sue a disloyal confidant even though the amount of recovery might be relatively small.

IV. RESTITUTION AND PROPERTY

Let us now consider the law of restitution, generally, in connection with the interference with property rights generally, before turning to the R3RUE's treatment, specifically. It should become clear that restitution is in many cases just a definition of the positive law of possessory interests in an object.

A. Common Law of Property

I reject the familiar "bundle of sticks" metaphor of property because it is analytically useful to group property rights into the three, traditional categories of possession, use, and alienation very broadly defined.²⁴⁸ I also reject the proposition, associated most closely with Wesley Newcomb Hohfeld, that property does not necessarily require an object.²⁴⁹ Of course, being a legal category, property rights are always relationships between and among legal subjects. However, in the case of property, these relationships always revolve around the control and use of an object. For this purpose, the term "object" is not necessarily a tangible thing, but can be anything external to the subjects claiming a property right. The primary property right — i.e., the one necessary for all other rights — is "possession." I am using this term not as the *fact* of physical possession of a tangible thing, but the exclusive

246. See *infra* text at notes 275–78, 468–69 for the facts of this case.

247. See *Carpenter v. United States*, 484 U.S. 19, 25 (1987) (describing how the Journal was "defrauded" by Winan's actions and that the intangible nature of its confidential business information constituted it as "property" protectable by the mail and wire fraud statutes).

248. The second chapter in my first book is an extended critique of this metaphor. See JEANNE LORRAINE SCHROEDER, *THE VESTAL AND THE FASCES: HEGEL, LACAN, PROPERTY AND THE FEMININE* 107–225 (1998).

249. WESLEY NEWCOMB HOHFELD, *FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN LEGAL REASONING* 85 (W. Cook, ed. 1919).

right to exclude others, which means to control access to and use of an object.²⁵⁰ This is how the Supreme Court uses the term with respect to possession of information in its misappropriation cases, *Carpenter*²⁵¹ and *O'Hagan*.²⁵²

Eminent scholars such as Richard Posner have suggested that rights in information can at best only be “quasi property” because more than one person can “possess” the same information — in the sense of having access to it — at the same time.²⁵³ But, this conflates the *empirical fact* of use with the *legal right* of possession. I am not arguing that we, as a society, *must* recognize property rights in material, nonpublic information — in fact, I am skeptical of the wisdom of the Supreme Court’s decision to do so in *Carpenter*, which in effect *criminalized* certain breaches of employment agreements that might be better addressed as matters of private law.²⁵⁴

However, I am arguing that *if* we were to decide to do so, it is coherent to analyze information as *true* property. Moreover, certain legal results flow from that decision. For example, as the Supreme Court ruled in *Carpenter* and *O'Hagan*,²⁵⁵ under some circumstances if a confidant uses nonpublic information for her own purposes without the permission of the source of the information, she is interfering with the source’s possessory rights to control its use. That is, she is misappropriating it and the source should have whatever legal and equitable property remedies that an owner would have with respect to any other object of property.

250. This is how Hegel defines possession in his *Philosophy of Right*. G.W.F. HEGEL, ELEMENTS OF THE PHILOSOPHY OF RIGHT 84–88 (W. Wood ed. & H. B. Nisbet trans. 1991); see also SCHROEDER, *supra* note 248, at 42; Jeanne L. Schroeder, *Unnatural Rights: Hegel and Intellectual Property*, 60 U. MIA. L. REV. 453, 469–70 (2006) [hereinafter, Schroeder, *Unnatural Rights*].

Unfortunately, although the U.C.C. ostensibly claims not to define the term “possession” despite the fact that it uses it over one hundred times, in context it is clear that it means not the *right* of possession but the *fact* of *physical* custody of *tangible* things. See Jeanne L. Schroeder, *Bitcoin and the Uniform Commercial Code*, 24 U. MIA. BUS. L. REV. 1, 23–27 (2016) [hereinafter Schroeder, *Bitcoin*].

251. 484 U.S. at 25–26 (“Confidential business information has long been recognized as property.”).

252. 521 U.S. 642, 681–82 (1997) (Thomas, J., concurring in part) (“The majority correctly notes that confidential information ‘qualifies as property to which the company has a right of exclusive use.’”).

253. David D. Friedman et al., *Some Economics of Trade Secret Law*, 5 J. ECON. PERSP. 61, 61–62 (1991); see also, Schroeder, *Unnatural Rights*, *supra* note 250, at 453 n.2.

254. Similarly, although Epstein agrees with the analysis that the source of the information might have a state common law cause of action against the defendants in *Carpenter*, he believes that it was probably not appropriate to bring a federal criminal action. See Epstein, *supra* note 73, at 1501.

255. See *infra* text at note 283; *supra* notes 252, 406.

i. Theft

To illustrate, let us look to the law of theft of goods. The advantage of starting with an analysis of tangible property is that it is more intuitive than intangibles.²⁵⁶ The disadvantage is that this intuitive attractiveness can lead to the wrong-headed Posnerian assumption that true property involves tangible rights and that rights with respect to other objects — such as intellectual property — are merely quasi-property and that rights of possession relate to the physical custody of tangible things. I agree with Hegel that intangibles are, in fact, the characteristic object of property and that tangibles are merely a special example.²⁵⁷ Nonetheless, I take the plunge and start with goods since the rules are generally familiar, even to lay persons.

Assume that A owns a valuable object, a gold brick, that she keeps locked in a safe in her home. B breaks in and steals the gold brick. B obtains neither legal nor equitable title in the gold brick.²⁵⁸ If A discovers the gold brick is in B's possession, she has the right to get her gold brick back.²⁵⁹ If she does so, she is neither compensating herself nor penalizing B. As is so often the case, however, self-help may not be practicable, and she will have to seek redress in the courts. If B is still in possession of the gold brick, A can choose her remedies. On the one hand, she can sue under the tort of conversion. This is, in effect, a forced sale — the court will declare that when B took the owner's property, he bought it on that day and must pay the owner the fair market value. If, and only if, A chooses conversion will title in the gold brick pass to B.²⁶⁰

256. As Hegel argued in his theory of property in his *Philosophy of Right*, on which I base my property jurisprudence. I set forth this argument in detail in Schroeder, *Unnatural Rights*, *supra* note 250.

257. HEGEL, *supra* note 250, at 74–75; Schroeder, *Unnatural Rights*, *supra* note 250, at 464–65.

258. Laycock bemoans the fact that, despite the R3RUE's laudable decision not to try to pigeonhole restitution into a legal/equitable dichotomy, when it speaks of restitution of property it continues to use the traditional language of legal and equitable interests. Laycock, *supra* note 6, at 931–32. Nevertheless, I agree with the drafters of the R3RUE that this distinction is analytically useful when discussing the relative rights and obligations of the original owner of an object, a wrongful transferee, and third parties. It is a distinction regularly made in debtor-creditor law. Moreover, it maps onto the U.C.C.'s concept of voidable title — i.e., when a transferee has legal, but not equitable, title.

259. JOHN O. HONNOLD ET AL., *THE LAW OF SALES AND SECURED FINANCING: CASES PROBLEMS AND MATERIALS* 40–42 (7th ed. 2002). Notoriously, the U.C.C. does not set forth this common law rule. *Id.* The issue of when and under what circumstances the owner can use self-help is beyond the scope of this Article.

260. *See, e.g.,* *Pierpoint v. Hoyt*, 182 N.E.2d 235, 236 (N.Y. 1932). The tort of conversion is defined in the Restatement (2d) Torts Section 222A:

(1) Conversion is an intentional exercise of dominion or control over a

Alternately, she can bring an action in replevin in which the court will order B to give A back her gold brick — i.e., restitution.²⁶¹ This is not *compensating* A for the loss. Nor is it *penalizing* B for theft. From a property perspective, B received nothing in the theft, so we are not taking anything from him.

What if B sells the gold brick before A can bring her replevy action? Because A owns the gold brick, the common law imposes a constructive trust on any proceeds B may receive on the sale — i.e., B in effect sold the gold brick for A's account.²⁶² However, for a constructive trust to be imposed, the plaintiff must be able to trace the proceeds from the sale.²⁶³ The advantage of the remedies of restitution and constructive trust is that they are *in rem*. This means that if the thief were to become insolvent the stolen goods or their traceable proceeds would not be property of his estate and the owner would not be a general creditor of the thief so that she would be entitled to receive her property prior to distributions to general creditors.²⁶⁴ If the proceeds cannot be traced, however, then the owner has an *in personam* claim for an amount equal to the thief's profits.²⁶⁵ This is what securities law calls disgorgement. Of course, the owner would be a general creditor in the thief's bankruptcy, and this means she would be unlikely to recover her entire claim.

chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel.

(2) In determining the seriousness of the interference and the justice of requiring the actor to pay the full value, the following factors are important:

- (a) the extent and duration of the actor's exercise of dominion or control;
- (b) the actor's intent to assert a right in fact inconsistent with the other's right of control;
- (c) the actor's good faith;
- (d) the extent and duration of the resulting interference with the other's right of control;
- (e) the harm done to the chattel;
- (f) the inconvenience and expense caused to the other.

RESTATEMENT (SECOND) OF TORTS § 222A (AM. L. INST. 1965).

261. Note, this isn't technically rescission because, in theft, no title passes to the thief so there is no transfer to rescind.

262. The R3RUE defines proceeds as "assets received as the direct product of an asset for which the defendant is liable in restitution to the claimant." R3RUE § 53(2).

263. See *id.* § 58, cmt. i.

264. See *id.* § 13, cmt. h.

265. See *id.* § 1, cmt. a.

Suppose that B cannot be found or is insolvent so that neither restitution nor disgorgement from B is possible as an *empirical* matter, but A finds that B transferred the gold brick to C. The basic rule of property is derivation — that is, a transferor can only obtain the title she has so that a transferee's title derives from that of his transferor — unless an exception applies.²⁶⁶ In the case of the *stolen* gold brick, since B had no title in the gold brick (sometimes referred to as “void title”), C only obtains void title in the gold brick. Under American law, there is no exception to this rule with respect to stolen *goods* (although, there are some exceptions for other categories of property).²⁶⁷ This means that A can replevy the gold brick from C no matter how innocent C is. When A asks the court to make C give the gold brick back, she is neither asking to be compensated for a loss — she is reversing the loss — nor is she penalizing C since, *vis a vis* A, C had no interest in the gold brick. Of course, if C had paid B for the gold brick, then C suffered a loss. But it is up to C to find the elusive and/or judgment proof B to (probably unsuccessfully) seek recourse for breach of implied warranty of good title.²⁶⁸

ii. *Fraud*

For insider trading to violate *federal* securities law it must involve fraud, not theft. Indeed, although the term “misappropriation theory” might misleadingly imply that it covers outright theft of information, it is in fact used to explain when the use of information in violation of a fiduciary or similar duty constitutes fraud on the source. Once again, let us first consider the more intuitive law of goods.

B fraudulently induces A to sell him the gold brick. In this case, B obtains *legal*, but not *equitable* title, in the gold brick — what the UCC refers to as voidable title.²⁶⁹ To simplify, B's title in the goods is good against the world except for A, but A needs to apply to a court to declare this the case. If she does so, A can choose to either sue under the tort of conversion or seek to replevy the gold brick — i.e., obtain restitution.²⁷⁰ As is the case with stolen goods, if B no longer owns the gold brick, A can seek to impose a constructive trust on traceable proceeds.²⁷¹ If the proceeds cannot be traced,

266. With respect to goods, this is located in U.C.C. § 2-403(1) (first sentence). With respect to information, this would be governed by common law. Sometimes this is known by the Latin “*nemo potest dare quod non habet*” (i.e., no one can give what he does not have). VIRGO, *supra* note 33, at 656.

267. HONNOLD ET AL., *supra* note 259, at 40–42.

268. See U.C.C. § 2-213 (AM. L. INST. & UNIF. L. COMM'N 1951).

269. U.C.C. § 2-403(1) (second and third sentences). The U.C.C. leaves to extra-code law the determination of when a transferee's title might be voidable, although it lists four examples (e.g., paying for a good with a check that is subsequently dishonored).

270. HONNOLD ET AL., *supra* note 259, at 40–42.

271. R3RUE § 55.

A can choose between bringing an action for equitable accounting (i.e., disgorgement of an amount equal to the fraudster's profits) or suing for conversion.

The major difference between theft and fraud (void title versus voidable title) involves A's right against third party transferees. Once again, the background rule is derivation — if B has title voidable *vis a vis* A, the default rule is that C's title in the gold brick is also voidable by A. In the case of voidable title, however, there are exceptions to protect innocent parties. With respect to goods, if C can prove he is a good faith purchaser for value he will take free of A's property claim.²⁷² Analogous rules apply to other types of property. For example, a holder in due course takes free of adverse claims by previous owners of negotiable instruments.²⁷³ It is important to note that it is the transferee who has the burden to show that he is entitled to keep the misappropriated property, not the original owner. This will become significant when we reconsider the *Dirks* rule for tippees under the misappropriation theory.²⁷⁴

Now that we have considered the classic rule of property with respect to goods obtained by fraud, we can move on to the misappropriation theory of insider trading.

B. The Supreme Court's Misappropriation Analysis

Let us start with the *ur-misappropriation* case, *Carpenter*.²⁷⁵ The Supreme Court accepted that, at least for the purposes of federal mail and wire fraud, material non-public information is property of the source of such information.²⁷⁶ The primary defendant was R. Foster Winans, a *Wall Street Journal* columnist who knew that the securities market predictably moved the morning his *Heard on the Street* column ran.²⁷⁷ He and his co-conspirators timed their securities trading based on his knowledge of the *Journal's* production schedule.²⁷⁸ The Second Circuit Court of Appeals found that Winans and his conspirators committed both wire and securities fraud, adopting a variation of what would become known as the

272. U.C.C. § 2-403(1) (AM. L. INST. & UNIF. L. COMM'N 1951) ("A person with a voidable title has power to transfer good title to a good faith purchaser for value.").

273. *Id.* § 3-305. In contrast to the law of goods, a holder in good faith of stolen *bearer* instruments takes free of the adverse property claims of the owner.

274. *See infra* text at notes 416–44.

275. 484 U.S. 19 (1987).

276. *Id.* at 24.

277. *Id.* at 23.

278. *Id.* at 22–24. The production schedule (not the content of the articles, which was based on market rumors and other public information) was the information owned by the *Journal*.

misappropriation theory.²⁷⁹

The Supreme Court found that this was mail and wire fraud but split 4-4 on whether it was also securities fraud, leaving the Second Circuit's misappropriation holding on securities fraud in effect for the defendants without approving it.²⁸⁰ Mail and wire fraud are defined as "scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises"²⁸¹ involving the jurisdictional hook of the use of the mail or wires. The Supreme Court found that material nonpublic information – in this case the production schedule — was property of the *Journal*.²⁸²

Winan's use of the information for his purposes deprived the *Journal* of its possession of such information understood as its exclusive right to control its use.²⁸³ It is akin to embezzlement, even though there are no monetary damages.²⁸⁴ I would note here that Justice White cites with approval the holding of *Diamond*:

It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.²⁸⁵

Here, unfortunately, the reasoning of the case becomes torturous because the Federal mail and wire fraud laws do not prohibit the *theft*, but only the *fraudulent acquisition*, of property.²⁸⁶ Nevertheless, the Supreme Court found that Winans defrauded the *Journal* because its company policy, as set forth in the employee manual, made it clear that employees could not use company information.²⁸⁷ It was also clear that Winans knew of the policy since he had twice reported leaks by others.²⁸⁸ His deceit was that "he played the role of a loyal employee."²⁸⁹

279. *Id.* at 23–24.

280. *Id.* at 24.

281. 18 U.S.C. §§ 1341, 1343.

282. *Carpenter*, 484 U.S. at 25–26.

283. *Id.* at 26–27.

284. *See id.* at 26.

285. *Id.* at 27–28 (quoting *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969)) (citing RESTATEMENT (SECOND) OF AGENCY §§ 388, cmt. c, 396(c) (AM. L. INST. 1958)).

286. *Id.* at 27 (noting that the mail fraud statutes "reach any scheme to deprive another of money or property by means of false or fraudulent pretenses, presentations, or promises").

287. *Id.* at 27–28.

288. *Id.* at 28.

289. *Id.* at 28. Because electronic communication and the mails were necessary to deliver the newspaper supplying the jurisdictional hook of the statutes. *Id.*

As I discuss below,²⁹⁰ one of the oddities of the misappropriation theory is that, because the *Journal* owned the material nonpublic information at issue, it could trade on the information without committing securities fraud. Moreover, there is no private right of action for mail or wire fraud.²⁹¹ And, as discussed,²⁹² under the *Blue Chip Stamps* rule, the *Journal* did not have standing to sue Winans for federal securities fraud because it did not itself trade securities. However, by his citation of *Diamond*, Justice White assumed that the *Journal* would have a *state* common law cause of action for disgorgement consistent with my thesis that the *Brophy/Diamond* principal should not be limited to classic insider trading.²⁹³

In the years following *Carpenter*, the Circuit Courts split as to whether or under what circumstances misappropriation might also constitute securities fraud, leading to the Supreme Court's granting *certiorari* to *O'Hagan*, in which the Eighth Circuit Court of Appeals rejected the misappropriation theory of insider trading.²⁹⁴ The Supreme Court reconfirmed its holding in *Carpenter*, that material nonpublic information could be property of the source and that the unauthorized use of that property could in some circumstances be viewed as a misappropriation of property.²⁹⁵ In this case the material nonpublic information was Grand Metropolitan PLC's ("GrandMet") intent to commence a hostile tender offer for Pillsbury Company.²⁹⁶ The defendant, James O'Hagan, learned of this in his capacity as a partner in a law firm that represented GrandMet.²⁹⁷ He used this information to acquire call options on Pillsbury stock in violation of his fiduciary duties to his former client and/or his law firm.²⁹⁸

There is no question that O'Hagan was a bad person. Although "a pillar

290. See *infra* text at notes 468–72.

291. Violation of the mail and wire fraud acts can, however, be predicate acts for liability to private plaintiffs under the Racketeer Influenced and Corrupt Organizations ("RICO") Act. 18 U.S.C. §1961(1).

292. See *supra* text at note 130.

293. See *Carpenter*, 484 U.S. at 27–28 (citing *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969)).

294. Notoriously, when the Supreme Court initially denied *certiorari* on *Carpenter*, Justice Powell, the author of the majority opinions in *Chiarella* and *Dirks*, drafted a dissent in which he argued that the misappropriation theory was inconsistent with the holdings of those earlier cases. By the time the Supreme Court reversed itself and heard *Carpenter*, Justice Powell had retired. If he had been on the Court, presumably he would have broken the split and the misappropriation theory would not have become law. CHOI & PRITCHARD, *supra* note 140, at 450–51.

295. See *United States v. O'Hagan*, 521 U.S. 642, 654 (1997) (citing *Carpenter*, 484 U.S. at 25–27).

296. *Id.* at 647.

297. *Id.*

298. *Id.* at 648.

of the Minneapolis business establishment [and] a star partner at Minnesota's largest and most prestigious law firm"²⁹⁹ he betrayed the trust of his client and his partners. Indeed, the reason why he engaged in the trade was that he previously embezzled cash from a number of his law firm's clients, including the Mayo Clinic (of which he was a trustee), and apparently wanted to surreptitiously replace the funds.³⁰⁰ The majority, no doubt, harbored a strong intuition that he should be punished. However, this trade clearly violated the prophylactic provisions of Rule 14e-3 governing tender offers, which was adopted in response to *Chiarella*.³⁰¹ The question was whether this trading also qualified as *actual* fraud in violation of Sec. 10(b) and Rule 10b-5 so that additional time could be added to O'Hagan's sentencing.

The *O'Hagan* holding raises several problems. As I discuss below,³⁰² although the source of the duty in classic insider trading derives from corporate law principles, courts have struggled with the question as to what constitutes the "fiduciary or similar duty of trust and confidence" necessary to make a misappropriation based on silence fraudulent. A second problematic aspect of *O'Hagan* is how does the fraud on the source, who does not necessarily purchase and sell securities, become fraud "in connection with the purchase and sale of securities" under section 10(b). After all, even DOJ prosecutors agreed that it would not be *securities* fraud if a disloyal fiduciary engaged in embezzlement of money (as O'Hagan did with respect to other clients) and used the funds to purchase or sell securities.³⁰³

Justice Ginsberg declared that the misappropriated information must be "of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities."³⁰⁴ Justice Thomas in his dissent objected, on the grounds that even though he agreed that *O'Hagan* did misappropriate property, Justice Ginsberg's standard is hardly a model

299. Eben Shapiro, *A Leading Lawyer's Fall is a Jolt to Minneapolis*, N.Y. TIMES (Jan. 20, 1990), <https://www.nytimes.com/1990/01/20/business/a-leading-lawyer-s-fall-is-a-jolt-to-minneapolis.html>.

300. *Id.*

301. This prophylactic rule prohibits trading, after a person has taken "substantial steps" towards the commencement of a tender offer in the securities of a person, in possession of material information that he knew, or had reason to know was nonpublic and came directly or indirectly from the bidder, the target, or their insiders. 17 C.F.R. §240.14e-3(a) (2021). In *O'Hagan* the Supreme Court confirmed that because the language of Exchange Act Section 14(e) is broader than that of Section 10(b), it is not limited to actual fraud, so that the broad prophylactic provisions of Rule 14e-3 are permitted. *O'Hagan*, 521 U.S. at 667–70.

302. *See infra* text at notes 377–412.

303. *See O'Hagan*, 521 U.S. at 656–57.

304. *Id.* at 656.

of clarity.³⁰⁵ I have discussed the “in connection with” element elsewhere and shall not expand on it in this Article.³⁰⁶

The third objection is more on point to my Article. Property law is usually thought to be the bailiwick of state common law. *O'Hagan*, following *Carpenter*, holds that the use of confidential information constitutes the misappropriation of property “akin to embezzlement.”³⁰⁷ In fact, although state law does protect rights in nonpublic information, it is not clear whether even information that is a trade secret should be analyzed in terms of property, contract, tort, or as a *sui generis* right.³⁰⁸ Nevertheless, according to the R3RUE, state courts have imposed restitution in the case of misappropriated information even in cases where it does not constitute trade secrets, suggesting that they might be implicitly reflecting a property or quasi-property analysis of information.

Consequently, as mentioned,³⁰⁹ Bainbridge has suggested that insider trading law would be simpler and clearer if it was conceptualized as the de facto federal law of property in information. Unfortunately, this would be inconsistent with the Supreme Court's holding that federal statute by its terms is limited to fraud, which is why I argue for a state common law analysis.³¹⁰

C. The Logic of Misappropriation

As I discuss in the next section,³¹¹ a property-based theory of disgorgement of insider trading profits is consistent with the R3RUE. If information is property, then the source of the information should theoretically have a right of restitution of possession of the information against the fraudster to return the property. Of course, since possession of information consists of the control of its use, once the misappropriator has

305. *Id.* at 681–84 (Thomas, J., dissenting in part).

306. Schroeder, *Taking Stock*, *supra* note 105, at 211–20. One of my conclusions is that, although I believe that Justice Ginsberg's “in connection” test is incoherent, the SEC and DOJ have not tested it to extremes, but rather have only brought misappropriation cases in a number of relatively uncontroversial fact patterns, such as trading on unannounced financial information or planned mergers or acquisitions, drug trials and approvals, and pre-publication journalism.

307. *O'Hagan*, 521 U.S. at 654.

308. Schroeder, *Envy*, *supra* note 101, at 2061 n.163.

309. *See supra* text at notes 150–51.

310. For a brief account of the academic debate as to whether the duty imposing insider trading liability should be federal or state law, see Molk, *supra* note 69, at 1741–45. Epstein, like me, argues that, although in cases such as *O'Hagan*, where there is a clear misappropriation of information through breach of a fiduciary duty, this should be a matter between the source and the misappropriator, and it is unclear why the SEC should be involved at all. Epstein, *supra* note 73, at 1499–1501.

311. *See infra* text at notes 331–59.

traded on it, it is impossible to return the source to the status quo. Consequently, the source should, instead, have a constructive trust on the proceeds received by the fraudster. If the proceeds are not traceable, then the source should instead have an *in personam* cause of action for an accounting of profits — which is known in securities law as disgorgement.³¹² Taking the Supreme Court's property theory of misappropriation seriously would also bring some logic to the Supreme Court's tortious analysis of tipper/tippee liability. I will now turn to the state law of restitution generally, and Delaware law specifically.

V. THE RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT

A. Introduction

The R3RUE, promulgated by the American Law Institute in 2011,³¹³ identifies restitution as the law of unjust enrichment. This, standing alone, says little.³¹⁴ It is like asserting that the reason why opium puts one to sleep is because it has a dormitive virtue.³¹⁵ The drafters were concerned that if they were to give a judge the power to order restitution on intuition that the defendant acted “unjustly,” the law would have no bounds — i.e., it would not be law-like.³¹⁶ This was arguably the problem of the federal courts’ pre-*Liu*’s imposition of disgorgement in securities law cases. The R3RUE insists that restitution is, in fact, not a matter of free-floating moral intuition but is

312. *O'Hagan* might be one of the rare cases where the source might have had standing to sue because GrandMet, the source, did eventually commence a successful tender offer for Pillsbury and, therefore, might have met the *Blue Chip Stamps* test.

313. Oddly enough, although there is a First Restatement of Restitution there is not, as the name Restatement (Third) might seem to imply, a Second Restatement of Restitution. Kull, the Reporter of the R3RUE, gives an account of the tumultuous and ultimately doomed attempt to draft a Second Restatement in Kull, *supra* note 19.

314. “Saying that liability in restitution is imposed to avoid unjust enrichment effectively postpones the real work of definition, leaving to a separate inquiry the question whether a particular transaction is productive of unjust enrichment or not.” R3RUE §1, cmt. b.

315. *The Imaginary Invalid* (Moliere 1673).

316. As Ernest Weinrib, a strong defender of the coherence of unjust enrichment law, properly understood, states “[f]or many years the development of unjust enrichment was impeded by the suspicion that, once recognized as a category of liability, it would direct judges away from traditional legal reasoning to the amorphous exercise of legal discretion on unspecified grounds that vary according to one’s personal sense of justice.” WEINRIB, *supra* note 25, at 186 (citations omitted). James Steven Rogers, similarly, defends unjust enrichment from the common criticism that it is particularly indeterminate when compared to other areas of law. James Steven Rogers, *Indeterminacy and the Law of Restitution*, 68 WASH & LEE L. REV. 1377, 1388 (2011); see also Laycock, *supra* note 6, at 932.

governed by identifiable legal rules.³¹⁷ Consequently, although the R3RUE continues to use the traditional nomenclature of “unjust enrichment” a more accurate terminology would be “unjustified enrichment” — i.e., gains that cannot be justified by recognized legal principles.

The R3RUE characterizes restitution as “the law of nonconsensual and nonbargained benefits in contrast to torts which is the law of nonconsensual and nonlicensed harms.”³¹⁸ Ernest Weinrib refers to unjust enrichment as “the law of non-gifts.”³¹⁹ Once again, as the drafters are aware, these formulations restate, but do not answer the issue of the content and bounds of the law. What is significant, however, is that in stark contrast to torts, harm to the plaintiff, is not an element in restitution. Restitution is, instead, based on benefit to the defendant.³²⁰ “The general principle . . . is the one underlying the ‘disgorgement’ remedies in restitution, whereby a claimant potentially recovers more than a provable loss so that the defendant may be stripped of a wrongful gain.”³²¹ Indeed, “[r]estitution [is] *an alternative to damages . . . for injury.*”³²² Consequently, the Seventh Circuit in *Freeman* incorrectly stated the common law when it guessed that Indiana would not recognize a *Brophy/Diamond* cause of action for insider trading on the grounds that the plaintiff/source of the information did not suffer out-of-pocket damages.³²³

As discussed,³²⁴ the Supreme Court has consistently insisted since the mid 1970’s that Exchange Act Sec. 10(b) and Rule 10b-5 are limited to *actual fraud* which means intentional wrongdoing by the fraudster and misappropriation of information understood as property.³²⁵ That is,

317. R3RUE § 1 cmt. c.; Laycock, *supra* note 6, at 932.

318. R3RUE § 1 cmt. d.

319. WEINRIB, *supra* note 25, at 218 (citing Abraham Drassinower, *Unrequested Benefits in the Law of Unjust Enrichment*, 48 U. TORONTO L.J. 459, 478 (1998)).

320. R3RUE § 3 cmt. b.

321. R3RUE § 3 cmt. a.

322. R3RUE § 3 cmt. b. (emphasis added).

323. See *supra* text at notes 202–06. Of course, there can be overlap between tort and restitution in that an act that injures a tort victim *may* also benefit the tortfeasor. In such a case, the victim can elect whether to sue for damages or restitution. Consequently, restitution has sometimes been referred to as waiver of tort particularly, in the United Kingdom. As Daniel Friedmann correctly suggests, this concept is “useful, if limited,” as many wrongs that give rise to restitutionary remedies are not tortious. Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504, 504–05 (1980).

324. See *supra* text at notes 52–57, 96–102.

325. There are a number or ways in which the R3RUE’s understanding of fraud/disgorgement differs from federal law that are beyond the scope of this Article. For example, in contrast to the federal law of insider trading where scienter is always an element in an action, conscious wrongdoing is usually, but *not always*, necessary for common law restitution, just as scienter is not an element of violations of property rights

misrepresentations made with scienter do not need to be material, and one can get restitution from a transferee who did not act with scienter, but only if the representations are material. As I shall discuss,³²⁶ state common law restitution, in contrast, is a cause of action for unjust enrichment predicated on violations of numerous independent grounds, including misappropriation of property, interference with intellectual property, and violation of fiduciary duty.

Indeed, as we have seen,³²⁷ one of the reasons why federal law is so complex (as Chancellor Laster alluded to in *Pfeiffer*³²⁸) is that, although it does not make violations of fiduciary duties or misappropriations of property directly unlawful (because they are not necessarily fraudulent), a fiduciary-type relationship of trust and confidence creates the duty to speak that makes silence fraudulent. That is, the existence of state law is necessary to the continued viability of the federal law of insider trading under the classic theory and, perhaps, the misappropriation theory as well. I argue the mirror image should be true as well. The existence of the federal law of *property* in material nonpublic information, fosters a state claim for a private action for restitution for insider trading.³²⁹

The R3RUE discusses restitution in many diverse contexts such as payment by mistake and breach of contract.³³⁰ I will only discuss those directly relevant to the Supreme Court's insider trading jurisprudence, namely breaches of fiduciary duty, fraud, and interferences in rights in property generally, and intellectual property specifically.

generally. That is, the "degree of culpable awareness necessary to establish a liability to disgorge profits varies with the context. [For example,] trustees and other fiduciaries may be liable for profits realized as the result of even an unintentional breach of fiduciary duty. Disgorgement in such instances serves a prophylactic function." R3RUE § 3 cmt. a.

Another significant difference from federal securities fraud concerns the relationship between materiality and scienter. Under federal law, misrepresentations and omissions must always be of a material fact. Materiality is an objective test — a *reasonable* investor would have considered the fact in making an investment decision. *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 445 (1976). Moreover, a plaintiff must also prove that the defendant acted with scienter. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Instead, under state law, the materiality depends on the defendant's state of mind.

326. See *infra* text at notes 331–75.

327. See *supra* text at notes 37–38, 52–53, 105–29.

328. See *supra* text at notes 220–27.

329. Laycock, *supra* note 6, at 922.

330. See R3RUE § 3 cmt. a.

B. Restitution and Misappropriation of Property (Generally)

One of the main advantages of looking at the state law of restitution is that it would greatly simplify and clarify the law of insider trading in many ways. The first way is that it would do away with the Supreme Court's logic that to fall within Rule 10b-5, insider trading must involve fraud *in addition* to either breaches of fiduciary type duties or interferences with property rights in information. Under state common law, however, fraud, breach of duty, and misappropriation of property are each independent harms that can justify disgorgement. In this section, I shall set forth the R3RUE's understanding of when restitution is appropriate. In the following section,³³¹ I will apply these rules to insider trading taking seriously the Supreme Court's holding that material nonpublic information is property of the source.

One of the classic situations where restitution is ordered is when one party obtains the property of another through fraud. According to R3RUE § 13 entitled *Fraud and Misrepresentation*:

(1) A transfer induced by fraud or material misrepresentation is subject to rescission and restitution. The transferee is liable in restitution as necessary to avoid unjust enrichment.

(2) A transfer induced by fraud is void if the transferor had neither knowledge or, nor reasonable opportunity to learn, the character of the resulting transfer or its essential terms. Otherwise the transferee obtains voidable title.³³²

I have already mentioned the example of voidable title in goods.³³³ The R3RUE makes clear that this can apply to intellectual property as well, even if it does not qualify as “trade secrets” within the meaning of state law.³³⁴

331. See *infra* text at notes 376–466.

332. R3RUE § 13.

333. See *supra* text at note 269–74.

334. Friedmann suggests two principles of restitution:

First . . . restitution may be justified on the general principle that a person who obtains — though not necessarily tortiously — a benefit . . . through appropriation of a property or quasi-property interest held by [another] person is unjustly enriched and should be liable to the other for any benefit attributable to the appropriation.

Friedmann, *supra* note 323, at 509. For this purpose, he believes property should be interpreted very broadly to include “ideas, information, trade secrets, and opportunity,” which he deems quasi-property “since they lack the element of exclusiveness — the right to exclude all others from enjoying it.” *Id.* As discussed (see *supra* text at notes 111–12, 250–55, 275–76, 294–95), I and the Supreme Court would consider them to be property, not quasi-property, because we disagree with Friedmann's characterization of possession and exclusivity. Friedmann confuses the *empirical fact* that more than one person can enjoy information, etc. at the same time with the *legal right* to do so.

Friedmann suggests that the Florida Supreme Court decision in *Schein v. Chasen* (see *supra* text at note 177–84) denying restitution in derivative action seeking to obtain the profits of a tippee who traded on inside information might be justified on the grounds

This is consistent with the Supreme Court's analysis in federal securities, mail and wire fraud law that implicitly creates a federal common law of property in material nonpublic information.

According to the R3RUE, a transferor must show that the transferee's misstatements must have "induced the fraud."³³⁵ This is parallel to the federal securities fraud requirement of transaction causation.³³⁶ But there are significant differences from the federal claim. In addition to transaction causation, the plaintiff in a private securities fraud cause of action must also prove loss causation. That is:

Rescission of a transfer induced by fraud or material misrepresentation requires no showing either that the transferor has suffered economic injury (the requirement in tort) or that the transferee has realized a benefit *at the transferor's expense* (the standard condition of unjust enrichment).³³⁷

Finally, the transferor can also obtain rescission from a transferee, unless she is a good faith purchaser for value. According to the R3RUE, "rescission is available against the third party who did not make the misrepresentation, rescission of a transfer induced by the fraud of a third party is not available against an immediate transferee who takes the property for value, without notice of the fraud."³³⁸ This is the reverse of the Supreme Court's *Dirks* rule for tippee liability. Under *Dirks* one can only hold a tippee liable for trading on material nonpublic information under the federal securities law if the plaintiff, the SEC, or DOJ can prove that the tippee knew, or had reason to know, that the tipper had violated her duty to her source.³³⁹

However, by the logic of the Supreme Court's analysis of nonpublic information as *property*, under the basic derivation principle of state common law (as recognized by the R3RUE), a tippee, as recipient of misappropriated property would only obtain the transferor's voidable title in the information. As such the tippee should be subject to the same limitations

that the inside information might not constitute property or quasi-property "because the tippee could not have been exploited by the corporation itself." *Id.* at 547–48. However, he also notes that the mere possibility that the corporation could have been damaged by the appropriation of the information should be sufficient to establish a right of restitution whether or not damages occurred. As discussed, the Supreme Court has determined that information is property that can be misappropriated by trading on it, and the Delaware Supreme Court has held that an insider trader is liable for restitution. Moreover, as discussed, the Florida Supreme Court did not deny restitution in the case of unlawful insider trading, it just found that plaintiff did not prove that the tippers' trading was unlawful.

335. R3RUE § 13 cmt. c.

336. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811 (2009) (discussing induced fraud).

337. R3RUE § 13 cmt. c. (emphasis added).

338. *Id.* § 13 cmt. g.

339. See *supra* text at notes 160–61.

on its use as the tipper unless the *tippee* can show that he is entitled to an exception as a good faith purchase for value.³⁴⁰ That is, in a private right of action under state common law the burden should be on the tippee to show that she is entitled to use the source's property. I will return to this.³⁴¹

One potential advantage of seeking restitution over suing for damages (in addition to the obvious one of not having to show harm), is that *if* proceeds received upon the use of property can be traced, a constructive trust can be imposed on the proceeds which should have priority over creditors of the transferee.³⁴²

As Weinrib states:

As has often been noted, the misappropriation of another's property is the paradigmatic example of an event that gives rise to gain-based damages. Because property rights give proprietors the exclusive right to deal with the thing owned, including the right to profit from such dealings, gains resulting from the misappropriation of property are necessarily subject to restitution. Gains from dealings in property are as much within the entitlement of the proprietor as the property itself.³⁴³

These basic rules of *in rem* remedies will probably have little or no *direct* application to my analysis of insider trading, however. That is because rescission actions seek to *repossess* the misappropriated property. However, when the property is information, the owner irrevocably loses its possession — defined as its exclusive control over its use and alienation — the moment the transferee (or her tippee) trades on the information. This is reflected in Justice Ginsberg's requirement in *O'Hagan* that misappropriation of non-public information is consummated as securities fraud when a trade

340. Epstein makes a similar point, arguing that under state common law principles, misappropriated information should be subject to a constructive trust in favor of the source which follows the transfer to the tippee who is not a good faith purchaser for value. Epstein, *supra* note 73, at 1505–07. In his brief discussion, however, he can be read as misstating the good faith purchaser law in that he seems to suggest that the source suing the tippee might have the burden of showing that either she is in bad faith or did not give value.

341. See *infra* text at notes 427–44.

342. The R3RUE states

Relief of this kind is most often achieved through the device of constructive trust. In particular circumstances, the appropriate remedy may be described in terms of equitable lien or subrogation. If the property itself is no longer available, the constructive trust should attach to any proceeds obtained by the transferee through the disposition of the property. Accordingly, in the case of insider trading, the source of the information should be able to recover the profits realized by the trader when she used the information obtained by fraud.

R3RUE § 13 cmt. h.

343. WEINRIB, *supra* note 25, at 125.

occurs.³⁴⁴ I am also assuming, for simplicity, that the proceeds of insider trading will rarely be traceable so that the plaintiff will not be able to get a constructive trust over them.³⁴⁵

Nevertheless, these basic rules are necessary for understanding the transferor's remedies when it is not possible to replevy the original transferred property or to place a constructive trust on traceable proceeds — i.e., the *in personam* remedy that is known in securities law as disgorgement.³⁴⁶

C. Restitution and Property in Information (Specifically)

In addition to these rules with respect to property generally, the law of restitution has specific rules with respect to interference with intellectual property. The R3RUE does not itself, however, identify what intellectual property rights are, leaving this to other law.³⁴⁷ As we have seen,³⁴⁸ Delaware, New York, and a few other states following the rule of *Brophy/Diamond* have implicitly or expressly found that material non-public information obtained from a corporation is property of that corporation and that insider trading by traditional insiders constitutes an actionable interference in the corporation's rights. In *Carpenter* and *O'Hagan*, the Supreme Court cited *Diamond* with favor for the proposition that a source has a property interest in its material nonpublic information although it is not absolutely clear whether it thought it was applying state law or formulating a federal common law of information.³⁴⁹

The R3RUE does not limit this rule to trade secrets. Moreover, the types of information that have formed the basis of many successful insider trading actions³⁵⁰ — such as the intent of a bidder to commence a tender offer

344. *United States v. O'Hagan*, 521 U.S. 642, 647 (1997).

345. Some commentators have criticized the logic and fairness of tracing to establish a property claim in proceeds of misappropriated property. See, e.g., Dale A. Oesterle, *Deficiencies of the Restitutionary Right to Trace Misappropriated Property in Equity and in UCC § 9-306*, 68 CORNELL L. REV. 172 (1983); Rogers, *supra* note 316, at 1399–1404. Rogers states that it springs from a “primitive” concept of property. Rogers, *supra* note 316, at 1402. While I, the drafters of the R3RUE, as well as Article 9 of the U.C.C. disagree with this analysis, this debate is beyond the scope of this Article, as I am assuming that tracing will rarely be available in *Brophy* cases as an empirical matter.

346. As I mentioned earlier (*see supra* note 20), the terminology of the R3RUE (and the federal caselaw) is arguably not as precise as it could be. Historically, the word rescission and restitution may have been applied to replevin and constructive trust. The R3RUE is more flexible using it to also “describe[] cases in which the claimant may be restored to the status quo ante by obtaining the *fungible equivalent* of personal property previously transferred to the other party.” R3RUE § 54 cmt. f.

347. *Id.* § 42 cmt. 1.

348. See *supra* text at notes 166–75, 190–92, 216–17.

349. *Carpenter v. United States*, 484 U.S. 19, 27–28 (1987).

350. See Schroeder, *Taking Stock*, *supra* note 105, at 211–20 for a discussion of the

(*O'Hagan*),³⁵¹ a valuable mineral strike (*Texas Gulf Sulphur*),³⁵² unpublished financial results (*United States v. Newman*),³⁵³ and unannounced information concerning pharmaceuticals (*United States v. Martoma II*),³⁵⁴ do not fall within the definition of trade secrets.³⁵⁵ This is why the U.S. Supreme Court's recognition that material non-public information can be property (either under state law or federal common law) is so significant. Consequently, the law of restitution should give a right of action not only for corporations against insiders, but for any source if the disloyal confidant trades on the information under the misappropriation theory. Indeed, in *Carpenter*, Justice White assumed that the *Diamond* rule adopted by New York in a case of classic insider trading would also apply to misappropriation.³⁵⁶

The R3RUE's definition of an infringement of an intellectual property right is essentially the same as the Supreme Court's definition of misappropriation. It states, "[t]here is no unjust enrichment . . . unless the defendant has obtained a benefit in violation of the claimant's right to exclude others from the interests in question."³⁵⁷

As I have just stated,³⁵⁸ under this definition, literal rescission — in the sense of the defendant returning possession of the property to the plaintiff — is impossible and I am assuming (for simplicity) that tracing of proceeds will

typical fact patterns underlying reported insider trading cases.

351. 521 U.S. 642 (1997). Indeed, one study indicates that most insider trading enforcement investigations are initiated after the observation of unusual trading activity before the announcement of a merger or acquisition. Michael A. Perino, *Real Insider Trading*, ST. JOHN'S SCH. L. LEGAL STUD. RES. PAPER SERIES 30, 47 (St. John's School Legal Stud. Research Paper No. 19-0005, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3338536 (showing 67% of prosecutions involve announcements of M&A activity).

352. 401 F.2d 933 (2d Cir. 1968).

353. 773 F.3d 438 (2d Cir. 2014).

354. 894 F.3d 64 (2d Cir. 2018).

355. The Uniform Trade Secrets Act, which has been adopted in some form by every state other than New York, defines a trade secret as

[I]nformation, including a formula, pattern, compilation, program, device, method, technique, or process, that:

- (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and
- (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

UNIF. TRADE SECRETS ACT §1(4) (UNIF. L. CMM'N 1985). The federal Defend Trade Secrets Act of 2016 has a similar, but not identical definition. 18 U.S.C. § 1836. The differences between the two provisions are not relevant to this Article.

356. *Carpenter v. United States*, 484 U.S. 19, 27–28 (1987).

357. R3RUE § 42 cmt. b.

358. See *supra* text at note 312.

rarely, if ever, be practicable. Consequently, the restitutional cause of action can be expected to be *in personam*. That is

As in every other case of profitable wrongdoing, restitution . . . allows the claimant to recover the benefits derived by the defendant from interference with the claimant's rights. Because a claimant entitled to disgorgement would also be entitled to damages, the practical result is that the claimant may recover either damages or profits, whichever is greater.³⁵⁹

D. Fiduciary and Similar Duties

As already introduced,³⁶⁰ although the Supreme Court usually, but not always, describes the relationship that imposes liability of insider trading as a “*fiduciary or similar duty of trust and confidentiality*,” the SEC has tried to vitiate this by using the language “*duty of trust or confidence*” in its questionable Rules 10b5-1 and 2.³⁶¹ Courts have struggled to identify how such duties are created.

The R3RUE, obviously channeling federal caselaw, states the rule as:

A person who obtains a benefit

- (a) in breach of a fiduciary duty,
 - (b) in breach of an equivalent duty imposed by a relation of trust and confidence, or
 - (c) in consequence of another's breach of such a duty,
- is liable in restitution to the person to whom the duty is owed.³⁶²

It notes that:

Courts in some jurisdictions distinguish fiduciary obligations in a strict sense (such as those existing between trustee and beneficiary, agent and principal, attorney and client, guardian and ward) from analogous obligations owed by persons not technically fiduciaries, who nevertheless occupy toward others a ‘relation of trust and confidence’ as regards the transaction in question. The distinction is irrelevant to the rule of this section³⁶³

The question as to the nature of the duty and how it arises is left to other

359. R3RUE § 42 cmt. d. Once again state and federal law differ on the issue of scienter. Under federal law, scienter is always required. Under state law, scienter is relevant to the remedy. According to the R3RUE “[b]ecause a liability limited to the use value of the claimant's property would provide inadequate incentive to bargain over the rights at issue, restitution authorizes the disgorgement of profits in all cases of *conscious wrongdoing*.” R3RUE § 42 cmt. g.

360. See *supra* text at notes 123–24.

361. See Schroeder, *Taking Stock*, *supra* note 105, at 199–200.

362. R3RUE § 43.

363. *Id.* § 43 cmt. a. Friedmann's second principle of restitution, where “the property approach does not apply [is] deterrence This principle justifies, for example, the reward of restitution in cases involving breach of fiduciary duty.” Friedmann, *supra* note 323, at 509–10 (citations omitted).

law. Delaware has recognized misappropriation in the traditional context of officers and directors to a corporation.³⁶⁴ In *O'Hagan* the Supreme Court recognized it in the traditional context of a lawyer's fiduciary duty to his client and/or his law firm partners.³⁶⁵ Consequently, a state common law cause of action for a source seeking to sue a faithless confidant for trading on its material nonpublic information will continue to struggle with these line-drawing problems.

The R3RUE discusses the issue of what duties might render a confidant actionable for use of nonpublic information.³⁶⁶ Traditional fiduciaries are subject to close strict liability, whereas other confidants, must be considered on a case by case basis.³⁶⁷ That is as "a practical matter, the confidential character of a relationship normally described as 'fiduciary' . . . will be presumed; while the confidential character of a relation outside the standard fiduciary models must be proved as a matter of fact in a particular case."³⁶⁸

According to the R3RUE:

If restitution takes the form of a liability to disgorge profits, a disloyal fiduciary — without regard to notice or fault — is treated as a conscious wrongdoer . . . though a defendant who obtains a benefit in consequence of another's breach of duty . . . might be treated for restitution purposes as an innocent recipient Restitutionary remedies (such as constructive trust) that give the claimant rights in identifiable property were originally devised to deal with disloyal fiduciaries³⁶⁹

It continues:

The basic determination that opens the way to restitution within the rule of this section is always the same: that there has been trust and confidence justifiably reposed on one side, and an advantage improperly gained on the other, either in violation of fiduciary duty or in circumstances posing so great a risk of violation that violation is presumed as a matter of law. Any such advantage must be given up to the beneficiary.³⁷⁰

The R3RUE also deals with the misappropriation of nonpublic information, specifically. It states:

Some notable instances of liability . . . respond to the misappropriation by a fiduciary of confidential information, whether or not the information in question is characterized under local law as a trade secret Restitution

364. Lyman Johnson, *Delaware's Non-waivable Duties*, B.U. L. REV. 91 (2011) (stating the fiduciary duties of officers and directors cannot be waived).

365. *United States v. O'Hagan*, 521 U.S. 642, 643 (1997).

366. R3RUE § 43 cmt. b.

367. *Id.* § 43 cmt. d.

368. *Id.* § 43 cmt. f.

369. *Id.* § 43 cmt. a.

370. *Id.* § 43 cmt. b.

by the rule of this section is likewise the basis of a corporation's claim to profits earned through prohibited insider trading in its securities.³⁷¹

The example the R3RUE gives for this is classic insider trading, where a director of public corporation sells stock on the basis of confidential information about its business activities.³⁷²

As mentioned above,³⁷³ because federal insider trading law must be grounded in *fraud* rather than in property standing alone, in *Dirks*, the U.S. Supreme Court held that mere access to information cannot impose the duty to refrain or disclose on a tippee.³⁷⁴ Since the tipper's liability must be derivative of her tipper's violation of a duty, liability depends in large part on the government's proof that the tippee had knowledge of the tipper's violation of her duties to the source.

In contrast, the burden of proof should be the opposite in a *property* regime. That is, a transferee of property with voidable title is liable to the owner of the misappropriated property unless she can show she had no knowledge of her transferor's misdeeds. The R3RUE clarifies:

Once property has been transferred in breach of the transferor's fiduciary duty, the beneficiary may obtain restitution from any subsequent transferee who does not qualify as a bonafide purchaser Benefits derived from a fiduciary's breach of duty may therefore be recovered from third parties not themselves under any special duty to the claimant, who acquired such benefits with notice of the breach.³⁷⁵

VI. APPLICATION OF TAKING MISAPPROPRIATION SERIOUSLY

Taking the common law of misappropriation and restitution seriously would go far toward solving some vexing issues that have arisen in the application of the misappropriation theory. Before continuing, however, let me specify one issue that I will not be raising. In insider trading cases, courts rarely specify whether they are applying state or developing a federal common law let alone the *Erie* federalism questions this raises. This important subject is beyond the scope of this Article since I am assuming that in cases brought in state courts the judges will apply their own state's common law.³⁷⁶

371. *Id.* § 43 cmt. c.

372. *Id.*

373. *See supra* text at notes 52–57.

374. *Dirks v. SEC*, 463 U.S. 646, 654 (1983).

375. R3RUE § 43 cmt. c.

376. Such a cause of action would not be preempted by the State Law Litigation Uniformity Standards Act, 15 U.S.C. 28(f), which requires securities fraud class actions to be brought in federal court. First, the causes of action would not be class actions, but rather direct or derivative actions brought by the source of the information. Second, the cause of action would not be for fraud, but for breach of fiduciary duty and/or the

A. Duties

There has been much confusion as to what type of relationship creates the type of duty to a source of information that would make trading on the basis of the information actionable. An examination of the law of rescission reveals that this analysis is backwards. Rather, we should ask whether the common law would find that the source had a property right in the information that would give it the right to seek restitution against the party who used it. As Weinrib notes, in examining whether an unlicensed transfer of property constitutes unjust enrichment justifying a restitutionary remedy, the judge should not merely address his moral intuition but ask “if its conditions are . . . consistent with the norms of justice that govern transfers generally.”³⁷⁷ That is, despite the unfortunate historical nomenclature, the question as a legal matter should be not whether the enrichment is unjust, but whether it is legally *unjustifiable*.

All too frequently, in my opinion, judges conflate moral outrage with legal liability. I have addressed the inconsistent caselaw elsewhere and will only discuss a few examples here.³⁷⁸ For instance, in *SEC v. McGee*³⁷⁹ and its criminal partner *United States v. McGee*,³⁸⁰ the District Court for Eastern District of Pennsylvania and the Third Circuit Court of Appeals considered whether trading on the basis of material nonpublic information gleaned from an insider by a friend he met through Alcoholics Anonymous meetings, in which participants are supposed to respect the confidentiality of participants, could be the basis of an misappropriation action.³⁸¹ The courts, held for the government on a motion to dismiss and an appeal for conviction respectively, on the grounds of *Chevron* deference to the SEC’s adoption of the controversial Rule 10b5-2, which purports to create a rebuttable presumption of a duty of trust or confidence for the purposes of the misappropriation theory.³⁸² They also stated, somewhat misleadingly, that the Supreme Court did not require the duty always be fiduciary in nature,³⁸³ ignoring the fact that it has stated that the duty must be either fiduciary or “similar.”³⁸⁴ The court gave no consideration to the issue of whether the source of the information would have had any legally recognizable claim against the defendant.

misappropriation of information analyzed as property.

377. WEINRIB, *supra* note 25, at 200.

378. Schroeder, *Taking Stock*, *supra* note 105.

379. 895 F. Supp. 2d 669 (E.D. Penn. 2012).

380. 763 F.3d 304 (3d Cir. 2014).

381. *Id.* at 309.

382. 763 F.3d at 310–16; 895 F. Supp. 2d at 676–81.

383. 763 F.3d at 313–15; 895 F. Supp. 2d at 677–78.

384. *See supra* text at notes 123–24.

More egregiously in *SEC v. Conradt*,³⁸⁵ Judge Jed Rakoff of the Southern District of New York allowed an SEC enforcement tipping action to proceed on the basis of an intense friendship between two foreign young men living in New York City even though he admitted that the defendant's argument that the SEC did not sufficiently allege that the "bond [between the two men] went beyond mere friendship into an actionable relationship of trust and confidence" and was "not without force."³⁸⁶ The two friends regularly shared both personal and business confidences.³⁸⁷ When one, an associate in a law firm, mentioned an upcoming business acquisition involving a client, the "friend" traded on the information and tipped off other friends who also did so.³⁸⁸ But it does not follow that this breach of the bonds of friendship should be legally actionable. However, Judge Rakoff opined in an earlier case that the issue of duty is established by federal common law.³⁸⁹

I would argue that in *McGee* and *Conradt*, the courts and the SEC should not have relied on their intuition that someone committed an unjust or immoral act — precisely the criticism so often aimed at unjust enrichment law.³⁹⁰ They should have asked whether, under general principles of applicable law, the source had a legally recognizable proprietary, fiduciary, or functionally similar interest in the nonpublic information that would give the source a cause of action against the unfaithful confidant. That is, the question should be, whether the defendants' acts were *legally justifiable*.

To further illustrate the *ad hoc* nature of judicial decision in this area compare *United States v. Kim*³⁹¹ with *SEC v. Kirsch*.³⁹² In *Kim*, the defendant belonged to a club for young executives in which it was understood that discussions of business matters would be private. Moreover, members were required to sign confidentiality agreements.³⁹³ Nevertheless, in his thoughtful opinion, Judge Charles Breyer held that this did not create the sort of fiduciary-type relationship of trust that should impose liability under the under the misappropriation theory.³⁹⁴

385. 947 F. Supp. 2d 406 (2013).

386. *Id.* at 411.

387. *Id.*

388. *Id.*

389. *United States v. Whitman*, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2010). Accordingly, he upheld the validity of Rule 10b5-2. This is so, even though the Second Circuit in *Chestman* expressly analyzed the duties of spouses under New York State law. See *supra* text at notes 398–401.

390. *SEC v. McGee*, 895 F. Supp. 2d 669, 675 (E.D. Penn. 2012); Rogers, *supra* note 316, at 1388.

391. 184 F. Supp. 2d 1006, 1008 (N.D. Cal. 2002).

392. 263 F. Supp. 2d 1144, 1149–50 (N.D. Ill. 2003).

393. *Kim*, 184 F. Supp. 2d at 1015.

394. *Id.*

In contrast, in *Kirsch*, Judge Milton Shadur granted summary judgment against a defendant on the grounds that membership in a business roundtable *did* establish such a duty.³⁹⁵ In doing so, Judge Shadur stated that the Supreme Court in *O'Hagan* did not limit misappropriation to breaches of fiduciary duties, but recognized other duties of trust and confidentiality.³⁹⁶ He ignored the fact that it required these duties to be functionally similar to traditional fiduciary duties and citing no legal precedent for his holding. In other words, Judge Shadur engaged in precisely the type of ad hoc intuition that has put unprincipled invocation of unjust enrichment in such bad odor.³⁹⁷

Compare this to the Second Circuit's opinion in *Chestman v. United States*.³⁹⁸ In considering whether spouses owe fiduciary or similar duties of trust and confidence to each other for the purposes of the misappropriation theory, the court looked at a number of traditionally recognized fiduciary relationships, "attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder"³⁹⁹ to induce, in classic common law fashion, what they all have in common. The court found that in each relationship there was a position of superiority, control, and dominance on the side of the fiduciary and dependence on the side of the beneficiary.⁴⁰⁰ Although it is possible that in a specific fact pattern, such a relationship could come to exist between two spouses, under modern law marital status *per se* does not create such a relationship of dominance and subordination. Consequently, the government failed to prove that a husband breached a fiduciary duty to his wife when he tipped off his broker with material nonpublic information.⁴⁰¹ To paraphrase, although my husband may not be able to testify against me in a court of law, and I would be very upset if he relayed or used information I told him in confidence, I would not have legal redress against him if he did so other than, perhaps, divorce.

The SEC's troublesome response to *Chestman* was to promulgate the notorious Rule 10b5-2,⁴⁰² which purports to impose a presumption of a duty

395. *Kirsch*, 263 F. Supp. 2d at 1150.

396. *Id.*

397. One potential way of reconciling *Kim* and *Kirsch* is that the former was a criminal action and the latter a civil, thus a stricter standard applied to the former. The courts, however, never discussed this issue. As Langevoort noted, courts tend to interpret the law identically in criminal and civil cases. *See supra* note 59.

398. 947 F.2d 551 (2d Cir. 1991).

399. *Id.* at 568.

400. *Id.* at 568–70.

401. Although, the Second Circuit did not expressly say it was applying New York law, it cited New York state cases along with another Second Circuit opinion citing to New York law, as well as the Restatement (Second) of Agency. *See id.*

402. 17 C.F.R. § 240.10b5-2 (2021).

of “trust or confidence” in three circumstances. It reads in relevant part:

(b) *Enumerated “duties of trust or confidence.”* For purposes of this rule, a “duty of trust or confidence” exists in the following circumstances, among others:

- (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, pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
- (3) Whenever a person receives or obtains material, nonpublic information from his or her spouse, parent, child, or sibling. . . .⁴⁰³

The validity of this rule is controversial in the academic literature.⁴⁰⁴ As Nagy has correctly stated, this is an attempt to write the Supreme Court’s fiduciary requirement out of the law.⁴⁰⁵ It also completely ignores the property aspect of *O’Hagan*.⁴⁰⁶

Of course, there is no logical or doctrinal reason why a legally recognizable duty functionally equivalent to a fiduciary one could not be established by contract. Indeed, the proprietary nature of trade secrets is frequently established through confidentiality and non-disclosure agreements. And traditional contract law principles — such as establishment of contract by course of custom — should be recognized. Indeed, the U.S. Supreme Court in *Carpenter* relied on the source’s employee manual and noted that a confidentiality agreement need not be in writing.⁴⁰⁷ Moreover, the common, if not dominant, analysis of a corporation as a nexus of contracts conceptualizes the fiduciary duties of officers and directors as

403. *Id.*

404. *See, e.g.,*

[T]he rule was untethered from even the messy bounds of existing fiduciary or fiduciary-like relationships, extending legal obligations of loyalty and confidentiality to familial relations and friendships. The relationships listed in Rule 10b5-2(b)(2)–(3) do not evince the critical qualities that would render them even quasi-fiduciary.

Sarah Baumgartel, *Privileging Professional Insider Trading*, 51 GA. L. REV. 71, 98 (2016); *see also* Jorge Pesok, *Insider Trading: No Longer Reserved for Insiders*, 14 FLA. ST. U. BUS. REV. 109 (2015); Joseph Pahl, *A Heart As Far from Fraud As Heaven from Earth: SEC v. Cuban and Fiduciary Duties Under Rule 10b5-2*, 106 NW. U. L. REV. 1849 (2012).

405. *See supra* text at note 125.

406. *See United States v. O’Hagan*, 521 U.S. 642, 643 (1997) (“A company’s confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement.”).

407. *Carpenter v. United States*, 484 U.S. 19, 26 (1987).

default contract terms.⁴⁰⁸ Nevertheless, despite qualms in academia, the trend seems to be that courts are upholding the rule.⁴⁰⁹

These were implicitly the issues in *McGee* (which upheld Rule 10b5-2), *Kim*, and *Kirsch*. However, when looking at express contracts (*Kim*) and implied contracts (*Kirsch*) one needs to look at the scope and purpose of the confidentiality agreement. I would argue, as the *Kim* court did, that the use of the nonpublic information to trade securities probably did not violate the purposes of the confidentiality agreements which was presumably to encourage frank conversations among the participants by promising not to reveal sensitive information to third parties. In *Kim*, Judge Breyer noted, correctly in my opinion, that, under the confidentiality agreement, no one had a legally enforceable right against the defendant for his trading.⁴¹⁰

As Judge Sydney Fitzwater of the Northern District of Texas noted in the well-known case of *SEC v. Cuban*, an agreement not to *disclose* information is not the same thing as an agreement not to *use* it.⁴¹¹ Thomas Hazan has argued that there should be an assumption that information divulged in confidence should be presumed to fall within the misappropriation rule and impose a duty not to use it.⁴¹² This is, of course, what the SEC has tried to

408. See, e.g., Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989). In the words of Delaware Chancellor Allan writing over 25 years ago, “[a]s a matter of intellectual interest, the debate over the contractual nature of the firm is over.” William T. Allen, *Contracts and Committees in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993). This view implies, of course, that they should be waivable by express contract terms. Consequently, as discussed *supra* in note 119, limited liability company law allows such duties to be disclaimed in a company’s organic documents, which raises issues about the application of the classic theory of insider trading with respect to companies that do so. Nevertheless, as discussed below (see *infra* text at note 473–84), whether these duties *should* be waivable, they probably are not under corporate, as opposed to limited liability company, law.

409. See, e.g., *United States v. Kosinski*, No. 3:16-CR-00148, 2017 U.S. Dist. LEXIS 130420 (D. Conn. Aug. 16, 2017); *United States v. McPhail*, 831 F.3d 1 (1st Cir. 2016); *United States v. Whitman*, 904 F. Supp. 2d 363 (S.D.N.Y. 2012); *SEC v. De La Maza*, No. 09-21977-CIV, 2011 U.S. Dist. LEXIS 157010 (S.D. Fla. Feb. 15, 2011); *SEC v. Nothorn*, 598 F. Supp. 2d 167 (D. Mass. 2009). I discuss the judicial reaction to Rule 10b5-2 in Schroeder, *Taking Stock*, *supra* note 105, at 198–206. For a more recent survey of judicial reactions to Rule 10b5-2, see Zachary J. Gubler, *Insider Trading As Fraud*, 98 N.C. L. REV. 533, 554–57 (2020).

410. *United States v. Kim*, 184 F. Supp. 2d 1006, 1013 (N.D. Cal. 2002).

411. *SEC v. Cuban*, 634 F. Supp. 2d 713, 730–31 (N.D. Tex. 2009). Jonathan Macey notes that the judge’s distinction is “rather obvious.” Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL’Y 639, 661 (2010). I agree. Bainbridge made a similar point several years before the *Cuban* case. Bainbridge, *Incorporating*, *supra* note 68, at 1200.

412. Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881 (2010). I find Hazen’s suggestion incorrect both empirically and as a matter of policy. He seems to suggest that, in the case of written contracts, it would be a drafting burden. I disagree. Contracts should set forth their terms. In my previous career as a practitioner, one of my specialties

smuggle into the law through Rule 10b5-2. As I have just said, there is no conceptual problem with a duty to abstain or disclose functionally similar to a fiduciary duty being imposed by contract.⁴¹³

Of course, in many situations, confidentiality arrangements can be more informal, and terms must be implied by custom and practice. However, I believe that it defies common understanding to say that when I tell someone that I will keep a secret I have accepted a legal as opposed to a moral duty.

B. Measure of Liability

The law of restitution provides an appropriate measure of recovery in misappropriation cases in other circumstances. As discussed,⁴¹⁴ one of the perplexing questions concerning private fraud action under Rule 10b-5 for classic insider trading over the securities markets is that it would result in either no damages or disproportionate damages. Therefore, Congress limited the recovery that a contemporaneous trader can obtain under Sec 20A.⁴¹⁵

If, however, we conceive of insider trading as a common law restitution action for misappropriation of property then there is only one plaintiff — the issuer or the other source of the information. The recovery would be the net profits earned (or losses avoided) of the trader and the plaintiff would not have to prove loss causation. This follows from the fact that restitution is not an action for damages, but for unjust enrichment.

C. Tippee Liability

There has been confusion as to when a tippee inherits the duty of his tipper not to trade on material nonpublic information. In *Dirks*⁴¹⁶ the Supreme Court first articulated the rule as to when a tippee violates Rule 10b-5 when she trades on material nonpublic information. The more recent trilogy of *Newman*,⁴¹⁷ *Salman v. United States*,⁴¹⁸ and *Martoma II*⁴¹⁹ shows how

was intellectual property, and I drafted and negotiated dozens, if not scores, of confidentiality agreements. What could or could not be done with information, and the remedies for breach, were of the essence and carefully negotiated. In the case of information that my clients considered to be trade secrets, we negotiated for a property analysis that would allow for injunctive relief. In other cases, monetary damages were important. I would note that the Uniform Trade Secrets Act defines misappropriation of trade secrets as disclosure, not as use.

413. UNIF. TRADE SECRETS ACT §1(2) (UNIF. L. COMM'N 1985).

414. See *supra* text at notes 135–37.

415. See *supra* text at notes 137–39.

416. 463 U.S. 646 (1983).

417. 773 F.3d 438 (2d Cir. 2014).

418. 137 S. Ct. 420 (2016).

419. 894 F.3d 64 (2d Cir. 2018).

difficult the personal benefit prong of *Dirks* is to apply.⁴²⁰ *Newman* also illustrates the difficulty courts have in determining precisely what the tippee must know, especially in the case of remote tippees who might not know the identity of the original tippee.⁴²¹

I will not discuss the substantive federal law on these issues for two reasons. First, there is already a voluminous literature on tipping, particularly after *Newman* was decided.⁴²² But more importantly, if we look

420. One study purports to show how sensitive sophisticated traders are to changes in insider trading law and prosecutions with circumstantial evidence, suggesting that the amount of insider trading increased significantly after *Newman* was decided but decreased when the Ninth Circuit's opinion in *Salman* came down. Mannish S. Patel, *Does Insider Trading Law Change Behavior? An Empirical Analysis*, 53 U.C. DAVIS L. REV. 447 (2019).

421. See *infra* text at notes 448–54 for a brief discussion of *Salman*.

422. See, e.g., Andrew W. Marrero, *Insider Trading: Inside the Quagmire*, 17 BERKELEY BUS. L.J. 234 (2020); United States v. Martoma: Second Circuit Redefines Personal Benefit Requirement for Insider Trading, 132 HARV. L. REV. 1730 (2019); Sari Rosenfeld, *The Ever-Changing Scope of Insider Trading Liability for Tippees in the Second Circuit*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 403 (2019); Jessica Historied, *Great Expectations, Good Intentions, and the Appearance of the Personal Benefit in Insider Trading: Why the Stage Needs Reset After Martoma*, 43 S. ILL. U. L.J. 703 (2019); Andrew Carl Spokane, *The Second Circuit's Curious Journey Through the Law of Tippee Liability for Insider Trading: Newman to Martoma*, 24 ROGER WILLIAMS U. L. REV. 1 (2019); Tai H. Park, *Newman/Martoma: The Insider Trading Law's Impasse and the Promise of Congressional Action*, 25 FORDHAM J. CORP. & FIN. L. 1 (2019); Langevoort, *Wobble*, *supra* note 61; Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018); Merritt B. Fox & George N. Tepe, *Personal Benefit Has No Place in Misappropriation Tipping Cases*, 71 SMU L. REV. 767 (2018); Zachary J. Gubler, "Maximalism with an Experimental Twist": *Insider Trading Law at the Supreme Court*, 56 WASH. U. J.L. & POL'Y 49 (2018); Joan MacLeod Heminway, *Tipper/Tippee Insider Trading As Unlawful Deceptive Conduct: Insider Gifts of Material Nonpublic Information to Strangers*, 56 WASH. U. J.L. & POL'Y 65 (2018); Peter J. Henning, *Making Up Insider Trading Law As You Go*, 56 WASH. U. J.L. & POL'Y 101 (2018); Matthew J. Wilkins, *You Don't Need Love . . . but It Helps: Insider Trading Law After Salman*, 106 KY. L.J. 433, 434 (2018); Matthew Williams, *Mind the Gap(s): Solutions for Defining Tipper-Tippee Liability and the Personal Benefit Test Post-Salman v. United States*, 23 FORDHAM J. CORP. & FIN. L. 597 (2018); Securities Exchange Act of 1934-Insider Trading- Tippee Liability-Salman v. United States, 131 HARV. L. REV. 383 (2017); Jonathan R. Macey, *Beyond the Personal Benefit Test: The Economics of Tipping by Insiders*, 2 U. PA. J.L. & PUB. OFF. 25 (2017); Austin J. Green, *(Beyond) Family Ties: Remote Tippees in A Post-Salman Era*, 85 FORDHAM L. REV. 2769 (2017); Ellen S. Podgier, *Salman: The Court Takes A Left-Hand Turn*, 49 CONN. L. REV. ONLINE 1 (2017); James Walsh, "Look Then to Be Well Edified, When the Fool Delivers the Madman": *Insider-Trading Regulation After Salman v. United States*, 67 CASE W. RES. L. REV. 979 (2017); Wendy R. Becker, *Friends with Benefits: Redefining Personal Gain in Insider Trading Under Salman v. United States*, 12 DUKE J. CONST. L. & PUB. POL'Y SIDEBAR 47 (2016); Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1 (2016); Sara Almousa, *Friends with Benefits? Clarifying the Role Relationships Play in Satisfying the Personal Benefit Requirement Under Tipper-Tippee Liability*, 23 GEO. MASON L. REV. 1251 (2016); Maria Babajanian, *Rewarded for Being Remote: How United States v. Newman Improperly*

to the common law of rescission, then the *Dirks* analysis is backwards. First, as Richard Epstein correctly argues, if one takes the Supreme Court's misappropriation theory seriously, then there should be no personal benefit test at all.⁴²³ That is, under the basic derivation principle of property and unjust enrichment, if I transfer stolen or fraudulently obtained property to a third party, my transferee inherits only my void or voidable title and the property and its proceeds are encumbered by a constructive trust, regardless of whether or not I benefit from the transfer. As discussed below, however, personal benefit to the tipper *is* relevant to the measurement of the profits that the tipper should be required to disgorge.

Strangely, Epstein discusses the Third Circuit *McGee* opinion discussed above,⁴²⁴ as involving the "personal benefit" test for tipping in his argument (with which I agree) as to why this element is inconsistent with the property rationale of the misappropriation.⁴²⁵ Unfortunately, in this case, even though the source of McGee's information was a traditional insider of the issuer whose stock the defendant purchased, the government did *not* allege that he was a tippee and the personal benefit test of *Dirks* is *never* even mentioned let alone discussed in the case. Rather, the government argued the alternate theory that the defendant misappropriated information from his source.⁴²⁶ Presumably, the government did not pursue a tipping theory precisely

Narrows Liability for Tippees, 46 STETSON L. REV. 199 (2016); Taylor Essner, *Insider Trading in Flux: Explaining the Second Circuit's Error in United States v. Newman and the Supreme Court's Correction of That Error in United States v. Salman*, 61 ST. LOUIS U. L.J. 117 (2016); Jonathan R. Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE 64 (2016); Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, 69 STAN. L. REV. ONLINE 46 (2016); Mark Hayden Adams, *Insider Trading Law That Works: Using Newman and Salman to Update Dirks's Personal Benefit Standard*, 49 LOY. L.A. L. REV. 575 (2016); Ronald J. Colombo, *Tipping the Scales Against Insider Trading: Adopting A Presumption of Personal Benefit to Clarify Dirks*, 45 HOFSTRA L. REV. 117 (2016); Brett T. Atanasio, "I'll Know It When I See It . . . I Think": *United States v. Newman and Insider Trading Legislation*, 121 PENN ST. L. REV. 221 (2016); Katherine Drummonds, *Resuscitating Dirks: How the Salman "Gift Theory" of Tipper-Tippee Personal Benefit Would Improve Insider Trading Law*, 53 AM. CRIM. L. REV. 833, 833 (2016); Reed Harasimowicz, *Nothing New, Man! — The Second Circuit's Clarification of Insider Trading Liability in United States v. Newman Comes at A Critical Juncture in the Evolution of Insider Trading*, 57 B.C.L. REV. 765, 765 (2016); Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482 (2016); A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015); Carlyle H. Dauenhauer, *Justice in Equity: Newman and Egalitarian Reconciliation for Insider-Trading Theory*, 12 RUTGERS BUS. L. REV. 39 (2015).

I did not include in this list other articles that discuss these cases as part of a broader discussion. No doubt, there probably are more articles that I may have missed.

423. Epstein, *supra* note 73.

424. See *supra* text at notes 379–90.

425. Epstein, *supra* note 73, at 1527–28.

426. *United States v. McGee*, 763 F.3d 304, 309–10 (3d Cir. 2014).

because there is no evidence that the associate received any benefit from confiding to his false friend.

The misappropriation theory and first-generation tipping theory are, in fact, logically incompatible. In misappropriation, the source reveals the information to the confidant with the understanding that he may *not* use it for his own purposes. In contrast, in tipping, the tipper gives the information to the tippee so that the tippee *will* use the information for his own purposes. Presumably, the government did not pursue the tipping theory of liability because the person disclosing the information did not intend that his friend trade on it. Rather, he indiscreetly blurted out the information in a moment of emotional distress. As such, in trading, the defendant was not acting in accordance with the tipper's intent, but in a betrayal of his friendship. My issue is that not all moral wrongs should be legal ones.

Moreover, under common law principles, *if* insider trading is a violation of a property right in information, then the *plaintiff* should *not* have the burden to prove the tippee's guilty knowledge. Rather, it is the *tippee* as the transferee of misappropriated property who should have the burden of showing that he is a good faith purchaser of value who took the misappropriated information free of the source's adverse claim.⁴²⁷

As discussed,⁴²⁸ a person who obtains property through fraud acquires only voidable title in that property. Consequently, the original owner can bring an action to replevy the property or the proceeds from the disposition of the property or, more likely in the case of insider trading where tracing is unlikely to be possible, to bring an in personam action for an amount equal

427. In the case of *United States v. Blaszczak*, 947 F.3d 19, 35–37 (2d Cir. 2019), the Second Circuit found that the personal benefit element of *Dirks* does not apply to tipping cases brought under wire fraud law or the criminal securities fraud provision added by Sarbanes-Oxley because it was designed to further the policies of the Exchange Act but is not a traditional element of embezzlement. Langevoort questions this reduction of insider trading to a violation of property rights that downplays the role of breach of duty, noting that, although the Supreme Court in *O'Hagan* said that misappropriation of information is “akin to” embezzlement, “[a]kin to” is not the same as “is.” Langevoort, *Wobble (draft)*, *supra* note 101, at 48. Once again, Langevoort's candid assessment did not make it into the final version of the article.

Without defending the merits of *Blaszczak* under *federal* law, this one aspect of the case is consistent with a misappropriation theory because all one should have to show is that the original tipper obtained information as property from the source in violation of an appropriate duty. The concern should not be whether the tippee “inherited” the tipper's fiduciary type *duty* to her source, as articulated in *Dirks*. It should be enough that the tippee obtained *voidable title in the property*. Indeed, a pure misappropriation theory would go further than *Blaszczak* in that case the government had to show that the tippees knew of the misappropriation.

As one commentator has noted, the *Blaszczak* opinion creates the oddity that the standard for convicting for criminal insider trading is now less stringent in the Second Circuit than for finding liability in civil insider trading cases. *See supra* note 153.

428. *See supra* text at notes 269–74, 332–45.

to the profits gained, or the loss avoided, from the exploitation of the information.

Nevertheless, the transferee would take the information free of the source's interest in it, and be able to use it freely, if she can establish that an applicable bona fide purchaser ("BFP") exception applies. At first blush this analysis might seem inapt in that BFP rules have developed to protect markets in property.⁴²⁹ That is, in the classic fraudulently obtained property dispute there is one guilty, but potentially two innocent parties and two competing values of property law. The fraudster is a bad person who should have liability for any losses suffered by the innocent parties. But fraudsters tend to abscond, be judgment proof, or both. Consequently, we must adopt an uneasy and always unsatisfactory compromise whereby one of the innocent parties gets the disputed property while the other bears the loss and the responsibility of tracking down the fraudster for compensation.

On the one hand, the fraudster has deprived the original owner of possession (the right to exclude and control), which the law guards zealously because it is necessary for all other property rights. Therefore, the default rule of property is the derivation principle. On the other hand, the transferee of the fraudster may have innocently paid good money for it. If we want markets to be efficient, we do not want to put an overly burdensome due diligence requirement on purchasers. Society also has an interest in encouraging the free alienability of property. Accordingly, we often have BFP exceptions to the derivation principle. BFP exceptions are often justified by the assertions that in some cases it might be less costly for owners to police their transferees, so that they are not defrauded, than it would be for buyers to perform due diligence with respect to title.⁴³⁰ Of course, this rationale is based on untestable empirical assumptions, but it has intuitive appeal.

This is why BFP rules usually require the acquirer to have an appropriate "innocent" state of mind and engage in favored market transactions, which always require that the BFP gave value.⁴³¹ We have already met the good faith purchaser of value of goods who takes free of voidable title under UCC § 2-403(1).⁴³² A holder in due course and a protected purchaser takes free of

429. See, e.g., Alan Schwartz & Robert E. Scott, *Rethinking the Laws of Good Faith Purchase*, 111 COLUM. L. REV. 1332, 1360 (2011) (writing that "Article 3 of the U.C.C. governs property right contests between an original owner of a lost or misappropriated instrument and a subsequent bona fide purchaser").

430. See, e.g., Stephen L. Sepinuck, *The Various Standards for the "Good Faith" of a Purchaser*, 73 BUS. LAW. 581, 587-88 (2018) (noting the "enhanced rights of good faith purchasers" represent policy considerations that the law is serving).

431. 12 U.S.C. § 3752(1).

432. See *supra* text at note 272.

adverse claims in instruments⁴³³ and securities, respectively.⁴³⁴ Property, such as information, that is not governed by a statutory schema, is governed by common law BFP principles. What all of the BFP rules I reference have in common is the requirement that the transferee be a purchaser,⁴³⁵ with the requisite innocent state of mind, who has given value.⁴³⁶

One might be tempted to say that the application of BFP principles to nonpublic information is inapt in the context of securities laws because, unlike the context of goods and instruments, we do not *want* there to be a market for misappropriated information. This objection is misplaced. Although we might not want a market in *misappropriated* information, we also do not want to encourage a market for *misappropriated* goods. Nevertheless, there is a widespread consensus that we want to promote efficient markets for securities and our securities laws are based on the assumption that this is furthered by the discovery and dissemination of material information.⁴³⁷ Efficient securities markets depend on professionals who investigate, gather, analyze, and trade on information about issuers and their securities and further disseminate the information to their clients.⁴³⁸ We should be encouraging, not discouraging this behavior. This was precisely Justice Powell's concern in *Dirks* when he declined to find that all tippees inherit the tipper's disclose-or-abstain duty.⁴³⁹

One might also be tempted to argue that the analogy to the BFP rules for goods and instruments is imperfect because they required the buyer to

433. U.C.C. § 3-306 (AM. L. INST. & UNIF. L. COMM'N 2012).

434. *Id.* § 8-303(b).

435. Although the two terms are synonyms in colloquial English, the legal definition of purchaser is broader than that of buyer. U.C.C. § 1-201(b)(29) includes in the term "purchase," "any other voluntary transaction creating an interest in property." Similarly, Bankruptcy Code § 101(43) defines "purchaser" as "transferee of a voluntary transfer, and includes immediate or mediate transferee of such a transferee." 11 U.S.C. § 101(43). For example, a donee is a purchaser, but not a purchaser for value. A lien creditor, however, is not a purchaser.

436. The 1984 and 2000 amendments to the U.C.C. have reversed this traditional burden with respect to important subclasses property, such as money, deposit accounts, and security accounts, where liquidity is considered of the essence. For example, the transferee of money takes free of security interests unless the claimant can prove that transferee acted in collusion with the transferor to violate the rights of the secured party. *See, e.g.*, U.C.C. § 9-332. I discuss these super-negotiability rules in Schroeder, *Bitcoin*, *supra* note 250.

437. *See* Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe from the Total Mix*, 25 WM. & MARY L. REV. 373, 373 (1983) (noting the "prodigious empirical and theoretical research and commentary" on the operations of markets and the dissemination of information).

438. The classic law review article on the relationship between professional trading and the efficient market hypothesis is Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

439. *Dirks v. SEC*, 463 U.S. 646, 657–59 (1983).

give value for the property and we do not want to encourage corruption in securities markets. Once again, this is inapt. There is nothing wrong with paying for information *per se*. Indeed, brokers hire analysts to discover information and I pay fees to my broker in connection with trades based on this. It is, however, problematic to pay for information one *knows* is misappropriated in the same way it is problematic to pay for goods that one knows have been fraudulently obtained. But if the buyer knows this, then he is not in good faith and cannot maintain the defense.

I am, however, concerned by my analysis in the case of remote tippees. For example, in *Newman* one of the grounds on which the Second Circuit Court of Appeals overturned the conviction of the alleged tippees who were three or four steps down the chain from the alleged original tippers (who were classic insiders) was that the government did not prove beyond a reasonable doubt that they met the *Dirks* element that they knew or should have known that the original tippers breached their fiduciary duties to the issuer.⁴⁴⁰ Under a property-based state court action, the defendants would have to prove they were in good faith (i.e., they neither knew nor should have known of the breach) and gave value.

In this fact pattern, the defendants may very well have been able to convince a jury that they were in good faith because they had no reason to know the origin of this specific information.⁴⁴¹ Security markets are driven by the search for information by market professionals who, among other things, exchange rumors. That is, the SEC's argument that the defendants must have known that the information was misappropriated is just empirically wrong. In addition, given that the original "tippees" were in the one instance an employee in the issuer's investor relations office and in the other an employee in the issuer's finance unit, the defendants may have reasonably assumed that their disclosure of the information was authorized by the issuers and, therefore, not tips. At worst, they may have suspected that they were violating Regulation FD,⁴⁴² by making selective disclosures. However, there is no evidence in *Newman* that the transferees of the

440. *United States v. Newman*, 773 F.3d 438, 442 (2d Cir. 2014). This part of the opinion was not challenged by the Supreme Court in *Salman* and presumably stands as the law in the Second Circuit. Whether or not *Newman* (a criminal case), which seems to require scienter on the behalf of tippees, affects the holding in *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012), which can be read as implying that remote tippees can be subject to civil liability on a negligence standard, is beyond the scope of this Article. Pritchard, *Edge*, *supra* note 102, at 949–50. In *Newman*, the Second Circuit Court of Appeals also held that the government did not prove the personal benefit prong of *Dirks* as well. 773 F.3d at 442.

441. Presumably, a *Brophy* action would be governed by a predominance of the evidence standard.

442. 17 C.F.R. § 243 (2021).

information gave value so even if they were good faith purchasers, they were not good faith purchasers for *value*.

Moreover, I would question whether, as the circle of market professionals who know about the information becomes increasingly large, eventually the information has effectively become public.⁴⁴³ To state the obvious, one of unusual aspects of treating material nonpublic information as property is that it constitutes property only insofar as it is, in fact, nonpublic. Certainly, the source would have lost its right to sue remote parties if the original tippee divulged the information in an online newsletter, even if it were subscription only. Under my interpretation of misappropriation, the tippee/publisher might have liability to the source of the information, but not subsequent traders.

Of course, it does not follow from this that we should allow remote tippees off the hook if they are members of a tipping ring who regularly exchanged information. Perhaps in these cases an alternate theory of liability for the remote tippees, such as aiding and abetting, could be used.⁴⁴⁴ These are the types of distinctions that common law courts are traditionally considered competent to make.

D. Tipper Liability for the Profits of a Tippee

Taking the misappropriation theory seriously and combining it with the Supreme Court's tipping jurisprudence justifies the one aspect of disgorgement that bothered the Supreme Court the most in *Kokesh*. There, the Court found that disgorgement was punitive in nature because a tipper

443. As Gilson and Kraakman famously argued, a semi-strong efficient information in securities does not require that information be universally known by all market participants, merely that it becomes known by professional traders. Gilson & Kraakman, *supra* note 438.

Epstein makes a related point with respect to the facts of *Newman* where the defendants, all market professionals, were many links away in the beginning of the chain of the distribution of information. Epstein, *supra* note 73, at 1523.

In addition, remote tippees might be protected by the shelter rule, the affirmative variation of the derivation principle that a transferee inherits the title of her transferor. We have seen this in the negative form where the transferee of a party with voidable title only received voidable title unless she can show she is a BFP under the applicable rule. However, this means that a transferee from a BFP receives *good* title even though she is not herself a BFP because she did not give value or have notice of the original owner's adverse claim. Obviously, the shelter rule does not protect a remote transferee who was a party to the original transaction that rendered the title in the property voidable. This is most clearly stated in U.C.C. §3-302(b), which states that the shelter principle does not apply to a transferee who "engaged in fraud or illegality affecting the instrument."

444. At least one court, applying Delaware law, failed to dismiss a claim alleging that a first generation tippee aided and abetted an insider in a *Brophy* action. *Heartland Payment Sys., LLC v. Carr*, No. 3:18-cv-9764, 2020 U.S. Dist. LEXIS 15302 (D.N.J. Jan. 27, 2020).

was often ordered to disgorge an amount equal to her tippee's profit even when she did not herself participate in this profit.⁴⁴⁵ Further, in *Liu*, the Supreme Court indicated in dictum that it might be inappropriate to find joint-and-several liability in "remote, unrelated tipper-tippee arrangements."⁴⁴⁶ However, following the logic of *O'Hagan* and *Dirks*, the tipper *should*, in some cases, be liable to disgorge an amount equivalent to the tippee's profits in close and related tipper-tippee arrangements. This is because in the context of gifts, the tippees' profits should be considered the ill-gotten gains of the tipper.

That is, in *Dirks*, the Supreme Court held that a tipper only violates her duty to her source insofar as she receives a personal benefit from the tip and that one way a tipper can personally benefit is if she intended to make a gift to the tippee.⁴⁴⁷ The Supreme Court confirmed this in *Salman*,⁴⁴⁸ when a tipper passed on material nonpublic information to help his brother who was in need of funds, who traded on the information. The brother then re-tipped a close friend who was also the brother-in-law of the original tipper.⁴⁴⁹

Under the law of restitution, the tipper should have to account to the source for the value of the benefit she received from her use of the misappropriated information. In the case where the benefit received by the tipper was a kickback or other quid pro quo, the benefit would be the amount of the payment by the tippee to the tipper. In some cases, such as where the *quid pro quo* is the expectation of future favors, this might be *empirically* difficult to measure but is not *logically* problematic.

In the case of a tip made as a gift, however, the tipper should have to disgorge the value of the gift. The most reliable measure of this value would be the profit gained (or loss avoided) by the tippee when she traded on the gifted information. This disgorgement would be the direct and primary, not a vicarious or secondary, liability of the tipper on a theory of joint-and-several liability or of aiding and abetting. In *Salman*, the source of the information should have been able to sue the original tipper who passed on information to his brother as a gift for an amount equal to his brother/tippee's profits and also sue the brother/tippee for his profits and perhaps also the profits or his friend/tippee.

Unfortunately, although restitution would give a proper measure of damages in a tip-as-gift case, it would not solve the morass raised in the *Newman*, *Salman*, and *Martoma II* cases.⁴⁵⁰ That is, how does one establish

445. See *Kokesh v. SEC*, 137 U.S. 1635, 1644–45 (2020).

446. *Liu v. SEC*, 140 S. Ct. 1936, 1949 (2016).

447. *Dirks v. SEC*, 463 U.S. 646, 663–66 (1983).

448. 137 U.S. 420 (2016).

449. *Id.* at 423–24.

450. See *supra* text at notes 416–21.

that a tip was in fact meant as a gift? This type of case-by-case adjudication is precisely the bailiwick of state common law courts.⁴⁵¹

E. "Solving" Dorozhko

Taking misappropriation seriously would erase the embarrassment of *Dorozhko*.⁴⁵² This case illustrates the unsatisfactory nature of the Supreme Court's insider trading jurisprudence. To recap, under federal law, for trading on the basis of material nonpublic information to be unlawful, it is not sufficient that the trader exploit information conceptualized as property belonging to the issuer or other source. To fall within the catch-all provisions of Sec. 10(b) and Rule 10b-5, the trader must also engage in fraud. That is, trading on the basis of stolen, as opposed to fraudulently obtained, information would not violate the federal securities law. This is so even though we usually treat theft as a greater violation of property rights than fraud (as shown in the distinction between the void title obtained by a thief and the voidable title obtained by a fraudster).

In *Dorozhko*, a hacker gained access to an issuer's computer and traded on securities based on the material nonpublic information it learned.⁴⁵³ As discussed,⁴⁵⁴ as an *empirical* matter insider trading almost always involves silence, which is why a fiduciary or similar duty to speak is required to make the trading fraudulent. The *Dorozhko* court recognized that trading could also be fraudulent if the trader made affirmative misstatements to the source of the information (in which case a fiduciary or similar duty would not be required).⁴⁵⁵

451. Donald Langevoort summarizes the academic debate after *Martoma II*:

Textualism aside, is it cogent and sufficiently compelling to proscribe deliberate gift tips outside the circle of family and friends as breaches of loyalty? Commenting on *Obus* and *Newman*, Pritchard says no; in contrast, Donna Nagy and Joan Heminway both say yes in part by reference to more recent Delaware fiduciary duty case law, which puts in the category of disloyalty and bad faith actions deliberately taken without regard for the interests of the corporation. Even without such resort, I think that there is benefit whenever fiduciaries takes something valuable as their own to do with as they please without serving their master (the issuer or source), regardless of what they ultimately choose to do. The exercise of dominion is itself a form of (unjust) enrichment.

Langevoort, *Wobble*, *supra* note 61, at 515 (citations omitted). Obviously, I agree with Langevoort's reading, although I argue that it is more coherent for an unjust enrichment claim to be brought under state law.

452. 574 F.3d 42 (2d Cir. 2009).

453. *Id.* at 44.

454. *See supra* text at notes 114–19.

455. *Dorozhko*, 574 F.3d at 49–50.

Because, in this case, the hacker had no duty to make disclosures to the source, the question then becomes, “is hacking a fraudulent misstatement or merely theft?” The Second Circuit Court of Appeals concluded that the answer is “it depends.”

In our view, misrepresenting one’s identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly “deceptive” within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain access is “deceptive,” rather than being mere theft.⁴⁵⁶

To use an analogy from the physical world, assume that the material nonpublic information was unreleased earnings results contained in a hard-copy draft report sitting on the desk of the issuer’s CFO. If the misappropriator persuaded the CFO to give her a copy of the draft by lying about her identity, this would constitute an affirmative misstatement and, therefore, could be fraud. If, however, the misappropriator broke into the office and purloined the draft, this would be theft, not fraud. The use of the information in the former case might constitute federal securities fraud but could not in the latter case. Consequently, the Second Circuit remanded the case to determine whether the hacking in this instance was more like the former (fraud) or the latter (theft).⁴⁵⁷

Although this result seems absurd on policy grounds,⁴⁵⁸ I agree with the Second Circuit that this is *O’Hagan* taken to its logical extreme.⁴⁵⁹ A state common law restitution claim, in contrast could be brought for either outright theft or fraud.⁴⁶⁰

456. *Id.* at 51.

457. *Id.*

458. Needless to say, it has generated a tremendous amount of controversy. See, e.g., Pesok, *supra* note 404, at 132–35.

459. Bainbridge questions as to how hacking could be deceptive if “the hacker ‘lies’ to a computer network, not a person.” Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 88. He agrees, however, that the securities laws have always made a distinction between “traditional” theft and fraud. *Id.* at 88–89. He thinks that the Second Circuit’s finding that hacking could be fraudulent should be “understood to be an end run” around this distinction. *Id.*

I disagree. We now allow “bots” to cause parties to enter into contracts, thereby implicitly establishing the necessary intent of the persons employing the bot (see, e.g., Electronic Signatures in Global and National Commerce Act (E-SIGN), 15 U.S.C. § 7001, and Uniform Electronic Transactions Act § 14, which have been adopted in every state except Illinois and New York who have their own similar, albeit non-uniform, acts). If we allow bots to establish the terms of a contract and the intent of the entity using it necessary to form a binding contract, I don’t see why we can’t also attribute deception of a bot to the entity as well.

460. *Dorozhko* has proven to be a fertile source for student notes. One note takes a very critical view of the Second Circuit’s finding in *Dorozhko* that an affirmative misstatement absent a fiduciary duty can constitute unlawful insider trading under federal current doctrine. Elizabeth A. Odian, *SEC v. Dorozhko’s Affirmative Misrepresentation*

Note, the R3RUE does not expressly discuss *stolen* property. But this is presumably because the owner's rights with respect to stolen property are not restitutionary at all. That is, the owner does not need to rescind a transfer of property because, in theft, there is no transfer of either equitable or legal title. Indeed, an action for stolen property would be stronger than fraudulently obtained property since there is no defense for good faith purchasers for value.⁴⁶¹

F. The Brazen Misappropriator

Following from the last point, replacing the fraud aspect of insider trading law with the law of restitution would do away with perhaps the most unsatisfying aspect of *O'Hagan* — the possibility of a brazen misappropriator. Justice Ginsberg conceptualized the *fraudulent* aspect of misappropriation as an implied *misrepresentation* of fidelity made by the recipient of material nonpublic information to the source of the material.⁴⁶² She analogized the misappropriation of information by a disloyal confidant akin to the embezzlement of money.⁴⁶³ Justice Ginsberg, reluctantly admitted that this meant that the confidant would not commit fraud if she disclosed her intent to trade to the source.⁴⁶⁴ The brazen *theft* of information disclosed in confidence would not be fraudulent. She stated:

[F]ull disclosure forecloses liability: Because the deception essential to

Theory of Insider Trading: An Improper Means to A Proper End, 94 MARQ. L. REV. 1313 (2011). The author argues that a property rights theory would, on the one hand, solve this problem since it would eliminate the need to show breach of fiduciary duty but, on the other, might be overly broad in that it could lead to over-enforcement. *Id.* Consequently, she calls for reviving Justice's Burger's dissent in *Chiarella*. *Id.* Unfortunately, abandoning the fiduciary or similar duty to establish that silence can be deceptive would be to abandon forty years of federal jurisprudence, which is one reason why I am looking at state law. Moreover, as state law would limit the right to seek disgorgement to the source of the information, it would do away with the over-enforcement issue.

In contrast, another student defended *Dorozhko* on the grounds that it is a straightforward application of the concept of deception. Sean F. Doyle, *Simplifying the Analysis: The Second Circuit Lays Out A Straightforward Theory of Fraud in SEC v. Dorozhko*, 89 N.C. L. REV. 357 (2010). A third student both characterizes the defendant as a deceptive thief but argues that the Second Circuit's holding should be expanded to all thieves. Adam R. Nelson, *Extending Outsider Trading Liability to Thieves*, 80 FORDHAM L. REV. 2157 (2012). Like Odian, he would like to revive Justice Burger's *Chiarella* dissent. *Id.* Unfortunately, although I agree with the intuition that the distinction seems to be absurd in this context, Section 10(b) is limited to fraud, and commercial law has long distinguished between theft and fraud for many purposes. Once again, this is one reason why I argue for a state law remedy.

461. See *supra* text at notes 266–68.

462. See *supra* text at notes 126–29.

463. *United States v. O'Hagan*, 521 U.S. 642, 643 (1997).

464. *Id.* at 655.

the theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the information, there is no “deceptive device” and thus no § 10(b) violation . . . [Second, § 10(b)’s requirement that the misappropriator’s deceptive use of information be “in connection with the purchase or sale of [a] security” [is] satisfied [by the misappropriation theory] because the fiduciary’s fraud is consummated, not when [he obtains] the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities.⁴⁶⁵

In contrast, a fiduciary cannot avoid liability for self-dealing with the property of her beneficiary or otherwise profiting from her position by *unilaterally* warning her beneficiary.⁴⁶⁶ A thief cannot avoid liability by announcing her intent to commit larceny: The stereotypical mugger who threatens “your money or your life!” is a robber.

G. Permitted Trading

Taking misappropriation seriously, however, would not solve the final aspect of *O’Hagan* that some might find problematic. That is, if the nonpublic information belongs to the source, then the source should be able to give the trader permission to trade on it under the misappropriation theory. This is logically correct, however. In most cases, if the source of the information is not the issuer of the securities traded, the source can buy and sell the securities since it has no fiduciary or similar duties to the market and is not subject to statutory restrictions on its trading.⁴⁶⁷ If it can trade on this

465. *Id.* at 655–56.

466. And, Justice Ginsberg does suggest, although the brazen misappropriator would not violate the federal securities law, she might remain liable under state law.

In *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), the First Circuit Court of Appeals largely vitiated the problem of the brazen misappropriator by finding, on the facts of the case, that a confidant’s post acquisition disclosure of her intent to tip her brother was made too late to insulate her from liability. See Nagy, *supra* note 125, at 1344 (*Rocklage* “essentially eviscerate[d] *O’Hagan*’s dictate that a fiduciary’s full disclosure to his principal forecloses Rule 10b-5 liability.”). However, as sensible as this position might seem from a policy standpoint, it is arguably inconsistent with Justice Ginsberg’s language that the fraud is not consummated until the confidant purchases or sells securities. This issue has yet to be considered in other circuits.

Note, if we follow the common law of unjust enrichment and eliminate the *Dirks* personal benefit element of tipping, then *Rocklage* becomes an easy case. Mr. Rocklage was a classic insider of the issuer. The SEC could not sue Mrs. Rocklage as a tippee because Mr. Rocklage did not give the information to her as a gift. He was distraught about his company’s unannounced financial results and confided the information to her, expecting her to keep it confidential. Consequently, the SEC had to argue that she was a dishonest confidant who misappropriated her husband’s material nonpublic information.

467. Cox is particularly concerned about this implication of a purely property analysis of insider trading. Cox, *supra* note 51, at 709.

information, it should be able to give others the permission to do so. In other words, insider trading is completely lawful if the source of the information consents, at least under the misappropriation theory.

Let us return once again to the *ur*-misappropriation case of *Carpenter* previously discussed.⁴⁶⁸ In that case, the source of the information was the *Wall Street Journal*, the misappropriator was a columnist, and the misappropriated property was the *Journal's* production schedule.⁴⁶⁹ It was clear the *Journal* considered this information to be confidential and the columnist understood that the terms of his employment agreement prohibited him from trading in securities on the basis of the information. However, so long as the *Journal* was not engaging in price manipulation,⁴⁷⁰ it would have been completely legal under the federal securities laws for it to have traded securities based on its production schedule (although that may have violated journalistic ethics) because it had no fiduciary or functionally similar duties to the public.⁴⁷¹ As such, there was also no reason why the *Journal* could not legally permit its employees to trade on this information as well, perhaps as a form of compensation.⁴⁷²

There are, of course, exceptions. Most importantly, in the case of a tender offer, both the bidder and the target are subject to both disclosure obligations and substantive restrictions on the purchases of the target's securities. See Rule 13d-1 (17 C.F.R. § 240.13d-1 (2021)); Rule 13e-3 (17 C.F.R. § 240.13e-3 (2021)); Rule 14d-3 (17 C.F.R. § 240.14d-3 (2021)); Rule 14d-4 (17 C.F.R. § 240.14d-4 (2021)); 14d-10 (17 C.F.R. § 240.14d-10 (2021)). The federal tender offer regime is beyond the scope of this Article.

Moreover, after a party has taken substantial steps towards the commencement of a tender offer, Rule 14e-3 prophylactically prohibits (with certain exceptions) trading by any person who is in possession of material nonpublic information who has reason to know that the information comes from the bidder, the target or their insiders. 17 C.F.R. § 240.14e-3 (2021).

468. See *supra* text at notes 276–93.

469. *United States v. Carpenter*, 484 U.S. 19, 22–24 (1987).

470. Intentionally publishing certain information with the intent of affecting the price of securities can in some circumstances be unlawful manipulation under Exchange Act § 9(a). 15 U.S.C. 78i(e). Manipulation is beyond the scope of this Article.

471. Bainbridge notes that the *Carpenter* implications are “incongruous” insofar as it purports to be based on investor confidence and market integrity, but it does make sense if, instead, we ground insider trading policy in property principles. Bainbridge, *Incorporating*, *supra* note 68, at 1243–44; Bainbridge, *Post-Fiduciary Duty*, *supra* note 120, at 85, 96–97.

472. As Langevoort says:

A fundamental implication of the property rights idea is that the owner gets to do with the information as it wishes, free of government meddling at least so far as the securities laws are concerned. [] While an early version of this said that there was no need for federal regulation at all — owners can protect themselves using common law agency, fiduciary, tort, contract and property principles — that idea has faded in favor of seeing insider trading law as a useful federal law tool for sanctioning informational embezzlers.

There is a question as to whether this analysis also applies to insider trading under the classic theory. Saikrishna Prakash once suggested that this was already the rule.⁴⁷³ Although this position arguably logically follows from the Supreme Court's analysis that information is the property of its source and that, for insider trading to be actionable, there must be a breach of fiduciary duties, it seems to be incorrect as a description of the federal case law.

As discussed,⁴⁷⁴ the federal court's understanding of fiduciary duty seems to go beyond state law in the case of classic insider trading, recognizing direct duties not only to the corporation, but also to its existing and future stockholders. That is, in *Cady, Roberts* the SEC held that a classic insider must either abstain or disclose the material nonpublic information to the market,⁴⁷⁵ a position that Justice Powell reiterated in *Chiarella*.⁴⁷⁶ As such, there seems to be a de facto federal fiduciary duty law that prohibits permissioned trading by traditional insiders under the classic theory. Consequently, Bainbridge argues, "[a]uthorization of insider trading by the issuer's board of directors, or even a majority of the shareholders, does not constitute consent by the specific investors with whom the insider trades."⁴⁷⁷ I suspect that federal courts would agree with Bainbridge's interpretation of federal law.

However, with respect to a *state* law *Brophy/Diamond* action for classic or misappropriation insider trading, Prakash might be correct. These disgorgement claims are derivative actions brought in the name of a corporation against its officers and directors for self-dealing. In other contexts, self-dealing and takings of corporate opportunity can be "sterilized" by the vote of disinterested directors and/or stockholders after full disclosure.⁴⁷⁸ This suggests that any "abstain or disclose" duty should run to the corporation itself, through its board. The information that must be disclosed would not be the material nonpublic information itself (which is already known by the corporation vicariously through the insider) but the fact that the insider intends to trade on the information. There would seem to be no *theoretical* reason why, for instance, a special committee consisting entirely of disinterested outside directors could not be able to grant an officer

Langevoort, *Wobble*, *supra* note 61, at 524.

473. Prakash, *supra* note 14, at 1511.

474. *See supra* text at notes 118–20.

475. *See Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

476. *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

477. BAINBRIDGE, *INSIDER TRADING*, *supra* note 55, at 97.

478. Jonathan Macey argues that, based on a property theory of information "[t]he question of whether and how to trade or otherwise utilize material inside information is, from a corporation's perspective, a matter of business judgment," relying in part on Ginsberg's footnote 9 in *O'Hagan*. Macey, *Martoma II*, *supra* note 162, at 872–73.

or director the right to trade on certain information, for example, as part of his compensation package, at least if there is full disclosure to stockholders.⁴⁷⁹

Nevertheless, I suspect that it is highly unlikely that this will happen. Whether or not classic insider trading could be “sterilized”⁴⁸⁰ by a disinterested director or stockholder vote under state law eliminating a *Brophy* action, it would still probably remain unlawful under federal law.⁴⁸¹ It would also probably continue to violate stock exchange listing requirements.⁴⁸² Perhaps more importantly, the existence of such an arrangement would have to be disclosed by an issuer, in its proxy statement seeking stockholder approval, and in the *Executive Compensation* section⁴⁸³ that must be included in a number of Securities Act and Exchange Act filings. Even the proponents of legalizing insider trading with the issuer’s permission insist that this must be disclosed.⁴⁸⁴ However, given the widespread revulsion against insider trading by the public generally, I would hazard that few issuers would risk such a public-relations *faux pas*.

479. Of course, the granddaddy of the argument that issuer permitted insider trading might be an appropriate form of compensation is Henry Manne. MANNE, *supra* note 78. He has reiterated this argument as late as Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, in HANDBOOK, *supra* note 62, at 67. For another classic defense of legalization of insider trading see Daniel R. Fischel & Dennis W. Carlton, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983). Epstein makes a more nuanced version of this argument based on the assertion that insider trading may or may not be efficient based on the specific context. Therefore, rather than having a blanket rule, we should allow boards to determine this on a case-by-case basis. Epstein, *supra* note 73.

For a recent discussion of the efficiency of doing so, see James C. Spindler, *The Coasian Firm and Insider Trading, Revisited*, 71 SMU L. REV. 967 (2018), expanding on a model developed by David Haddock and Jonathan Macey over 30 years ago. David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986).

480. See, e.g., DEL. CORP. ANN. tit. 8, § 144 (2021).

481. More recently, Thomas Lambert has suggested issuers should be allowed to permit insider trading with full disclosure as a way of enhancing informational efficiency while constraining agency costs. Thomas A. Lambert, *Decision Theory and the Case for an Optional Disclosure-based Regime for Regulating Insider Trading*, in HANDBOOK, *supra* note 62, at 130 [hereinafter Lambert, *Decision Theory*].

482. See WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 613–14 (3d. Ed. 2010); Nick Walter, *Prioritizing Enforcement in Insider Trading*, 30 YALE L. & POL’Y REV. 521, 529, n.38 (2011).

483. *Regulation S-K — Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975, Item 402 Executive Compensation*, 17 C.F.R. § 229.402 (2021).

484. See Lambert, *Decision Theory*, *supra* note 481, at 130 (explaining that disclosure should be necessary, and that disclosure should always make insider trading permissible).

VII. CONCLUSION

Although the Supreme Court's understanding of the law of restitution and disgorgement as illustrated in its decisions in *Kokesh* and *Liu* is flawed, the logic of the Supreme Court's insider trading jurisprudence suggests that the proper party to bring a disgorgement cause of action for insider trading should not be the SEC, but the issuer or other source of the material nonpublic information. Moreover, the cause of action should be brought in state courts under property, breach of fiduciary duty, or fraud grounds under the traditional common law of restitution. To do so would greatly simplify and do away with the absurdities and excrescences that currently deform federal case law and send people to prison for what is a *de facto* common law crime.

However, such state law cases sounding in unjust enrichment can be expected to be relatively few and far between. If one is concerned with deterrence, they should be a supplement to, not a substitution for, federal civil and criminal actions. Indeed, implicit in my argument is that these state law causes of action designed protect the individual *private* rights of owners of information are inadequate as the basis of a federal securities law that is concerned with *public* policies such as market integrity, efficiency, and protection of investors.

The Supreme Court's strained amalgam of property, fiduciary duty, and fraud justifications for insider trading liability does not capture what, if anything, is wrong about purchasing or selling securities on the basis of material nonpublic information from the perspective of the securities markets generally. The Supreme Court correctly believes that the federal case law is currently bound by the fact that Sec. 10(b) of the '34 Act only bans fraud, not bad acts generally. Consequently, coherence in federal law requires Congressional action which, in turn, would require identifying what is wrongful about insider trading from a market perspective so that we can define it. Unfortunately, although there is a widespread, albeit far from universal, intuition that some trading on the basis of material nonpublic information violates the policies underlying the federal securities laws so far there is no consensus as to why.

THE SEAL HAS BEEN LIFTED: NCAA AND PREDOMINANTLY WHITE COLLEGES MUST SOON STOP EXPLOITING THEIR BLACK ATHLETES

DANIEL BARTLETT*

I. Introduction	186
II. The Troubled History of Student-Athletes and the NCAA.....	189
A. What is the NCAA and What is the Issue?	190
B. Cases Where Student-Athletes Fell Short	191
C. New Legislation to Level the Playing Field.....	193
D. Attempting to Protect College Athletes	195
E. The Exploitation of Black Athletes	196
III. How the Passing of College Athlete Compensation Legislation Will Have an Unforeseen Effect on the College Landscape	198
A. How the NCAA Has Failed Its Athletes	199
B. Case Law's Shortcomings and How Future Collegiate Compensation Litigation Can Provide Relief.....	199
C. The Impact of Modern College Athlete Compensation Legislation	202
D. Setting a New Legal Standard for Compensation	204
E. New Legislation and Outcomes for Black College Athletes	205
IV. Are There Alternative Avenues for Black Athletes to Take When Combatting Commercial Exploitation?	208
A. Looking Forward	208
B. The Push for Publicity Rights Legislation	209

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C. A New Perspective.....	211
D. HBCUs as the Future of College Sports	212
V. Conclusion	213

I. INTRODUCTION

Collegiate athletics is a dominant form of entertainment in the United States, with upwards of ten million average viewers for select tournaments.¹ Sports fans and universities come together on a nightly basis to watch their team perform at student-athletes' expense. Introduced in the 117th Congress's second session, the Amateur Athletes Protection and Compensation Rights Act of 2021 ("AAPCA"), and similar legislation, aim to solve the issue of the lack of compensation for college athletes competing on behalf of their university.²

From a business perspective, college athletics is a lucrative industry with high-profit margins for the NCAA and individual universities.³ While the NCAA and its partner universities offer athletic scholarships to cover the cost of attending a four-year school, athletes are otherwise limited in their ability to capitalize and receive compensation for their athletic success.⁴ Nevertheless, popular college athletes' names, images, and likenesses ("NIL") are used to sell video games, merchandise, and other items, while the athletes receive none of the profit.⁵ The NCAA continues to perform

1. See Christina Gough, *NCAA March Madness Basketball Tournament Average TV Viewership from 2013 to 2019*, STATISTA (Oct. 21, 2021), <https://www.statista.com/statistics/251560/ncaa-basketball-march-madness-average-tv-viewership-per-game/> (showing average television viewership of the NCAA March Madness Tournament).

2. See Amateur Athletes Protection and Compensation Act, S. 414, 117th Cong. (2021); see also CAL. EDUC. CODE § 67456 (West 2021); College Athlete Economic Freedom Act, S. 238, 117th Cong. (2021); College Athletes Bill of Rights, S. 5062, 116th Cong. (2020).

3. Eben Novy-Williams, *NCAA Says It Lost \$800 Million in Revenue from Cancelled March Madness*, SPORTICO (Jan. 25, 2021), <https://www.sportico.com/leagues/college-sports/2021/ncaa-lost-800-million-1234621088/> (noting that the NCAA's 2019 revenue totaled \$1.18 billion).

4. Patrick Hruby, *The NCAA Says Paying Athletes Hurts Their Education. That's Laughable.*, WASH. POST (Sept. 20, 2018), https://www.washingtonpost.com/outlook/the-ncaa-says-paying-athletes-hurts-their-education-thats-laughable/2018/09/20/147f26c0-bb80-11e8-a8aa-860695e7f3fc_story.html.

5. See Jasmine Harris, *In the Name of 'Amateurism,' College Athletes Make Money for Everyone Except Themselves*, THE CONVERSATION (Apr. 5, 2019, 7:58 PM), <https://theconversation.com/in-the-name-of-amateurism-college-athletes-make-money-for-everyone-except-themselves-114904> (noting that "college sports programs took in US \$14 billion in 2018 through ticket sales, television contracts, apparel deals and merchandise sales," while the athletes receive no portion of this revenue).

legal gymnastics through loopholes and narrow rulings regarding college compensation, harming its athletes, particularly Black athletes.⁶

Black men only make up 2.8% of undergraduate students at the University of North Carolina-Chapel Hill (“UNC”), but sixty-two percent of the school’s basketball and football players.⁷ Basketball and football athletes financially support entire non-profit producing programs such as track, tennis, golf, and swimming.⁸ For example, at Louisiana State University (“LSU”) alone, the 2018–2019 football team earned a profit of \$56.6 million.⁹ Excluding Men’s football, basketball, and baseball, twelve other LSU sports lost over \$1 million.¹⁰ That same Men’s Football roster was comprised of roughly 68% Black athletes.¹¹

It is no secret that Black athletes dominate the high revenue-producing sports of Men’s Basketball and Football.¹² To maintain amateur status and thus NCAA eligibility, these athletes cannot ever be directly paid for their efforts.¹³ Coaches, universities, and athletic departments consistently receive lucrative, multi-year contracts.¹⁴ Three notable Power Five¹⁵ coaches, Nick Saban of Alabama football, Dabo Swinney of Clemson football, and John Calipari of Kentucky basketball, each make roughly \$9 million annually.¹⁶ These contracts can last for up to ten years, and these

6. See *id.* (citing the NCAA’s insistence that college athletes must remain amateurs to preserve their college and educational experience).

7. Victoria L. Jackson, *A Jim Crow Divide in College Sports*, CHI. TRIB. (Jan. 16, 2018), <https://www.chicagotribune.com/opinion/commentary/ct-perspec-college-sports-ncaa-black-athletes-exploited-0117-20180116-story.html>.

8. *Id.*

9. Brooks Kubena, *LSU athletics brought in \$157 million in 2018-19; See Details of Annual Budget*, THE ADVOCATE (Jan. 24, 2020), https://www.theadvocate.com/baton_rouge/sports/lsu/article_6cf42366-3edb-11ea-970e-5bd6522b3e13.html.

10. *Id.*

11. *2019 Football Roster*, LSU SPORTS, <https://lsusports.net/sports/fb/roster/season/2019/> (last visited Jun. 13, 2021).

12. See Mark J. Burns, *Racial Divides Persist on Compensation for Student-Athletes*, MORNING CONSULT (Mar. 20, 2019), <https://morningconsult.com/2019/03/20/racial-divides-persist-on-compensation-for-student-athletes/> (noting that “in 2018, 56 percent of Division I men’s college basketball players and 48 percent of football student-athletes were black.”).

13. See Brandi Collins-Dexter, *NCAA’s Amateurism Rule Exploits Black Athletes as Slave Labor*, THE UNDEFEATED (Mar. 27, 2018), <https://theundefeated.com/features/ncaas-amateurism-rule-exploits-black-athletes-as-slave-labor/>.

14. *Id.*

15. The Power Five conferences are considered the highest level of Division I competition and is comprised of the Atlantic Coast Conference (“ACC”), Big Ten Conference, Big 12 Conference, Pac-12 Conference, and Southeastern Conference (“SEC”).

16. Ricky L. Jones, *Opinion: Power 5 Schools, Built on Black Athletes, Should*

coaches are some of the highest-paid employees in their respective states.¹⁷ Notably, in an industry dominated by Black male athletes, the head coaches and administrators are overwhelmingly white, with about eighty-two percent of college basketball coaches, ninety-two percent of Football Bowl Subdivision (“FBS”) head coaches, and eighty-six percent of conference commissioners are white.¹⁸ Moreover, For March Madness alone, the NCAA Men’s Basketball Championship tournament, Turner Sports and the NCAA entered into a television deal valued at \$8.8 billion.¹⁹

In 1992, Jalen Rose, Chris Webber, Juwan Howard, Jimmy King, and Ray Jackson decided to team up and play for the University of Michigan’s basketball program.²⁰ Referred to as the Fab Five, this is one of the most significant recruiting accomplishments in sports to date.²¹ Before the Fab Five’s recruitment, Michigan’s 1990 – 1991 season record was 14-15.²² After assembling the Fab Five, Michigan’s record jumped to 25-9 in 1992 and then to 31-5 in 1993 with back-to-back NCAA Finals appearances.²³

The Fab Five could have gone to any institution and achieved athletic dominance.²⁴ However, if another Fab Five appeared and attended a Historically Black College or University (“HBCU”) rather than a Predominately White Institution (“PWI”), they could find success on the court as well as through marketing compensation.²⁵ Under the AAPCA

Share Sports Wealth with HBCUs, COURIER J. (Apr. 15, 2020, 6:42 PM), <https://www.courier-journal.com/story/opinion/2020/04/15/ncaa-power-5-schools-should-share-sports-wealth-black-colleges/2994350001/>.

17. See John Duffley, *In 40 States, Sports Coaches are the Highest-Paid Public Employees*, FANBUZZ (Dec. 31, 2019, 12:04 PM), <https://fanbuzz.com/national/highest-paid-state-employees/> (noting that in 40 of 50 states, college head coaches were the highest-paid state employees during the 2018–2019 season).

18. See Jones, *supra* note 16. Exact percentages calculated by the author during research for this Comment.

19. *Id.*

20. Chris Tomasson, *Michigan’s Fab Five were Rock Stars at Minnesota’s Final Four in 1992*, TWIN CITIES, <https://www.twincities.com/2019/04/03/michigans-fab-five-captivated-the-country-at-twin-cities-final-four-in-1992/> (last updated June 9, 2020).

21. See Scott Davis, *Where are They Now? Michigan’s Legendary Fab 5 Team*, BUS. INSIDER, <https://www.businessinsider.com/where-are-they-now-michigan-fab-5-2017-3> (last updated Mar. 21, 2018) (describing the 1991–92 team’s “lasting impact . . . on basketball on all levels” and its status as having “some of the top recruits in the U.S.”).

22. *Michigan Wolverines School History*, SPORTS REFERENCE, <https://www.sports-reference.com/cbb/schools/michigan/> (last visited June 13, 2021).

23. *Id.*

24. See Kendrick Marshall, *The Fab Five Got It Wrong: They Needed to Look in the Mirror*, BLEACHER REP. (Mar. 14, 2011), <https://bleacherreport.com/articles/635835-the-fab-five-got-it-wrong-maybe-they-needed-to-look-in-the-mirror> (noting the potential “revolutionary” impact of the Fab Five playing for an HBCU).

25. See *id.* (highlighting that “the Fab Five became a commercial hit to the tune of

future Black stars can team up at an HBCU and completely change the college sports landscape again.²⁶

This Comment argues that passing the AAPCA, Fair Pay to Play Act, and similar legislation will allow college athletes to rightfully profit from their NIL and open the door for star athletes to choose HBCUs over traditional Power Five sports programs.²⁷ Part II of this Comment will explain the legislative and procedural battles student-athletes have faced when arguing against the NCAA for the right to earn compensation. Traditionally the NCAA has avoided compensating its athletes, and courts have avoided tackling the issue. Part III will analyze previous litigation under the lens of current and pending legislation surrounding these athletes' rights and allowances. Finally, Part IV will recommend a new route for Black student-athletes to take when advocating for the improvement of their rights and the prosperity of the Black community.

II. THE TROUBLED HISTORY OF STUDENT-ATHLETES AND THE NCAA

Since its inception, the NCAA has profited from the entertainment of student athletic competitions.²⁸ Utilizing the shield of amateurism, the NCAA succeeds in litigation suppressing player compensation and avoids allowing its athletes to profit from their NIL.²⁹ The NCAA defines an amateur as “someone who does not have a written or verbal agreement with an agent, has not profited above his/her actual and necessary expenses or gained a competitive advantage in his/her sport.”³⁰

\$10 million in merchandise sales for Michigan while on campus those two years.”).

26. See *id.* (“The Fab Five at an HBCU could have paved the way for more young black amateur athletes to consider those schools.”).

27. See Dennis Dodd, *Majority of Power Five Schools Favor Breaking Away to Form Own Division Within NCAA, Survey Shows*, CBS SPORTS (Oct. 13, 2020, 3:47 PM), <https://www.cbssports.com/college-football/news/majority-of-power-five-schools-fav-or-breaking-away-to-form-own-division-within-ncaa-survey-shows/> (defining the Power Five as athletic programs in the Big Ten, SEC, Big 12, Pac-12, and ACC athletic conferences).

28. See *Finances of Intercollegiate Athletics*, NCAA, <https://www.ncaa.org/about/resources/research/finances-intercollegiate-athletics> (last visited June 13, 2021) (stating that the NCAA’s “total athletic revenue” across all its athletics departments was \$18.9 billion in 2019).

29. See *O’Bannon v. NCAA*, 802 F.3d 1049, 1061 (9th Cir. 2015) (citing *NCAA v. Bd. of Regents of the Univ. of Okla.*, 468 U.S. 85 (1984)) (holding that “the compensation rules at issue here are not covered by the Sherman Act at all because they do not regulate commercial activity . . .”).

30. *What is Amateurism?*, NCAA, <https://ncaa.egain.cloud/kb/EligibilityHelp/content/KB-2219/What-is-amateurism> (last visited Dec. 27, 2021); see NAT’L COLLEGIATE ATHLETIC ASS’N, NCAA DIVISION I MANUAL § 12.1.2 (2021).

Power Five athletic programs are most often the primary source of revenue for a university.³¹ Moreover, select sports such as Men's basketball and football, usually generate enough revenue to support entire athletic departments.³² This lucrative business model consists of brand sponsorships, endorsements, and television broadcasting deals; however, the actual performers see little to no profit.³³

A. What is the NCAA and What is the Issue?

The NCAA is a non-profit organization that regulates collegiate athletics and provides a bridge between high school and professional sports.³⁴ NCAA rules restrict athletes' rights, preventing the athlete from profiting from their NIL.³⁵ Athletic programs have lost financial aid, recruiting resources, and post-season eligibility as a punishment for violating the NCAA's rules by attempting to compensate their players.³⁶ For example, Southern Methodist University's football program received the "death penalty" in 1987 for paying its future and present players, resulting in a canceled season, over fifty lost scholarships, recruiting restrictions, and post-season bans.³⁷ Today, several states have pending legislation to give college athletes their long-deserved right to receive compensation.³⁸

31. See David Broughton, *Power Five: An \$8.3 Billion Revenue Powerhouse*, SPORTS BUS. J. (Aug. 17, 2020), <https://www.sportsbusinessdaily.com/Journal/Issues/2020/08/17/Colleges/Revenue.aspx>.

32. Denise-Marie Ordway, *Power Five Colleges Spend Football, Basketball Revenue on Money-losing Sports: Research*, JOURNALIST'S RES. (Sept. 10, 2020), <https://journalistsresource.org/studies/society/education/college-sports-power-five-revenue/>.

33. See Broughton, *supra* note 31; see also Taylor Branch, *The Shame of College Sports*, THE ATLANTIC (Oct. 2011), <https://www.theatlantic.com/magazine/archive/2011/10/the-shame-of-college-sports/308643/> (stating that the SEC was the first to reach more than \$1 billion in "athletic receipts" with "[t]he Big Ten pursu[ing] closely at \$905 million [T]he great bulk of [the money] comes from television contracts.").

34. See NAT'L COLLEGIATE ATHLETIC ASS'N, NCAA DIVISION I MANUAL § 1 (2019).

35. See *id.* § 12.5.3 (allowing athletes to participate in "media activities" but prohibiting athletes from receiving any "remuneration" as a result of their participation in such an activity).

36. See, e.g., *Southern Methodist University Football Scandal*, AM. FOOTBALL DATABASE, https://americanfootballdatabase.fandom.com/wiki/Southern_Methodist_University_football_scandal (last visited Jun. 13, 2021).

37. *Id.* (using "death penalty" to describe the NCAA's cancellation of SMU's 1987 season).

38. See Zachary Zaggar, *4 Key Issues As States Tackle College Athlete Pay*, LAW360 (Oct. 9, 2020, 4:47 PM), <https://www.law360.com/articles/1318247/4-key-issues-as-states-tackle-college-athlete-pay> (explaining that states including California, Florida, Colorado, Nebraska, and New Jersey have passed laws to permit student-athlete

B. Cases Where Student-Athletes Fell Short

Despite raising legitimate arguments for compensation, student-athletes have long been unsuccessful in gaining the right to profit from their success. In *Marshall v. ESPN Inc.*,³⁹ former Division I Men's basketball and football players failed to gain publicity rights under Tennessee state law after suing several athletic conferences and broadcasting networks.⁴⁰ The players alleged that defendants used their publicity rights without their consent.⁴¹ The NCAA's defense was rooted in its definition of amateurism: "amateurs in intercollegiate sport[s], and their participation should be motivated primarily by education and by the physical, mental and social benefits to be derived . . . and student-athletes should be protected from commercial exploitation by professional and commercial enterprises."⁴² Notably, the court failed to address compensation and fairness.⁴³

Similarly, in *Northwestern University and College Athletes Players Association* ("CAPA"),⁴⁴ athletes unsuccessfully petitioned the National Labor Relations Board ("the NLRB") for compensation rights. Here, football players from Northwestern University asked the NLRB to extend labor rights to college athletes because the players generated substantial amounts of money for their institution.⁴⁵ The players argued that their receipt of grant-in-aid scholarship funds for their athletic performance classified them as school employees.⁴⁶ The NLRB declined to extend jurisdiction, instead, electing to not weigh in on the substantive issue.⁴⁷ The NLRB explained that it would not be appropriate to decide on this matter given that Northwestern was the only private institution in the Big Ten Conference, and this decision would create precedent over public FBS teams.⁴⁸

compensation).

39. 111 F. Supp. 3d 815 (M.D. Tenn. 2015).

40. *Id.* at 820–21.

41. *See id.* at 823 (noting the statutory right of publicity violation under Tennessee law).

42. *Id.* at 822–23.

43. *Id.* at 822.

44. 362 N.L.R.B. 1350 (2015).

45. *Id.* at 1351 ("Northwestern's football program generated some \$30 million in revenue.").

46. *See id.* at 1350–51.

47. *See id.* at 1355 (refusing to decide "whether the scholarship players are employees under Section 2(3)").

48. *See id.* at 1354; *see also* *How Do the Rules Differ on a Public vs. Private College Campus*, ACAD. SUCCESS (May 10, 2019), <https://academysuccess.com/how-do-the-rules-differ-on-a-public-vs-private-college-campus/> (explaining that private universities do not receive funding through taxes, and therefore, they may impose their own rules and regulations).

In addition to fighting for compensation, college athletes have also attempted to protect their NIL from being utilized for profit by other entities.⁴⁹ In *In re NCAA Student-Athlete Name & Likeness Licensing Litigation*,⁵⁰ the Ninth Circuit analyzed college athletes' name and likeness rights concerning video games. Electronic Arts ("EA") created a college football video game series in which college football players' data was used to develop user-controlled avatars for in-game use.⁵¹ Here, the issue was whether college athletes had name and likeness rights to the video game avatars based on their real-life attributes.⁵² The Ninth Circuit established that college athletes have a legitimate right to protect their NIL, but courts have failed to extend this to athletic compensation.⁵³ Despite the court finding that the First Amendment did not protect EA's use of the athletes' NIL under the transformative use test, no direct protections were awarded to the harmed college athletes.⁵⁴

EA has partnered with the Collegiate Licensing Company to bring back the coveted NCAA Football video game franchise amid the AAPCA likeness conversation.⁵⁵ This franchise was halted by *In re NCAA Student-Athlete Name & Likeness Licensing Litigation* and *O'Bannon v. National Collegiate Athletic Association*.⁵⁶ While both cases resulted in settlements for their respective players, neither case established a broader system to compensate athletes for their NIL rights and participation in the video game franchise.⁵⁷ EA and the Collegiate Licensing Company are attempting to toe the legal line of likeness by opting to "include the rights from more than 100

49. E.g., *In re NCAA Student-Athlete Name & Likeness Licensing Litig.*, 724 F.3d 1268, 1271 (9th Cir. 2013).

50. 724 F.3d 1268 (9th Cir. 2013).

51. *Id.* at 1271.

52. *Id.*

53. See *id.* at 1284 (noting that "EA's use of the likenesses of college athletes like Samuel Keller in its video games is not, as a matter of law, protected by the First Amendment," due to the transformative use test not standing as a valid defense).

54. See *Keller v. Elec. Arts, Inc.*, No. 4:09-cv-1967, 2015 U.S. Dist. LEXIS 114387 (N.D. Cal. Aug. 18, 2015) (marking the official settlement of the dispute with cash payouts, instead of legal protections).

55. Zachary Zaggar, *EA To Bring Back College Football Game Amid NIL Debate*, LAW360 (Feb. 2, 2021, 8:55 PM), <https://www.law360.com/articles/1351290/ea-to-bring-back-college-football-game-amid-nil-debate>.

56. *In re NCAA Student-Athlete Name & Likeness Licensing Litigation*, 724 F.3d at 1271; *O'Bannon v. NCAA*, 802 F.3d 1049 (9th Cir. 2015).

57. Zaggar, *EA To Bring Back College Football Game Amid NIL Debate*, *supra* note 55 (stating that EA and Collegiate settled with the plaintiffs for \$40 million, and the NCAA settled with the players for \$20 million).

institutions to use the logos, stadiums, uniforms and game day traditions.”⁵⁸ However, the game and its avatars will not contain any characteristics of real-life college athletes.⁵⁹

C. New Legislation to Level the Playing Field

Previously, the NCAA barred student-athlete compensation to maintain the line between amateur and professional athletics, that decision is now being challenged by state legislatures across the country.⁶⁰ First introduced in California, the revolutionary Fair Pay to Play Act (“FPPA”) allows college athletes to receive marketing compensation without forgoing their NCAA eligibility.⁶¹ The FPPA will come into effect in January 2023 and permits student-athletes to receive compensation outside of a traditional athletic scholarship.⁶² Similar legislation around the country has placed pressure on the NCAA to reform its bylaws and address the issue of student-athlete compensation.⁶³ Several other states, including, New Jersey, Colorado, Florida, and Nebraska, have also passed legislation to combat the NCAA’s excessive regulation over student-athlete compensation.⁶⁴ In each state, the respective compensation laws will prohibit colleges and universities from denying their athletes’ right to earn compensation as the result of marketing their NIL, placing immense pressure on the NCAA.⁶⁵

The FPPA, for example, sets clear compensation guidelines for post-secondary education institutions and athletic conferences within certain states.⁶⁶ For instance, these schools cannot restrict athletes from marketing themselves to local brands, organizations, and third-party sponsors.⁶⁷

58. *Id.*

59. *Id.*

60. *Maintaining Amateur Statuses to Play Sports in College*, PETERSON’S (Dec. 13, 2017), <https://www.petersons.com/blog/maintaining-amateur-status-to-play-sports-in-college/>.

61. CAL. EDUC. CODE § 67456 (West 2021).

62. *Id.*

63. Dan Murphy, *College Basketball Players Push for NIL Reform Using #NotNCAAProperty Message*, ESPN (Mar. 17, 2021), https://www.espn.com/mens-college-basketball/story/_/id/31082285/college-basketball-players-push-nil-reform-using-notncaaproperty-message (“Six states have already passed laws that will make current NCAA amateurism rules illegal in the future, and more than a dozen other states have similar bills actively moving through the legislative process.”).

64. See Zaggar, *EA To Bring Back College Football Game Amid NIL Debate*, *supra* note 55.

65. See, e.g., S. 414, 117th Cong. § 4 (2021) (conveying a list of conference and school prohibitions to protect student athletes).

66. EDUC. § 67456.

67. *Id.*

Additionally, the NCAA is barred from punishing athletes from capitalizing on their marketability by revoking their eligibility.⁶⁸ After the FPPA takes effect in 2023, athletes will no longer fear losing their eligibility or scholarship if they choose to market themselves at the state and local level.⁶⁹

Notably, this Act, only affords state-level protection as there is no active federal legislation supporting student-athlete compensation.⁷⁰ The AAPCA, and others like it, are designed to allow athletes to market themselves and receive compensation on the federal level.⁷¹

Thus, it also protects the athletes and schools from being barred from athletic competitions if such compensation is received, and fills the gaps left by the NCAA and previous court's refusal to reform.⁷² This bill will allow athletes to receive third-party sponsorships and similarly bar any collegiate athletic association from punishing the school or its athletes for engaging in such activity.⁷³ Under the bill, athletes may enter endorsement contracts with companies, except for those promoting alcohol, tobacco, gambling, or drugs.⁷⁴ As seen in other facets of the entertainment industry, student-athletes can enjoy proper protection of their likeness.⁷⁵ Essentially, this legislation gives college athletes their right to publicity.

68. *Id.* § 67456(a)(3) (prohibiting the NCAA, other athletic conferences, and universities from “prevent[ing] a student of a post-secondary educational institution participating in intercollegiate athletics from earning compensation as a result of the use of the student’s name, image, or likeness”).

69. *See id.*

70. *See Michael McCann, California’s New Law Worries the NCAA, But a Federal Law Is What They Should Fear*, SI (Oct. 4, 2019), <https://www.si.com/college/2019/10/04/ncaa-fair-pay-to-play-act-name-likeness-image-laws> (explaining the unavoidable risks surrounding competing state and federal legislation with respect to student-athlete compensation and NIL rights).

71. Amateur Athletes Protection and Compensation Act, S. 414, 117th Cong. (2021); *see also* H.R. 3379, 117th Cong. § 6 (2021) (establishing a government corporation to allow student-athlete agency agreements, NIL agreements, and compensation allowances).

72. *See generally* S. 414, 117th Cong. (2021) (balancing prohibitions against allowances throughout the bill to elucidate the areas of student-athlete compensation and NIL concerns that Congress has decided to address with legislation).

73. *Id.*

74. *See Zagger, 4 Key Issues As States Tackle College Athlete Pay*, *supra* note 38 (noting that “the NCAA now faces increased pressure to reform, spurring Congress to consider a federal law to ensure consistency across the country”).

75. *See Midler v. Ford Motor Co.*, 849 F.2d 460, 463 (9th Cir. 1988) (explaining that professional singers with distinct voices have a legitimate right to protect when and where their likenesses are used).

D. Attempting to Protect College Athletes

The right to publicity awards protection for celebrities and should be extended to a modern celebrity, the student-athlete. The Ninth Circuit grappled with the right to publicity in *White v. Samsung Electronics America, Inc.*⁷⁶ There, “Wheel of Fortune” host, Vanna White, sued Samsung Electronics for using a robotic look-a-like in commercials.⁷⁷ Ultimately, the court recognized that celebrities have the right to protect themselves from exploitation for profit,⁷⁸ explaining that the “law protects the celebrity’s sole right to exploit this value,” a value also attributable to the modern college athlete.⁷⁹

In *O’Bannon*, former Men’s basketball and football players brought a class action against the NCAA for violating their NIL rights.⁸⁰ The Ninth Circuit acknowledged that the NCAA must operate under the Sherman Act’s rules, but the court emphasized the ruling’s limited scope rooted in the NCAA’s amateurism rules.⁸¹ More specifically, the court found that the NCAA’s rules surrounding NIL violated the Sherman Act and federal antitrust laws because they restricted the athletes’ freedom to receive any compensation for their efforts.⁸² Accordingly, the court held that the NCAA had no right to profit off an individual athlete’s image while withholding the athlete’s compensation but did not require the NCAA to affirmatively allow the student to profit off their image.⁸³

The court in *O’Bannon* applied the Rule of Reason and found it necessary for the NCAA to allow its schools to offer up to the cost of attendance to their student-athletes with a deferred payment of \$5,000 upon graduation because it was a pro-competitive policy and attracted athletes.⁸⁴ The Rule of Reason is “a standard used in restraint of trade actions that requires the

76. See 971 F.2d 1395 (9th Cir. 1992) (diving into the legal issues surrounding right to publicity and celebrities).

77. *Id.* at 1396.

78. See *id.* at 1398–99 (noting that the law protects celebrities’ right to exploit or market their own identity if they so choose).

79. See *id.* (explaining that “[c]onsiderable energy and ingenuity are expended by those who have achieved celebrity value to exploit it for profit”).

80. *O’Bannon v. NCAA*, 802 F.3d 1049 (9th Cir. 2015).

81. *Id.* at 1062–63; see also Bobby Chen, *Antitrust Law and the Future of the NCAA’s Amateurism Rules*, REGUL. REV. (Feb. 21, 2019), <https://www.theregreview.org/2019/02/21/chen-antitrust-future-ncaa-amateurism-rules/> (“If the [NCAA’s] amateurism rules were no longer necessary or procompetitive, the court wrote, they would then be illegal under federal antitrust law.”).

82. *O’Bannon*, 802 F.3d at 1067–68.

83. *Id.*

84. *Id.* at 1078.

plaintiff to show and the factfinder to find that under all the circumstances the practice in question unreasonably restricts competition in the relevant market.”⁸⁵ By holding that the NCAA’s compensation rules were subject to antitrust scrutiny, the court placed pressure on the NCAA to reform its bylaws concerning athlete compensation.⁸⁶ In the wake of *O’Bannon*, it was made clear that the NCAA regulated “labor for in-kind compensation . . . [and student-athlete labor] is a quintessentially commercial transaction.”⁸⁷

E. The Exploitation of Black Athletes

An HBCU is defined by the Higher Education Act of 1965 as “any historically [B]lack college or university that was established prior to 1964, whose principal mission was, and is, the education of [B]lack Americans.”⁸⁸ These institutions provide Black students non-discriminatory access to higher education and play a significant role in professional development.⁸⁹ HBCU graduates account for 25% of African-American college graduates, and 50% of all future African-American lawyers graduate from an HBCU.⁹⁰

As opposed to Power Five institutions, HBCUs have proven to be a more difficult path to play professional sports.⁹¹ For example, there is only one active player from an HBCU in the NBA, Robert Covington from Tennessee State University.⁹² When it comes to college compensation, HBCUs are still under the NCAA’s bylaws and cannot directly pay their Black athletes.⁹³ Despite fewer opportunities to play professional sports and resource inequality, HBCUs provide Black students with a fair chance for a college

85. *Rule of Reason*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/legal/rule%20of%20reason> (last visited June 13, 2021).

86. *O’Bannon*, 802 F.3d at 1079.

87. *Id.* at 1066.

88. *White House Initiative on Historically Black Colleges and Universities*, U.S. DEP’T OF EDUC., <https://sites.ed.gov/whhbcu/one-hundred-and-five-historically-black-colleges-and-universities/> (last visited Jun. 13, 2021).

89. *What is an HBCU?*, HBCU LIFESTYLE, <https://hbculifestyle.com/what-is-an-hbcu/> (last visited June 13, 2021).

90. *Id.*

91. Jerry Bembry, *Texas Southern Stars Want to Reverse Trend of HBCU Players Not Making It to the NBA*, THE UNDEFEATED (Mar. 16, 2018), <https://theundefeated.com/features/texas-southern-stars-demontrae-jefferson-trayvon-reed-want-to-reverse-trend-of-hbcu-players-not-making-it-to-the-nba/>.

92. Gilbert McGregor, *HBCU NBA Players: Historically Black Colleges and Universities Have Produced Some of the Game’s Most Iconic Figures*, NBA (Mar. 7, 2021), <https://ca.nba.com/news/hbcu-historically-black-colleges-and-universities-nba-legends-list-active-players-hall-of-famers/1owv/b4kla7mt1k12hrv1ld7dz>.

93. David Steele, *Can HBCU Athletes Get Paid for Use of Their Images and Names?*, THE UNDEFEATED (Dec. 18, 2019), <https://theundefeated.com/features/can-hbcu-athletes-get-paid-for-use-of-their-images-and-names/>.

education.⁹⁴ With the help of the AAPCA and FPPA, they will become a collegiate destination for Black athletes to promote the NCAA's mission for competitive equality.⁹⁵

The opportunity for a professional sports career heavily incentivizes attending a predominately white Power Five institution⁹⁶ as these programs produce the majority of professional athletes.⁹⁷ From a competitive standpoint, choosing a Power Five program carries the potential to earn millions at the professional level.⁹⁸

To meet the media and endorsement demands for elite performance, Black athletes in revenue-producing sports must spend over fifty hours a week practicing and competing.⁹⁹ However, they are only compensated up to \$5,000 to meet the cost of attendance for an institution.¹⁰⁰ Black athletes are promised an elite education at top universities, but in reality, their athletic performance is prioritized to benefit coaches, athletic departments, and universities.¹⁰¹ The athletes are pressured to preference practice over classes, and the classes they do attend are often effortless or fraudulent, evidenced by *McAdoo v. UNC*,¹⁰² where former student-athletes sued the University of North Carolina for failing to provide them an adequate education.¹⁰³ With the promise of receiving a purposeful education from UNC and the support

94. *See id.*

95. *Id.*

96. *Where the NBA Players Come From*, RPI RATINGS, <http://rpi-ratings.com/NBA.php> (last visited June 13, 2021) (stating that of the 496 players active in the NBA during the 2019–20 season, 307 come from Power Five schools); Spencer Parlier, *NFL Players by College on 2020 Rosters*, NCAA (Sept. 8, 2020), <https://www.ncaa.com/news/football/article/2020-09-07/nfl-players-college-2020-rosters> (stating that of the 1696 players active in the NFL during its 2020 season, 1512 come from Power Five Conferences).

97. *Where the NBA Players Come From*, *supra* note 96; Parlier, *supra* note 96.

98. *See* Parlier, *supra* note 96 (noting in particular, the SEC and Big Ten conferences, have the most NFL players of all college conferences).

99. *See* Victoria L. Jackson, *A Jim Crow Divide in College Sports*, CHI. TRIB. (Jan. 16, 2018), <https://www.chicagotribune.com/opinion/commentary/ct-perspec-college-sports-ncaa-black-athletes-exploited-0117-20180116-story.html> (noting further that these athletes often enroll in easier classes than athletes in sports who receive less media attention, such as track and field, and may not graduate because of their intense practice schedules, media schedules, and studying playbooks).

100. *See* O'Bannon v. NCAA, 802 F.3d 1049, 1078 (9th Cir. 2015) (noting television sports consultant Neal Pilson's skepticism that "paying students \$5,000 per year will be as effective in preserving amateurism as the NCAA's current policy").

101. *See* Jackson, *supra* note 99.

102. *Id.*; e.g., *McAdoo v. Univ. of N.C. at Chapel Hill*, 248 F. Supp. 3d 705 (M.D.N.C. 2017).

103. *McAdoo*, 248 F. Supp. 3d at 709 (alleging that student athletes were instructed to take essentially meaningless classes).

of the athletic department, star student-athletes were “funneled into a shadow curriculum of bogus courses.”¹⁰⁴

The current student-athlete argument is not advocating for direct pay but allowing athletes to profit from their rights through individual efforts.¹⁰⁵ Most athletes do not make it to the professional level and only have a small four-year window to capitalize on athletic success.¹⁰⁶ Black athletes bring in a substantial amount of revenue that supports entire athletic programs.¹⁰⁷ This newfound freedom will allow Black athletes to choose athletic programs without the fear of losing their marketability because they can capitalize nationally on their NIL rights from any university.¹⁰⁸ With the FPPA, AAPCA, and other new college compensation acts, the door is now open for Black athletes to play for HBCUs and still be in the national spotlight.¹⁰⁹

III. HOW THE PASSING OF COLLEGE ATHLETE COMPENSATION LEGISLATION WILL HAVE AN UNFORESEEN EFFECT ON THE COLLEGE LANDSCAPE

The AAPCA’s impact on NIL and the right to publicity will help rectify the financial injustice created by the NCAA’s exploitation of Black athletes by providing the opportunity for equitable compensation.¹¹⁰ Without the NCAA controlling players under its amateurism rules, the athletes will have more freedom to choose where they wish to participate in collegiate sports.¹¹¹

104. *Id.*

105. See Daniel Locke, *Should NCAA Athletes Be Allowed to Profit from Their Own Fame?*, BLEACHER REP. (Oct. 31, 2011), <https://bleacherreport.com/articles/918372-free-market-ncaa-athletes-should-be-allowed-to-profit-off-their-own-fame>.

106. See *Estimated Probability of Competing in Professional Athletics*, NCAA, <https://www.ncaa.org/about/resources/research/estimated-probability-competing-professional-athletics> (last updated Apr. 8, 2020) (explaining that only roughly twenty-one percent of draft eligible NCAA athletes are drafted to professional leagues).

107. See Jackson, *supra* note 99.

108. Dan Murphy, *Everything You Need to Know About the NCAA’s NIL Debate*, ESPN (Sept. 1, 2021), https://www.espn.com/college-sports/story/_/id/31086019/everything-need-know-ncaa-nil-debate (explaining how NCAA rule changes and a Supreme Court decision have created a way for athletes to capitalize on their name, image and likeness).

109. See Marshall, *supra* note 24.

110. See Earl Smith, *On The Issues Associated With Exploitation of Student Athletes*, SMITH & HATTERY (Sep. 7, 2020), <https://smithandhattery.com/2020/09/07/on-the-issues-associated-with-exploitation-of-student-athletes/> (noting that during a global pandemic in which Black athletes are being compelled to play sports unpaid while white coaches are receiving bonuses).

111. See Richard Obert, *Recruiting Landscape Will Change with California’s ‘Fair Pay to Play’ Law*, AZ CENT. (Oct. 13, 2019), <https://www.azcentral.com/story/sports/>

This presents the opportunity for Black athletes to play for HBCUs, as without federal legislation and due to their limited location, many HBCU's would be left without the opportunity to attract athletes.¹¹²

A. How the NCAA Has Failed Its Athletes

The NCAA acts as its own court of law and operates under its own system of regulations.¹¹³ The court in *Board of Regents v. NCAA*¹¹⁴ notes that “the NCAA is essentially an integration of the rulemaking and rule-enforcing activities of its member institutions.”¹¹⁵ Courts have heavily deferred to decisions made by NCAA administrators on the topic of sports, as judges do not wish to impede on the nature of college athletics.¹¹⁶ Under these protections, the NCAA has failed to establish a monetary system of compensation for its primary performers, despite requests from its current and former student-athletes.¹¹⁷ In essence, the NCAA has ignored its athletes and shown a preference for making money over the best interest of its players.¹¹⁸

B. Case Law's Shortcomings and How Future Collegiate Compensation Litigation Can Provide Relief

Courts' historical reluctance to afford student-athletes compensation may finally be subject to legislative scrutiny. In *Marshall*, the plaintiffs sought compensation for the lucrative broadcasting deals with ESPN.¹¹⁹ Here, the

high-school/2019/10/13/recruiting-landscape-change-fair-pay-play-act/3946513002/ (alleging that this new legislation will greatly impact college athletics in as early as the program's recruiting stage).

112. See *List of HBCUs by State*, HBCUFIRST, <https://hbcufirst.com/resources/hbcu-list-map> (last visited Feb. 14, 2022) (highlighting that HBCUs are located in only 19 states).

113. *Bd. of Regents of Univ. of Okla. v. NCAA*, 707 F.2d 1147, 1153 (10th Cir. 1983).

114. 707 F.2d 1147 (10th Cir. 1983).

115. *Id.*

116. *Id.* (“[The NCAA] is the guardian of amateurism in the athletic programs of its members in essentially all intercollegiate sports.”).

117. See *id.*

118. See Kevin B. Blackstone, *The NCAA was Created to Protect College Athletes. Now It's Trotting Them Out During a Pandemic*, WASH. POST (Dec. 13, 2020, 11:48 AM), <https://www.washingtonpost.com/sports/2020/12/13/ncaa-college-basketball-pandemic/> (highlighting the NCAA's insistence on continuing a college sports season during the Coronavirus pandemic).

119. See *Marshall v. ESPN, Inc.*, 111 F. Supp. 3d 815, 821 (M.D. Tenn. 2015) (including other networks such as “CBS Broadcasting Inc., NBCUniversal Media, LLC, ABC, Inc., Fox Broadcasting Company, Big Ten Network, LLC, SEC Network, and Longhorn Network.”).

student-athletes challenged the NCAA's revenue streams, such as Power Five sports programs including FBS football and Division I basketball.¹²⁰ The court deferred to the NCAA's rules barring amateurs from receiving compensation¹²¹ and failed to extend such rights to the players through the right of publicity or the Lanham Act.¹²² However, if *Marshall* were decided under the FPPA or the AAPCA, the court might resolve the case differently.

With little to no legislative backing, the plaintiffs could not rely on the Tennessee Personal Rights Protection Act.¹²³ Here, the plaintiffs saw issues with the NCAA and broadcasting companies entering into multi-billion dollar deals and the athletes receiving none of the profits for their efforts.¹²⁴ While acknowledging this issue, the court failed to establish a pay-for-play standard and found for the NCAA and broadcasting networks once again.¹²⁵ The court further noted that the right to publicity does not establish a fundamental right to profit off that publicity.¹²⁶

Beginning in 2023, California and several other states will make this a non-issue.¹²⁷ Student-athletes' NIL rights will be protected concerning compensation, and the NCAA is barred from "prevent[ing] a student of [a] post-secondary educational institution participating in intercollegiate athletics from earning compensation"¹²⁸ Student-athletes have tried multiple avenues to receive compensation for their time and dedication to

120. See *id.* at 821 (alleging in the complaint that the athletes were excluded from their own licensing marketplace with no compensation).

121. See *id.* at 821, 838 (concluding that it is not the court's role to determine whether student-athletes should receive compensation while noting that an "amateur" is an artificial label in college sports); see also *James Wiseman, the NCAA, and State Action*, HARV. CIV. RTS. – CIV. LIBERTIES L. REV. (Dec. 3, 2019), <https://harvardcrcl.org/james-wiseman-the-ncaa-and-state-action/> (noting that "[s]chools escape accountability by deferring to the NCAA, while the NCAA claims its conduct is private and exempt from the requirements of constitutional rights").

122. See *Marshall*, 111 F. Supp. 3d at 824 (citing *Wells v. Chattanooga Bakery, Inc.*, 448 S.W.3d 381, 390 (Tenn. Ct. App. 2014) and *Apple Corps Ltd. v. A.D.P.R., Inc.*, 843 F. Supp. 342, 348 (M.D. Tenn. 1993)) (The TPRPA "was intended to create an inheritable property right for those people who use their names or likenesses in a commercial manner, such as an entertainer or sports figure — someone who uses his or her name for endorsement purposes[.]"); see also *id.* at 836–37 (examining the Lanham Act claim).

123. *Id.* at 824–26 (reasoning that although the plaintiffs had a common law claim to their right to publicity in Tennessee, they had no federal claim to publicity rights as federal statutes prevail over common law claims).

124. *Id.* at 823–24.

125. *Id.* at 838.

126. See *id.* at 830 (highlighting that there is no "fundamental right" to profit).

127. E.g., CAL. EDUC. CODE § 67456 (West 2021).

128. See *id.* § 67456(a)(2).

college sports but have not succeeded in the courtroom.¹²⁹ Currently, these statutes are the only means of protection for these college athletes.¹³⁰

The plaintiffs in *Northwestern University and CAPA* afforded the NLRB an opportunity to assert jurisdiction and deem the players' participation as inequitable working conditions¹³¹ however, the board found that the athletes could not gain labor rights as employees because of their amateur status.¹³² The NCAA has scarcely protected amateurism as it is essential to the make-up of collegiate sports.¹³³ This status allows for collegiate athletic competition and creates a clear line of distinction between college and professional sports.¹³⁴ Thus, while the *Northwestern University and CAPA* athletes sought to challenge this approach and force the NCAA to acknowledge its players as employees,¹³⁵ this argument mainly failed due to the lack of legislation, such as the upcoming student-athlete compensation laws.¹³⁶

The NLRB, in 2023, must analyze the student-athlete compensation laws and how they now recognize a student-athletes' amateur status in light of these changes.¹³⁷ The College Athlete Bill of Rights would give student-athletes the explicit right to "market the use of their NIL or athletic reputations."¹³⁸ With this legislation in play, student-athletes may be able to

129. See, e.g., *Nw. Univ. & Coll. Athletes Players Ass'n (CAPA)*, 362 N.L.R.B. 1350 (2015) (finding that it would not promote stability in labor relations to assert jurisdiction in this case given that Northwestern is a private institution).

130. See Jack Kelly, *Newly Passed California Fair Pay to Play Act Will Allow Student Athletes to Receive Compensation*, FORBES (Oct. 1, 2020, 12:36 PM), <https://www.forbes.com/sites/jackkelly/2019/10/01/in-a-revolutionary-change-newly-passed-california-fair-pay-to-play-act-will-allow-student-athletes-to-receive-compensation/?sh=6e266d1b57d0> (explaining that college athletes can now receive compensation from endorsing products).

131. See *Nw. Univ. & CAPA*, 362 N.L.R.B. at 1352 (citing *NLRB v. Town & Country Electric, Inc.*, 516 U.S. 85, 89 (1995)) (pointing to a goal of the case being to obtain rights "belong[ing] only to those workers who qualify as 'employees'").

132. *Id.* at 1352.

133. See Robert Litan, *The NCAA's "Amateurism" Rules*, MILKEN INST. REV. (Oct. 28, 2019), <https://www.milkenreview.org/articles/the-ncaas-amateurism-rules> (citing the "preservation of amateurism" as the main factor the NCAA exists).

134. See *id.* (pointing to two reasons for the NCAA's stout reasons for protection: lowered fan interest and scholarship caps).

135. See *Nw. Univ. & CAPA*, 362 N.L.R.B. at 1351–52 (noting that "if the players are not statutory employees, then the Board lacks authority").

136. See *id.* (explaining that the NLRB has never before dealt with athletes, and in this context, it were not inclined to do so).

137. See *id.* (declining to decide on the issue because of the lack of congressional or legislative direction).

138. College Athletes Bill of Rights, S. 5062, 116th Cong. § 3(a)(1) (2020).

argue that they deserve university employment status.¹³⁹ Thus, while the NLRB previously declined to extend authority, the student-athletes in 2023 will have legislative protections to warrant a proper analysis.¹⁴⁰ The goal in seeking employment status was to provide accurate compensation, and athletes will now get a fair chance to receive payment under the new legislation.¹⁴¹

C. The Impact of Modern College Athlete Compensation Legislation

The AAPCA will render previous litigation surrounding players' and entertainers' rights moot.¹⁴² If the AAPCA is enacted, cases similar to *O'Bannon* would likely have different outcomes.¹⁴³ There, the court used amateurism as a shield to antitrust scrutiny under the Sherman Act.¹⁴⁴ The issue of antitrust scrutiny is now under the Supreme Court's review, but in applying the new student-athlete compensation laws, the NCAA is left with little to no defense.¹⁴⁵ In several states, the NCAA is now barred from restricting scholarships or revoking eligibility from players seeking compensation.¹⁴⁶

The California Fair Pay to Play Act, for example, does not explicitly require a school to pay its student-athletes; however, it allows athletes to promote and endorse their personal brands like an ordinary non-athlete college student.¹⁴⁷ Further, this Act enables student-athletes to protect themselves by hiring management without fear of the NCAA revoking their

139. *See id.*

140. *See Nw. Univ. & CAPA*, 362 N.L.R.B. at 1352; S. 414, 117th Cong. (2021).

141. *See Nw. Univ. & CAPA*, 362 N.L.R.B. at 1352; S. 414, 117th Cong. (2021).

142. Amateur Athletes Protection and Compensation Act, S. 414, 117th Cong. (2021) (allowing student athletes to receive compensation).

143. *O'Bannon v. NCAA*, 802 F.3d 1049 (9th Cir. 2015) (suing over the use of a student athlete's NIL in a video game without compensation or consent).

144. *Id.* at 1052–53.

145. *Supreme Court Agrees to Hear NCAA Athlete Compensation Case*, ESPN, https://www.espn.com/college-sports/story/_/id/30530625/supreme-court-agrees-hear-ncaa-athlete-compensation-case (last visited June 13, 2021).

146. *See Zagger, EA To Bring Back College Football Game Amid NIL Debate*, *supra* note 55.

147. Lee Green, *Impact of California's 'Fair Pay to Play Act' On High School Athletes*, NFHS (Nov. 13, 2019), <https://www.nfhs.org/articles/impact-of-california-s-fair-pay-to-play-act-on-high-school-athletes/> (arguing the promotion of economic fairness since student-athletes can now fully be a part of the college experience and enjoy the freedom to market themselves on any platform).

eligibility status.¹⁴⁸ This legislation has spurred interstate involvement to reevaluate the compensation rights system for student-athletes.¹⁴⁹

The specific endorsement deal provisions also allow for flexibility regarding an athlete's right to receive compensation.¹⁵⁰ This language restricts schools from denying a student-athlete the right to a brand deal without a valid reason.¹⁵¹ The Act explains the need for explicit contractual language showing a conflict between the school's brand and the athlete's potential sponsor.¹⁵²

Athletic brands such as Nike, Adidas, and Under Armour have long battled for control of the college sports landscape regarding sponsorship.¹⁵³ In FBS college football, Nike is the sponsor for 79 of the 128 FBS teams.¹⁵⁴ Nike's association conveys not only its brand dominance but also a correlation of on-field success.¹⁵⁵ Student-athlete compensation laws are drafted mainly to prevent contractual disputes between large brands like Nike, Adidas, and Under Armour, as that would cause complicated litigation and jade the primary purpose of providing student-athletes an avenue to receive compensation.¹⁵⁶ In reality, these laws will enable lesser-known amateur

148. See *id.* (affirming that “the statute allows college student-athletes to hire professional representation for NIL matters, but requires that those individuals be licensed attorneys or athlete-agents”).

149. See Gregg E. Clifton, *UPDATE: Michigan Joins Growing Number of States Granting Name, Image, Likeness Rights to Collegiate Student-Athletes*, JACKSONLEWIS (Jan. 1, 2021), <https://www.collegeandprosportslaw.com/> (noting that with the passing of House Bills 5217 and 5218, Michigan has become the sixth state to “pass a law protecting the rights of student-athletes to be paid for the commercial use of their name, image, and likeness rights”).

150. See CAL. EDUC. CODE § 67456(e)(1) (West 2021) (“A student athlete shall not enter into a contract providing compensation to the athlete for use of the athlete's name, image, or likeness if a provision of the contract is in conflict with a provision of the athlete's team contract.”).

151. See *id.* § 67456(f) (“A team contract of a postsecondary educational institution's athletic program shall not prevent a student athlete from using the athlete's name, image, or likeness for a commercial purpose when the athlete is not engaged in official team activities.”).

152. *Id.* § 67456(e)(3).

153. See *Which Brand Has the Most Influence in College Sports Nike, Adidas, Or Under Armour?*, BYOG, <https://www.byoglogo.com/brand-influence-college-sports-nike-adidas-armour/> (last visited June 13, 2021) (explaining that since the 1980s, athletic brands have found major influence and success with brand association and sports).

154. See Sara Griffith, *Statistically Speaking Nike Dominates College Football*, SAMFORD UNIV. (July 18, 2017), <https://www.samford.edu/sports-analytics/fans/2015/nike-and-its-domination-of-college-football> (explaining that Nike is the lead sponsor across the college sports landscape).

155. See *id.* (“Nike sponsors 88.2 percent of the last 19 FBS National Champions and 64.7 percent of the last FCS National Champions.”).

156. See Steve Radick, *Brand Marketing and the Fair Pay to Play Act*, PUB.

athletes to accept deals from local vendors.¹⁵⁷ Thus, allowing athletes at every collegiate level to market themselves as influencers.¹⁵⁸

D. Setting a New Legal Standard for Compensation

The AAPCA and FPPA set forth a new standard for college athletes with respect to compensation. Now, athletes faced with similar complications as seen in *In re NCAA Student-Athlete Name & Likeness Licensing Litigation* will achieve a just outcome.¹⁵⁹ There, the court found that college athletes had publicity and likeness rights¹⁶⁰ and that EA improperly applied California's transformative use defense in favor of the plaintiff.¹⁶¹ However, this decision was a hollow win for the athletes. In reasoning that the right to publicity is not a right to compensation, the court failed to extend any compensation towards athletes, and EA merely discontinued the gaming series.¹⁶² However, under the new AAPCA and California's FPPA, the game may make its return with its featured college athletes having the ability to receive a percentage of the profits.¹⁶³ Accordingly, plaintiffs today would have the proper tools to achieve a more favorable and applicable outcome.

These tools will soon be put to the test as EA announced the return of the NCAA Football franchise in February 2021.¹⁶⁴ However, instead of agreeing

RELATIONS STRATEGY, <https://www.steveradick.com/2019/11/22/brand-marketing-and-the-fair-pay-to-play-act/> (last visited June 13, 2021) (touching on the overarching impact the California Fair Pay to Play Act will have on the sports branding industry).

157. *See id.* (considering the idea that a third-string recruit who is not being coveted by the likes of Nike, now has options to accept deals and receive compensation from local car dealerships, restaurants, etc.).

158. *See id.* (noting that the student-athlete compensation laws will not only favor star Power Five athletes, such as Zion Williamson, but provide equal opportunity for any athlete to profit from their own merit).

159. *See id.*; *In re NCAA Student-Athlete Name & Likeness Licensing Litigation*, 724 F.3d 1268, 1289 (9th Cir. 2013) (Thomas, C.J., dissenting) (articulating the standard at the time of this case that "even if an athlete wished to license his image to EA, the athlete could not do so without destroying amateur status;" however, under state laws, like the California law this would now be possible).

160. *See id.* at 1271; *see also id.* at 1289 (Thomas, C.J., dissenting) (further explaining that "NCAA Bylaw 12.5 specifically prohibits commercial licensing of an NCAA athlete's name or picture").

161. *Id.* at 1273–79.

162. *See id.* at 1271, 1281, 1284; *see also id.* at 1284 (Thomas, C.J., dissenting) ("[T]he right to compensation for the misappropriation for commercial use of one's image or celebrity is far from absolute.").

163. Bryan Wiedey, *The Door is Finally Open for "NCAA Football" Franchise to Return*, SPORTING NEWS (Oct. 30, 2019), <https://www.sportingnews.com/us/ncaa-football/news/door-finally-open-for-ncaa-football-franchise-to-return/1akmgbyijqk2d1opirg5wzu2o0>.

164. Zachary Zagger, *EA To Bring Back College Football Game Amid NIL Debate*,

to support and pay college athletes, EA has attempted to circumvent burgeoning NIL rights, opting to cut the athletes out of the equation entirely by using non-specific video game avatars to represent select NCAA football teams.¹⁶⁵ With the proposed legislation to allow players the right to profit from their NIL, EA and other game developers must make a conscious effort to distinguish their avatars from college athletes.¹⁶⁶ This return to action will be severely impacted by legislation such as the AAPCA and FPPA as soon college athletes will have legislative support in their financial claims to likeness.¹⁶⁷

Power Five sports programs, such as Notre Dame football, have already supported compensating their players for their participation in the NCAA football video game reboot.¹⁶⁸ The school explained that it would not give EA permission to use their school in the game absent clear and concrete rules around player compensation were finalized. This withholding of participation empowers other Power Five football programs to show their support for student-athlete compensation.¹⁶⁹ In 2023, college athletes will be able to sue the NCAA if it attempts to restrict an athlete's marketing and endorsement efforts.¹⁷⁰ Under the AAPCA and the FPPA, schools and their respective student-athletes will soon have legal weapons to utilize against the NCAA and third parties, such as EA, seeking to exploit college athletics for financial benefit to the detriment of its student-athletes.¹⁷¹

E. New Legislation and Outcomes for Black College Athletes

On its face, the AAPCA will directly impact the business of college sports but not through the expected avenue.¹⁷² The FPPA in California is only the first step and multiple states are soon to follow.¹⁷³ In due time, Congress

supra note 55.

165. *Id.*

166. *Id.*

167. *Id.*

168. Zachary Zagger, *Notre Dame Signals Supports For Athlete Name, Image Rights*, LAW360 (Feb. 22, 2021, 9:34 PM), <https://www.law360.com/articles/1357617/notre-dame-signals-support-for-athlete-name-image-rights>.

169. *See id.* (illustrating Notre Dame's decision to withhold its image from EA as a way of support for NCAA rule changes involving athlete compensation).

170. Michael McCann, *What Will Happen If the California 'Fair Pay to Play Act' Gets Signed Into Law?*, SI (Sept. 10, 2019), <https://www.si.com/college/2019/09/10/california-fair-pay-play-act-law-ncaa-pac-12>.

171. *Id.*

172. *See* McCann, *supra* note 170 (the anticipated area of impact would be the shift of endorsement revenues from the schools to the players; however, I am proposing this further shifts the recruiting landscape for PWIs to HBCUs).

173. *See id.* (detailing how some states have already proposed legislation like

will enact federal law, given the unavoidable Commerce Clause implications.¹⁷⁴ Black athletes can now justify playing for HBCUs as they can profit from third-party sponsorship.¹⁷⁵ For example, HBCU football star Steve ‘Air’ McNair, who was on the cover of *Sports Illustrated* and third in the Heisman voting, would have been able to profit from his fame in college.¹⁷⁶

This Act will allow for Black star athletes to play for HBCUs without the threat of losing financial and career possibilities.¹⁷⁷ The stark reality is that HBCUs do not provide the direct route to professional sports that high-level athletes seek, and many end up transferring to predominantly white Power Five schools.¹⁷⁸ With multiple states enacting NIL legislation to allow for publicity right compensation, the NCAA has changed its rules to favor college athletes.¹⁷⁹ In the coming years, we will see student-athletes in complete control of their right to publicity and NIL.¹⁸⁰ NIL will affect the core business of collegiate sports and alter its landscape.¹⁸¹

The NCAA outlines in its Bylaws that its purpose is to “promote opportunity for equity in competition to ensure that individual student-athletes and institutions will not be prevented unfairly from achieving the benefits inherent in participation in intercollegiate athletics.”¹⁸² The capitalizing structure of the Power Five conference’s dominance has crippled

California’s and how some states plan to draft similar legislation).

174. See *id.* (noting that the Commerce Clause gives Congress the power to regulate interstate commerce, and college athletics being an interstate entity will undoubtedly be subject to the passing of NIL state legislation).

175. See Steele, *supra* note 93.

176. *Id.* (quoting Pep Hamilton’s explanation as to how players like McNair would have benefitted from these NIL rules).

177. See Donovan Dooley, *Transferring to Power 5 Schools is a Path to the Pros for HBCU Basketball Players*, THE UNDEFEATED (Jun. 19, 2018), <https://theundefeated.com/features/transferring-to-power-5-schools-is-a-path-to-the-pros-for-hbcu-basketball-players/>.

178. See *id.*

179. See McCann, *supra* note 170; Michelle Brutlag Hosick, *NCAA Adopts Interim Name, Image and Likeness Policy*, NCAA (Jun. 30, 2021), <https://www.ncaa.org/about/resources/media-center/news/ncaa-adopts-interim-name-image-and-likeness-policy> (pointing to the NCAA’s interim policy update on NIL and further noting their intent to adhere to state laws concerning the issue).

180. See Greta Anderson, *Eyeing Future Profits*, INSIDE HIGHER ED (Jan. 14, 2020), <https://www.insidehighered.com/news/2020/01/14/market-rights-college-athletes-name-image-likeness-emerging> (discussing how companies are already looking to capitalize on the prospect of college athletes receiving NIL compensation).

181. See *id.*

182. NCAA DIVISION I MANUAL, *supra* note 30, § 2.10 (“The Principle of Competitive Equity”).

the competitive landscape and made it impossible for smaller programs, chiefly HBCUs, to compete.¹⁸³

The student-athlete compensation laws will provide a means for HBCUs to improve their star athletic representation.¹⁸⁴ The need for representation not only combats Black athletic exploitation by PWIs but also analyzes the issue of a lack of resources for HBCUs.¹⁸⁵ HBCUs are not afforded the same luxuries as Power Five athletic programs with respect to resources and recruiting.¹⁸⁶ Adequate resources and proper recruiting are fundamental to any athletic program's success, and the current system does not provide a fair or competitive ground for HBCUs to compete against Power Five programs.¹⁸⁷ The AAPCA and FPPA can provide support for the NCAA's mission for competitive equality by increasing the incentive for Black athletes to compete at HBCUs.¹⁸⁸

Current and former Black athletes are coming together to close the funding, education, and athletics gap in the Black community.¹⁸⁹ Even white players from other sports are ready to help change the narrative.¹⁹⁰ With this

183. See Chris Johnson, *HBCUs vs PWIs: Why Division I Historically Black Athletic Programs Struggle Against Predominantly White Institutions*, JOURNEY MAG. (Jan. 22, 2019), <https://jmagonline.com/articles/hbcus-vs-pwis-why-division-i-historically-black-athletic-programs-struggle-against-predominantly-white-institutions/>.

184. See Tyler Tynes, *The Ripple Effects of California's 'Fair Pay to Play' Act*, THE RINGER (Oct. 11, 2019, 6:55 AM), <https://www.theringer.com/2019/10/11/20909171/california-sb-206-ncaa-pay-college-players> (acknowledging the lack of compensation for student-athletes as "primarily an issue of civil rights and exploitation of black student-athletes").

185. See Cassandra Negley, *Deion Sanders Calls Out Inequities at HBCU Jackson State: 'It Causes a Kid Not to Dream'*, YAHOO SPORTS (Jan. 14, 2021), <https://sports.yahoo.com/deion-sanders-sounds-off-on-football-inequities-at-hbcu-jackson-state-it-causes-a-kid-not-to-dream-173928273.html>.

186. *Id.*

187. Johnson, *supra* note 183.

188. *NCAA Allows Right of Publicity Endorsement*, INTELLECTUAL PROP. CTR. (Apr. 29, 2020), <https://theipcenter.com/2020/04/student-athletes-earning-money-from-rights-of-publicity/> (noting that such acts will allow student-athletes from all schools to earn "income off endorsements and licensee fees for the use of the student's likeness in video games and online").

189. See Negley, *supra* note 185 (emphasizing the impact that the hiring of professional football legend Deion Sanders as a coach for Jackson State will have on the HBCU).

190. E.g., Charlotte Wilder, *Patriots' Chris Long Says He Supports His Peers' 'Right to Protest'*, USA TODAY (Sep. 14, 2016, 11:02 AM), <https://www.usatoday.com/story/sports/ftw/2016/09/14/patriots-chris-long-says-he-supports-his-peers-right-to-protest-in-an-indepth-interview/90351490/> (quoting Chris Long: "I play in a league that's 70 percent black and my peers . . . are very socially aware . . . if they identify something that they think is worth putting their reputations on the line [for] . . . I'm going to listen to those guys").

new legislation comes the freedom and financial flexibility for Black athletes to redirect money back into their community.¹⁹¹ Now, the NCAA cannot defeat California's FPPA, and other states are creating their own regulations in an effort to finally support the college athletes they watch for entertainment every weekend.

IV. ARE THERE ALTERNATIVE AVENUES FOR BLACK ATHLETES TO TAKE WHEN COMBATting COMMERCIAL EXPLOITATION?

With the AAPCA proposal, the collegiate landscape is bound to see significant changes in the coming years.¹⁹² Soon, student-athletes may receive compensation and protect their right to publicity¹⁹³ as the proposed bill will enable these athletes to benefit from their NIL.¹⁹⁴ Variations of the bill have been offered in five states, including California, New Jersey, Colorado, Florida, and Nebraska.¹⁹⁵ Now, the issue turns on whether schools and athletes will act under NCAA or state regulations.

A. Looking Forward

In revisiting the significance of *O'Bannon*, *Marshall*, and the *NCAA Likeness Litigation*, courts will have a new set of compensation rules to apply to college athlete's NIL.¹⁹⁶ In the past, athletes have been denied the opportunity to gain compensation for their athletic efforts and achievements.¹⁹⁷ The "cost of attendance" and a "scholarship" have been accepted as an appropriate justification for billions of dollars in the pockets of the NCAA and its schools for far too long.¹⁹⁸ With the budding state laws

191. See Negley, *supra* note 185 (quoting Coach Deion Sanders: "It's not a level playing field. It's unacceptable").

192. Amateur Athletes Protection and Compensation Act, S. 414, 117th Cong. (2021).

193. See *id.* (defining covered compensation as "any remuneration, in cash or in kind and regardless of the date on which the remuneration is provided, to an amateur intercollegiate athlete").

194. See Modernizing the Collegiate Student Athlete Experience Act, H.R. 3379, 117th Cong. (2021) (noting the term publicity right "permits an individual to control and profit from the commercial use of the name, image, or likeness of the individual").

195. Zagger, *4 Key Issues As States Tackle College Athlete Pay*, *supra* note 38.

196. See *O'Bannon v. NCAA*, 802 F.3d 1049 (9th Cir. 2015); see also *Marshall v. ESPN Inc.*, 111 F. Supp. 3d 815 (M.D. Tenn. 2015); *Keller v. Elec. Arts Inc.*, 724 F.3d 1268 (9th Cir. 2013).

197. See Jon Solomon, *The History Behind the Debate Over Paying NCAA Athletes*, ASPEN INST. (Apr. 23, 2018), <https://www.aspeninstitute.org/blog-posts/history-behind-debate-paying-ncaa-athletes/> (explaining that "a basic purpose of the NCAA was to make the student-athlete an integral part of the student body").

198. See *O'Bannon*, 802 F.3d at 1079 (noting that, under the Rule of Reason, NCAA schools are not exempt from the Sherman Act and must provide up to the cost of

concerning NIL, the NCAA and Supreme Court must address sharing the profits with those who rightfully earn them.¹⁹⁹ Thus, college athletes will no longer be punished for their social media presence or entrepreneurial efforts associated with their athletic ability.²⁰⁰

B. The Push for Publicity Rights Legislation

The Collegiate Athlete Compensation Rights Act failed to move forward in the 116th Congress; however, its language surrounding publicity rights should be adopted by the current college athlete compensation legislation as it provides a relevant perspective on college athletes and social media.²⁰¹

Athletes have long struggled to obtain their rights of publicity.²⁰² The right to publicity is “an individual’s right to control and profit from the commercial use of his/her name, likeness and persona, . . . [p]rotecting the individual from the loss of commercial value resulting from the unauthorized appropriation of an individual’s identity for commercial purposes.”²⁰³ While copyrights are protected under federal law, the right of publicity is only available at the state level.²⁰⁴ This right is appropriately invoked when protecting a celebrity as there is an incentive to protect against the improper use of an individual’s identity that has commercial value.²⁰⁵ This right exists to protect individuals from unwanted brand associations or, as college athletes argue, to provide a legal right to marketing compensation.²⁰⁶ Athletes may now receive compensation through avenues such as third-party endorsements, social media influencing, personal business, and promotional ventures.²⁰⁷ Accordingly, athletes, particularly Black athletes, will now have more flexibility when choosing which university to attend for athletics.

In *White*, the Ninth Circuit expanded on the theory that celebrities have a

attendance for its student-athletes).

199. Zaggar, *Notre Dame Signals Supports For Athlete Name, Image Rights*, *supra* note 168 (noting that current NCAA rules are “in direct conflict” with new state laws concerning NIL rights).

200. *See id.*

201. *See* S. 5003, 116th Cong. § 2 (2020).

202. McCann, *supra* note 170.

203. *Right of Publicity*, FINDLAW, <https://corporate.findlaw.com/litigation-disputes/right-of-publicity.html#> (last updated May 26, 2016).

204. *See id.* (explaining that “uniform federal law does not currently protect the individual’s right of publicity”).

205. *See id.*

206. *See NCAA Allows Right of Publicity Endorsement*, *supra* note 188.

207. *See id.* (noting however that “the NCAA has not indicated if they will be imposing a monetary cap on student-athletes endorsement deals”).

precious right to publicity.²⁰⁸ With the passing of student-athlete compensation laws, this standard will extend to the college athlete as they will now have similar claims to their likeness.²⁰⁹ College athlete compensation legislation should allow for student-athletes to capitalize on their right to publicity.²¹⁰ Student-athletes will no longer be bound by the holdings of cases like *White*, as the athletes will be protected under the legislation.²¹¹

The modern college athlete enjoys the same level of celebrity as some movie stars, which the rise of social media has amplified.²¹² In *O'Bannon*, the court failed to extend a right to publicity for video games to college athletes because the NCAA prevented such action under its current regulations and the court did not feel it had the authority to change such rules.²¹³ Under the new protections afforded through student-athlete compensation laws, such as the AAPCA and California's FPPA college athletes are now, in a legal sense, entertainers and should be afforded the same right to publicity protections that entertainers have been awarded.²¹⁴

208. See *White v. Samsung Elecs. Am., Inc.*, 971 F.2d 1395, 1398 (9th Cir. 1992) (citing *Carson v. Here's Johnny Portable Toilets, Inc.*, 698 F.2d 831, 835 (6th Cir. 1983)) (highlighting that celebrities have a right to protect their identity from commercial exploitation).

209. See L. Kent Wolgamott, *Players in Sports and Music Have Much in Common*, J. STAR (Oct. 4, 2008), https://journalstar.com/entertainment/music/players-in-sports-and-music-have-much-in-common/article_c7986f88-99d7-5430-bc61-a2a6973a9504.html (linking athletes to musicians as they "share everything from performance anxiety to injuries, rigorous training to celebrity").

210. See S. 5003, 116th Cong. (2020), <https://www.congress.gov/bill/116th-congress/senate-bill/5003/text/is?overview=closed&format=xml> (including under the term covered compensation: "social media compensation and payments for licensing or use of publicity rights").

211. See *id.* (defining a publicity right to "include any right that is licensed under a name, image, and likeness agreement").

212. See Samuel In, *UCLA Quarterback Walks the Line Between YouTube Monetization and NCAA Regulations*, DAILY BRUIN (Nov. 3, 2020, 6:15 PM), <https://dailybruin.com/2020/11/03/ucla-quarterback-walks-the-line-between-youtube-monetization-and-ncaa-regulations> (noting that in UCF kicker Donald De La Haye was monetizing his videos before the NCAA intervened).

213. See *O'Bannon v. NCAA*, 802 F.3d 1049, 1067–69 (9th Cir. 2015).

214. See CAL. EDUC. CODE § 67456 (West 2021); *SB-206 Collegiate Athletics: Student Athlete Compensation and Representation*, CAL. LEGIS. INFO. (Oct. 1, 2019, 2:00 PM), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200SB206.

C. A New Perspective

In 2023, under the enacted bills such as California's FPPA, athletes will have the legislative tools to ensure they are protected.²¹⁵ This act establishes a framework for student-athletes to apply and prevent unjust judicial outcomes.²¹⁶ Courts have proven to be unable to properly award rights to such athletes, but now there is a new standard.²¹⁷ Judges can consider whether compensation was given for pure recruiting purposes, still a clear violation of NCAA rules, or whether the payment was rooted in marketing.²¹⁸

Once barred from interracial competition, Black athletes are now the focal point of many prominent sports programs; a new avenue for opportunity is now available.²¹⁹ With no procedural bars to compensation, athletes such as Michigan's Fab Five, Duke's Zion Williamson, High School sensation Mikey Williams, and Howard's Makur Maker have the freedom to earn money outside of a college scholarship.²²⁰

HBCUs are more attractive than ever for Black athletes.²²¹ Athletes seeking elite training and national exposure have shied away from HBCUs, taking the traditional Power Five route.²²² Zion Williamson, for example, chose Duke for its basketball pedigree and NBA-producing promise.²²³

215. EDUC. § 67456.

216. *Id.*

217. *Id.*; O'Bannon, 802 F.3d at 1049.

218. EDUC. § 67456 (defining clearly the types of agreements student athletes can permissibly enter).

219. See Richard Johnson, *College Football Wasn't Made for its Black Players, and They're Pushing Back*, FORTHEWIN (June 19, 2020, 2:19 PM), <https://ftw.usatoday.com/2020/06/college-football-black-players> (declaring that "[c]ollege football was not made for its Black players, so they're trying to remake it").

220. See Shaheem Sutherland, *Five and Four-Star Black Athletes are Choosing HBCUs Over PWIs*, SSUTHERLAND MEDIA (July 31, 2020), <http://shaheem-sutherland.com/five-and-four-star-black-athletes-are-choosing-hbcus-over-pwis/> (quoting Mikey Williams: "If there's anybody that is getting paid from me being at their school, I'd want it to be my own people").

221. See Mary Louise Kelly & Jess Kung, *Should Black Athletes Go To Black Schools?*, NPR CODE SWITCH (Sept. 11, 2019, 4:18 PM), <https://www.npr.org/sections/codeswitch/2019/09/11/410268200/should-black-athletes-go-to-black-schools> (agreeing with Jemele Hill's argument that "top-tier black college athletes should take their talents to historically black institutions").

222. See Jemele Hill, *It's Time for Black Athletes to Leave White Colleges*, THE ATLANTIC (Oct. 2019), <https://www.theatlantic.com/magazine/archive/2019/10/black-athletes-should-leave-white-colleges/596629/> ("About 30 Division I schools each bring in at least \$100 million in athletic revenue every year . . . [B]lack men make up 55 percent of the football players in those conferences, and 56 percent of basketball players.").

223. See Scott Fowler, *Why did Zion Williamson Really Choose Duke over UNC, Clemson and Kentucky?*, CHARLOTTE OBSERVER (Jan. 21, 2018),

However, Williamson's basketball abilities would have ensured his top prospect position regardless of his choice of college, a possibility not available to many.²²⁴

D. HBCUs as the Future of College Sports

College athletes have faced major injustices, and historically, Black athletes are exploited the most.²²⁵ The AAPCA and the FPPA will ultimately lessen the exploitation of Black athletes and redirect the economic benefit from the Power Five programs to the Black community.²²⁶

For instance, Makur Maker was a top-twenty college recruit, making him the highest-ranked player to commit to an HBCU by attending Howard University.²²⁷ His commitment shocked the basketball world, as playing for a Power Five School is an almost guaranteed path to competing for a college championship and, ultimately, a spot in the NBA.²²⁸ Maker turned down offers from numerous Power Five Schools and will be sure to draw attention, thus warranting national broadcasting time, for the Howard Bison.²²⁹ Shaqir O'Neal, son of NBA legend Shaquille O'Neal, has committed to play for the

<https://www.charlotteobserver.com/sports/spt-columns-blogs/scott-fowler/article195806969.html>.

224. See Trevor Hooth, *NBA Draft Prospect Zion Williamson Claims He Would've Still Gone to College Even if He was Eligible to Go to NBA Straight Out of High School*, CLUTCHPOINTS (Feb. 20, 2019), <https://clutchpoints.com/nba-draft-news-zion-williamson-claims-he-wouldve-still-gone-college-even-if-he-was-eligible-to-go-to-nba-straight-out-of-high-school/>.

225. See Shaun R. Harper, *Good Bet for the Office NCAA Pool: Black Men Will Play and White Men Will Profit*, CHI. TRIB. (Mar. 11, 2018, 2:45 PM), <https://www.chicago.tribune.com/sports/college/ct-spt-ncaa-tournament-race-pool-20180311-story.html> (highlighting that in the annual March Madness tournament, which brings in over \$821 million, the majority of unpaid players will be black, and the majority of excessively compensated head coaches will be white); see also Paul Steinbach, *Academics Confront the Exploitation of African-American Male Athletes*, ATHLETIC BUS. (May 27, 2010), <https://www.athleticbusiness.com/People/academics-confront-the-exploitation-of-african-american-male-athletes.html> (noting the NCAA generates 90% of its revenue during March Madness, a tournament where 60% of the athletes are black).

226. See Sutherland, *supra* note 220 (emphasizing the need to "re-write the narrative and strengthen the black community . . . to help generate the millions of dollars their talent is worth for a black institute instead of a predominately white school").

227. See Jeff Borzello, *Five-star College Basketball Recruit Makur Maker Commits to Howard Over UCLA*, ESPN (Jul. 3, 2020, 8:39 AM), https://www.espn.com/mens-college-basketball/story/_/id/29403929/five-star-recruit-makur-maker-commits-howard-ucla.

228. See *id.* (quoting Makur saying, "I need to make the HBCU movement real so that others will follow").

229. See *id.* (highlighting that "[Makur] would be the first such HBCU product since Kyle O'Quinn (Norfolk State) in 2012").

HBCU Texas Southern University.²³⁰ In the college football realm, the 2022 top ranked recruit Travis Hunter committed to play for HBCU Jackson State and Deion Sanders.²³¹ These recruits have shifted the NCAA's economic benefit and should lead to more players playing for HBCUs.²³²

This college athlete compensation legislation has provided Black athletes an opportunity to choose an HBCU and have a successful career.²³³ Judges will no longer have to ignore the request for just compensation when a Black athlete brings a case alleging the third party will capitalize on their NIL.²³⁴ Black athletes will not be punished and threatened for receiving compensation for their athletic gifts in an effort to support themselves or their families.²³⁵

V. CONCLUSION

In utilizing the AAPCA, and similar legislation, there is a legitimate chance for athletes to receive their long-overdue compensation. The courts and NCAA have failed to protect athletes on a federal level, and we are now only seeing change due to state legislative pressure. The NCAA cannot surrender the Power Five's monetary significance, but sports advocates can encourage a redistribution of Black talent through other economic outlets. The emphasis is on Black star athletes to launch their careers through an HBCU. HBCUs are historic universities that produce a wealth of Black entrepreneurs and scholars. The revenue these star athletes can generate for these institutions will significantly benefit the Black community. It will provide more access to tools, scholarships, and resources to further education for Black people. HBCUs provide a great environment and platform for Black students, who may otherwise not attend or complete college. There lies tremendous potential in bringing money back to the Black community if the up-and-coming athletes are ready and empowered to take the next step.

230. Tolly Carr, *Shaquille O'Neal's Son Commits to Texas Southern*, HBCU GAMEDAY (Apr. 30, 2021), <https://hbcugameday.com/2021/04/30/shaquille-oneals-son-commits-to-texas-southern/>.

231. See Chase Goodbread, *Top Recruit Travis Hunter Spurns Florida State to Commit to Deion Sanders, Jackson State*, NFL (Dec. 12, 2021), <https://www.nfl.com/news/deion-sanders-travis-hunter-jackson-state-florida-state-commit>.

232. See Sutherland, *supra* note 220 (discussing that top black recruits like Maker are aware of the impact their college decision can have on the black community).

233. See *id.* (noting that Black athletes are making the move to HBCUs over traditional Power Five athletic programs).

234. See Nw. Univ. & Coll. Athletes Players Ass'n (CAPA), 362 N.L.R.B. 1350 (2015).

235. *Id.* at 1363.

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