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THE EU-CHINA CAI AND THE UYGHUR CHALLENGE IN THE CONTEXT OF CHINA'S DOMESTIC LAW BARRIERS TO INTERNATIONAL LABOR AND HUMAN RIGHTS STANDARDS

RONALD C. BROWN*

While China engages in world commerce as a global player and is signatory to international labor and human rights standards, at the same time it uses treaty reservations and its own domestic laws to limit and undermine the full application of those standards. Concern from Western governments and global human rights groups regarding China's longstanding treatment of the Uyghur people has resulted in a freeze in negotiations for the EU-China Comprehensive Investment Agreement (CAI). This was also a result of China's failure to ratify or implement relevant United Nations (U.N.) covenants and International Labour Organization (ILO) conventions and placing reservations or domestic legal barriers on them, as well as foreign accusations of forced labor. Now that China has recently ratified ILO Convention Nos. 29 and 105 prohibiting forced labor, what will be the effect on the currently frozen negotiations of the EU-China CAI, now at an impasse due to issues relating to China's alleged discrimination and forced labor treatment of Uyghurs in Xinjiang, China? In unbundling the legalities of this stalled draft agreement, this paper progressively examines the global obligations of the U.N. covenants and ILO conventions, as well as relevant provisions in the draft CAI, in the context of the Chinese approach to international labor and human rights standards, including the EU's emerging due diligence laws and the 2021 Uyghur Forced Labor Prevention Act in the U.S.

Following Part I, Part II of this paper outlines the key international labor and human rights obligations of which China is a signatory, such as the Declaration of Human Rights, U.N. treaties, ILO labor standards, free

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trade agreements, and national legislation. Part III addresses the legal consequences of alleged non-compliance as it may affect the Uyghurs; and Part IV provides analysis and presents the dichotomy between international standards and Chinese practices. Part V offers a conclusion suggesting the use of national legislation and more effective remedies in international standards.

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I. INTRODUCTION

While China engages in world commerce as a global player and is signatory to some international labor and human rights standards, it simultaneously uses treaty reservations[1] and domestic laws to limit and undermine the full application of those standards, which may hamper its

1. China is not alone in using treaty reservations and non-ratification of labor standards, as it is a practice exercised by many countries, including the U.S. However, many of these countries have domestic laws to protect many international labor and human rights standards. For example, the U.S. has not ratified the Discrimination (Employment and Occupation) Convention (ILO Convention No. 111), but it does have comprehensive domestic legislation prohibiting discrimination, *see Title VII of the Civil Rights Act of 1964*, 42 U.S.C. § 2000e.

ambition to be accepted as a full global player in the eyes of the West.[2] China's long-standing issue with Uyghurs and foreign accusations of forced labor, as well as China's failure to ratify relevant United Nations (U.N.) covenants and International Labour Organization (ILO) conventions has caused a freeze in the EU-China Comprehensive Agreement on Investment (CAI) negotiations.[3] On April 20, 2022, China ratified ILO Convention Nos. 29 and 105 prohibiting forced labor.[4] What will be the effect on the currently frozen negotiations of the EU-China CAI, now at an impasse due to issues arising from China's alleged forced labor treatment of Uyghurs in Xinjiang? In unbundling the legalities of this stalled draft agreement, this paper progressively examines the global obligations of the U.N. covenants and ILO conventions, as well as relevant provisions in the draft CAI, in the context of the Chinese approach to international labor and human rights standards, including EU's due diligence laws and the 2021 Uyghur Forced Labor Prevention Act in the U.S.[5]

In understanding China's approach to acceding to international labor and human rights standards, one can examine, for example, China's signing of the U.N. International Covenant on Civil and Political Rights (ICCPR)[6] and

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2. However, even if there may be political repercussions, China, as an autocratic country, still fares well in the global economic community even as it uses its own, sometimes contrary to global norm, labor and human rights standards, *see* Ibrahim Chowdhury et al., *Rebalancing Act: China's 2022 Outlook*, WORLD BANK (Jan. 12, 2022), https://www.worldbank.org/en/news/opinion/2022/01/12/rebalancing-act-china-s-2022-outlook.

3. *See* Stuart Lau, *European Parliament Votes to 'Freeze' Investment Deal Until China Lifts Sanctions*, POLITICO (May 20, 2021, 5:23 PM), https://www.politico.eu/article/european-parliament-freezes-china-investment-deal-vote/.

4. *China Ratifies Two ILO Conventions on Forced Labour*, BUS. & HUM. RTS. RES. CTR. (Apr. 25, 2022), https://www.business-humanrights.org/en/latest-news/china-ratifies-two-ilo-conventions-on-forced-labour/ [hereinaftetr *China Ratifies Two ILO Conventions*].

5. H.R. 6256, 117th Cong. (2021) (enacted); *see also Uyghur Forced Labor Prevention Act*, U.S. CUSTOMS & BORDER PROT. (June 28, 2022), https://www.cbp.gov/trade/forced-labor/UFLPA.

6. *See Status of Ratification Interactive Dashboard*, U.N. HUMAN RTS. OFF. OF THE HIGH COMM'R, [hereinafter *Human Rights Dashboard*], https://indicators.ohchr.org/ (last visited Aug. 1, 2022). In 1998, China signed, but has not ratified, the ICCPR, guaranteeing freedom of expression, fair trial, protection against arbitrary detention, protection against torture, and freedom of association, *see International Covenant on Civil and Political Rights*, U.N. HUMAN RTS. OFF. OF THE HIGH COMM'R, [hereinafter *ICCPR*], https://www.ohchr.org/sites/default/files/ccpr.pdf. In 1997, China signed the ICECSR (which provides especially for trade union rights), *see also Human Rights Dashboard*, *supra* note 6; *International Covenant on Economic, Social, and Cultural Rights*, U.N. HUMAN RTS. OFF. OF THE HIGH COMM'R, [hereinafter *ICESCR*], https://www.ohchr.org/sites/default/files/cescr.pdf. Although China ratified the

the U.N. Covenant on Economic, Social and Cultural Rights (ICESCR),[7] both of which protect the right to choose a union.[8] However, China has not ratified the former and has placed a reservation on the latter that domestic law prevails.[9] Likewise, though a member of the ILO, it has not yet ratified all of the fundamental labor standards promulgated by that body, caused in large part by its domestic legal requirement of an exclusive national labor union. China's record of alleged human rights violations and forced labor in its Xinjiang region has contributed to a hiatus in the CAI and has caused the looming limitation of its international commerce on products from that region, exemplified by the 2021 Uyghur Forced Labor Prevention Act (UFLPA) in the U.S.[10] It remains to be seen whether China's recent ratification of ILO conventions prohibiting forced labor could lead to a thawing of the EU-China CAI, or whether this lack of ratification will be a continuation of its domestic law barriers to international labor and human

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ICESCR, it added a reservation giving precedence to domestic laws, *see Human Rights Dashboard*, *supra* note 6; *see also China Signs UN Accord on Civil, Political Rights*, IRISH TIMES (Oct. 6, 1998, 1:00 AM), [hereinafter IRISH TIMES], https://www.irishtimes.com/news/china-signs-un-accord-on-civil-political-rights-1.200678.

7. *See Human Rights Dashboard*, *supra* note 6.

8. *See ICESCR*, *supra* note 6.

9. *See id.*

> On February 28, 2001, 'In accordance with the Decision made by the Standing Committee of the Ninth National People's Congress of the People's Republic of China at its Twentieth Session, the President of the People's Republic of China hereby ratifies the [ICESCR].' The statement went on to say, 'The application of Article 8(1)(a) of the Covenant to the People's Republic of China shall be consistent with the relevant provisions of the Constitution of the People's Republic of China, Trade Union Law of the People's Republic of China and Labor Law of the People's Republic of China.' . . . the Trade Union Law denies Chinese workers the right to organize independent union.

Appendix 4: China's Statement Made Upon Ratification of the International Covenant on Economic, Social, and Cultural Rights (ICESCR), and What Effects that Statement has on China's Obligations Under the Covenant, HUM. RTS. WATCH, [hereinafter *Appendix 4, China's Statement Regarding ICESCR*], https://www.hrw.org/reports/2002/chinalbr02/chinalbr0802-08.htm (last visited Aug. 1, 2022) (reposting full text of China's statement made upon the ratification of the ICESCR).

10. The Act's effective date is June 21, 2022. Uyghur Forced Labor Prevention Act, Pub. L. No. 117–78 (2021) [hereinafter *UFPLA*]; *see The Uyghur Forced Labor Prevention Act Goes Into Effect in the United States*, GIBSON DUNN (Jan. 14, 2022), https://www.gibsondunn.com/the-uyghur-forced-labor-prevention-act-goes-into-effect-in-the-united-states/. Subsection 2 of the Sunset Provision provides "a determination that [China] has ended mass internment, forced labor, and any other gross violations of human rights experienced by *Uyghurs, Kazakhs, Kyrgyz, Tibetans, and members of other persecuted groups in the Xinjiang Uyghur Autonomous Region*," *UFPLA*, *supra* note 10 (emphasis added).

rights standards in the mix of international and national obligations.[11]

II. CHINESE AGREEMENTS UNDER INTERNATIONAL LABOR AND HUMAN RIGHTS STANDARDS

A. U.N. Treaties Addressing Labor and Human Rights

The U.N. oversees eleven international human rights standards and fundamental treaties.[12] Beginning with the adoption of the Universal Declaration of Human Rights (UDHR) in 1948, such standards and treaties include the International Covenant on Economic, Social and Cultural Rights (ICESCR), International Covenant on Civil and Political Rights (ICCPR), International Convention on the Elimination of all Forms of Racial Discrimination, Convention on the Elimination of all Forms of Discrimination against Women, and five others dealing with torture, children, migrant workers, disabilities, and the right to development.[13] Contemporary discourse alleges that China "has violated and continues to violate multiple human rights treaties to which it is a party."[14]

The UDHR establishes fundamental human rights, ranging from free association to the prohibition of forced labor:

> The [UDHR] is a milestone document in the history of human rights. Drafted by representatives with different legal and cultural backgrounds from all regions of the world, the Declaration was proclaimed by the United Nations General Assembly in Paris on 10 December 1948 (General Assembly resolution 217 A) as a common standard of achievements for all peoples and all nations. It sets out, for the first time, fundamental

11. *See* Oliver Young, *China Ratifies ILO Treaties Ahead of UN Visit to Xinjiang*, CHINA DIGITAL TIMES (Apr. 25, 2022), https://chinadigitaltimes.net/2022/04/china-ratifies-ilo-treaties-ahead-of-un-visit-to-xinjiang; *see also* Ronald C. Brown, *EU-China Bit and FTA Enhance Labor Cooperation and Protection*, 4 UNIV. OF BOLOGNA L. REV. 367, 371–84 (2019) (describing China's labor treaties in the ILO context).

12. *See generally* U.N. High Commissioner for Human Rights, *International Human Rights Standards and Main Treaties,* https://docplayer.net/21165781-Human-rights-a-basic-handbook-for-un-staff.html (last visited Oct. 14, 2023).

13. *See id*; *see also* Convention on the Elimination of All Forms of Discrimination against Women, Dec. 18, 1979, 1249 U.N.T.S. 13 [hereinafter *CEDAW*]; U.N. Convention on the Rights of Persons with Disabilities, Dec. 13, 2006, 2515 U.N.T.S. 3 [hereinafter *CRPD*]; U.N. Convention on the Rights of the Child, Nov. 20, 1989, 1577 U.N.T.S. 3 [hereinafter *CRC*]; *ICESCR, supra* note 6; U.N. International Convention on the Elimination of All Forms of Racial Discrimination, Mar. 7, 1966, 660 U.N.T.S. 195 [hereinafter *CERD*].

14. Preston Jordan Lim, *Applying International Law Solutions to the Xinjiang Crisis*, ASIAN-PAC. L. & POL'Y J., Jan. 2021, at 90, 107; *see also* Giavanna O'Connell, *How China is Violating Human Rights Treaties and its Own Constitution in Xinjiang*, JUST SEC. (Aug. 19, 2020), https://www.justsecurity.org/72074/how-china-is-violating-human-rights-treaties-and-itsown-constitution-in-xinjiang.html.

> human rights to be universally protected and it has been translated into over 500 languages. The UDHR is widely recognized as having inspired, and paved the way for, the adoption of more than seventy human rights treaties, applied today on a permanent basis at global and regional levels (all containing references to it in their preambles).[15]

The ICESCR includes provisions on labor rights, which includes the right to choose one's work (Article 6.1), and requiring Parties to train individuals in their chosen work (Article 6.2).[16] The ICESCR also protects the right to join and form trade unions (Article 8.1(a)).[17] The ICESCR states "[n]o restrictions may be placed on the exercise of this right other than those prescribed by law and which are necessary in a democratic society in the interests of national security or public order or for the protection of the rights and freedoms of others."[18] Article 8(a) and Article 8(b) seek to ensure "[t]he right of trade unions to establish national federations or confederations and the right of the latter to form or join international trade-union organizations."[19] Article 8(c) seeks to ensure "[t]he right of trade unions to function freely subject to no limitations other than those prescribed by law and which are necessary in a democratic society in the interests of national security or public order or for the protection of the rights and freedoms of others."[20] And finally, the ICESCR Article 8(d), seeks to ensure "[t]he right to strike, provided that it is exercised in conformity with the laws of the particular country."[21] Several parties, including China, Japan, and India,

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15. *See Universal Declaration of Human Rights*, UNITED NATIONS, [hereinafter *UDHR*], https://www.un.org/en/about-us/universal-declaration-of-human-rights (last visited Aug. 2, 2022) (prohibiting in Article 4 all forms of slavery); *see also* Eileen Byrnes & Ismael Hayden, *A Summary of the Universal Declaration of Human Rights*, DEVELOPMENTEDUCATION.IE (June 11, 2002), https://developmenteducation.ie/feature/human-rights/a-summary-of-the-universal-declaration-of-human-rights/; Michael Ashley Stein, *China and Disability Rights,* 33 LOY. OF L.A. INT'L & COMPAR. L. REV. 7 (2010); *Human Rights*, UNITED NATIONS, https://www.un.org/en/global-issues/human-rights (last visited Aug. 3, 2022); *UN Treaty Body Database*, UNITED NATIONS https://tbinternet.ohchr.org/_layouts/15/TreatyBodyExternal/Treaty.aspx?CountryID=36&Lang=EN (last visited Aug. 3, 2022) (showing how China has not ratified some treaties); *Human Rights Dashboard, supra* note 6.

16. *ICESCR, supra* note 6.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* (additionally requiring in Article 6 "decent work"); *see also China Law and Review: Trade Unions & Employers Associations*, HR IN ASIA, (July 14, 2020 3:52 PM) [hereinafter *China Law and Review*], https://www.hrinasia.com/company-policy/trade-unions-employers-associations-china/ ("In China, all trade unions must be affiliated with the All-China Federation of Trade Union (ACFTU) and there is no independent trade

have placed reservations on this clause, allowing interpretations consistent with their constitutions. [22]

Though not ratified by China, Article 21 of the ICCPR provides for peaceful assembly and in Article 22 that "[e]veryone shall have the right to freedom of association with others, including the right to form and join trade unions for the protection of his interests."[23] The Treaty also provides in Articles 21 and 22 that "[n]o restrictions may be placed on the exercise of this right" other than those imposed in conformity with the law.[24] However, China's Trade Union Law denies Chinese workers the right to organize independent unions.[25]

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union. ACFTU is a national-level organisation that reports directly to the Chinese Communist Party and has branches at the provincial, city, and district levels."). *But cf. China Ratifies ICESCR: A Change in Sight or More of the Same?*, CHINA LABOUR BULL. (Mar. 1, 2000), https://www.clb.org.hk/content/china-ratifies-icescr-change-sight-or-more-same.

22. *See ICESCR, supra* note 6; *Appendix 4, China's Statement Regarding ICESCR, supra* note 6 (noting the consistency to be drawn between ICESCR Article 8(1)(a) and China's constitution, trade union law, and labor law).

23. *ICCPR, supra* note 6. Article 21 of the ICCPR states:

> The right of peaceful assembly shall be recognized. No restrictions may be placed on the exercise of this right other than those imposed in conformity with the law, and which are necessary in a democratic society in the interests of national security or public safety, public order, the protection of public health or morals or the protection of the rights and freedoms of others.

Id. at Art. 21. Subsection 2 of Article 22 provides:

> No restrictions may be placed on the exercise of this right other than those which are prescribed by law and which are necessary in a democratic society in the interests of national security or public safety, public order, the protection of public health or morals or the protection of the rights and freedoms of others. This article shall not prevent the imposition of lawful restrictions on members of the armed forces and of the police in their exercise of this right.
>
> *Id.* at Art. 22.2. Additionally, subsection 3 adds: Nothing in this article shall authorize States Parties to the [ILO] Convention of 1948 concerning Freedom of Association and Protection of the Right to Organize to take legislative measures which would prejudice, or to apply the law in such a manner as to prejudice, the guarantees provided for in that Convention.

Id. at Art. 22.3.

24. *See ICCPR, supra* note 6, at Arts. 21, 22.

25. *See Trade Union Law of the People's Republic of China*, CONG.-EXEC. COMM'N ON CHINA (Apr. 3, 1992), [hereinafter *China's Trade Union Law*], https://www.cecc.gov/resources/legal-provisions/trade-union-law-of-the-peoples-republic-of-china-amended (providing that the "All-China Federation of Trade Unions and all of its trade union organizations shall represent the interests of the employees"); *see also China Law and Review, supra* note 21.

B. Forced Labor Prohibitions and the Challenge of China's Uyghurs

The Uyghurs live in the largest region of China, Xinjiang, in the northwest, which is known as the Xinjiang Uyghur Autonomous Region (XUAR). They possess limited powers of self-governance, being subordinate to the central government.[26] The Uyghurs number approximately 12 million in population, and are predominantly Muslim, speaking a language that is similar to Turkish and are culturally similar to Central Asian nations.[27] The region has expansive manufacturing and produces about one-fifth of the world's cotton.[28] Human rights groups argue that "China has detained more than one million Uyghurs against their will over the past few years in a large network of what the state calls 're-education camps', and sentenced hundreds of thousands to prison terms."[29] These groups maintain there is widespread forced labor.

Many Uyghurs have been assigned to employment in factories that are far from their families and communities. In 2016, the government "stepped up security and surveillance measures aimed at the Uyghur population."[30] Such actions included the installation of thousands of neighborhood police kiosks and ubiquitous placement of surveillance cameras, collection of biometric data for identification purposes, and more intrusive monitoring of Internet use. The central government sent an estimated one million officials from outside Xinjiang, mostly ethnic Han, to live temporarily in Uyghur homes to assess their compliance with government policies.[31]

In January 2022, the U.S. Congressional Research Service published a Report on the Uyghurs that documented a list of international labor and human rights issues, including forced assimilation, mass internment, and forced labor. [32]

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26. *See* *China: Uyghers*, MINORITY RGTS. GRP. INT'L https://minorityrights.org/minorities/uyghurs/ (last visited Aug. 7, 2022).

27. *See Who are the Uyghurs and Why is China Being Accused of Genocide?*, BBC NEWS (May 24, 2022), https://www.bbc.com/news/world-asia-china-22278037 [*Who are the Uyghurs*].

28. *Id.*

29. *Id.*

30. THOMAS LUM & MICHAEL A. WEBER, CONG. RSCH. SERV., UYGHURS IN CHINA (2021).

31. THOMAS LUM & MICHAEL A. WEBER, CONG. RSCH. SERV., CHINA PRIMER: UYGHURS (2022).

32. *Id.* In relation to forced assimilation, the report stated that:

> Since 2017, in tandem with a national policy referred to as 'Sinicization,' XUAR authorities have instituted measures to assimilate Uyghurs into Han Chinese society and reduce the influences of Uyghur, Islamic, and Arabic cultures and languages. The XUAR government enacted a law in 2017 that prohibits 'expressions of extremification' and placed restrictions upon dress

Forced labor of Uyghurs in Xinjiang? It is argued that China's treatment of Uyghurs in Xinjiang has violated, and continues to violate, multiple human rights standards,[33] including ILO Conventions Nos. 29 (Forced Labour Convention)[34] and 105 (Abolition of Forced Labour Convention),[35] through the Chinese government's placement of interned Uyghurs into labor-intensive sweatshops.[36] The timing of China's ratification of these two

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> and grooming, traditional Uyghur customs, and adherence to Islamic dietary laws (halal). Thousands of mosques in Xinjiang reportedly have been demolished or 'Sinicized,' whereby Islamic motifs and Arabic writings have been removed. The XUAR has carried out a campaign to forcefully reduce birth rates or 'illegal births' among Uyghurs. Furthermore, forced family separations among Uyghurs have become widespread.

Id. Pertaining to mass internment of Uyghers, the report adds that:

> Between 2017 and 2020, Xinjiang authorities arbitrarily detained between 1 million and 1.8 million Muslims by some estimates, mostly Uyghurs and smaller numbers of ethnic Kazakhs, and Kyrgyazs as well as Hui, in 'reeducation' centers . . . [D]etainees, were compelled to renounce many of their Islamic beliefs and customs as a condition for their release.

Id. As to forced labor, the report states that "[t]he PRC government has pressured many Uyghurs including former detainees, into accepting employment in textile, apparel, agricultural, consumer electronics, and other labor-intensive industries . . . . Uyghurs who refuse to accept such employment, which often involves heavy surveillance and political indoctrination, may face detention," *id.* For a perspective on the extent of reported government surveillance of Uyghurs, *see* Yael Grauer, *Revealed: Massive Chinese Police Database*, INTERCEPT (Jan. 29, 2021, 3:00 AM), https://theintercept.com/2021/01/29/china-uyghur-muslim-surveillance-police/.

33. *See CEDAW, supra* note 13; *CRPD, supra* note 13; *CRC, supra* note 13; *ICESCR, supra* note 6; *CERD, supra* note 13; *see also* O'Connell, *supra* note 14; Lim, *supra* note 14, at 107.

34. Article 1.1 of the convention states that "[e]ach Member of the [ILO] which ratifies this Convention undertakes to suppress the use of forced or compulsory labour in all its forms within the shortest possible period," *C029, Forced Labour Convention, 1930 (No. 29)*, INT'L LABOUR ORG., [hereinafter *Forced Labour Convention*], https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C029 (last visited Aug. 7, 2022).

35. Article 1 of the convention provides that:

> Each Member of the [ILO] which ratifies this Convention undertakes to suppress and not to make use of any form of forced or compulsory labour-- (a) as a means of political coercion or education or as a punishment for holding or expressing political views or views ideologically opposed to the established political, social or economic system; (b) as a method of mobilising and using labour for purposes of economic development; (c) as a means of labour discipline; (d) as a punishment for having participated in strikes; (e) as a means of racial, social, national or religious discrimination.

C105 – Abolition of Forced Labour Convention, 1957 (No. 105), INT'L LABOUR ORG, https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C105 (last visited Aug. 7, 2022).

36. *See* Simina Mistreanu, *Study Links Nike, Adidas and Apple to Forced Uighur Labor*, FORBES (Mar. 2, 2020, 11:10 AM),

fundamental ILO conventions came more than a year after China and the European Union (EU) ended seven years of talks on the CAI,[37] which included an agreement that Beijing would ratify the ILO's fundamental conventions on forced labor.[38]

The ILO provides a framework for eleven indicators covering the main possible elements of a forced labor situation, thus establishing a basis to assess whether an individual worker is a victim of forced labor.[39] Such indicators include: "Abuse of vulnerability, Deception, Restriction of movement, Isolation, Physical and sexual violence, Intimidation and threats, Retention of identity documents, Withholding of wages, Debt bondage, Abusive working and living conditions, and Excessive overtime."[40]

Viewpoints vary on the situation in Xinjiang. "Several [western] countries, including the US, UK, Canada, and the Netherlands," recognize China's treatment of the Uyghur people to be a genocide.[41] International convention defines genocide as the "intent to destroy, in whole or in part, a national, ethical, racial or religious group."[42] It follows reports that, as well as interning Uyghurs in camps,[43] China has been forcibly mass sterilizing

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https://www.forbes.com/sites/siminamistreanu/2020/03/02/study-links-nike-adidas-and-apple-to-forced-uighur-labor/?sh=5295cbce1003; *see also ILO Welcomes China's Move Towards the Ratification of Two Forced Labour Conventions*, INT'L LABOUR ORG. (Apr. 20, 2022), https://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS_842739/lang--en/index.htm; *Forced Labour Convention*, *supra* note 34; Ratifications *for China*, INT'L LABOUR ORG., https://www.ilo.org/dyn/normlex/en/f?p=1000:11200:0::NO:11200:P11200_COUNTRY_ID:103404 (last visited Aug. 7, 2022).

37. *See* Chris Devonshire-Ellis, *The EU Suspends Ratification of CAI Investment Agreement with China: Business and Trade Implications*, CHINA BRIEFING (May 5, 2021), https://www.china-briefing.com/news/the-eu-suspends-ratification-of-cai-investment-agreement-with-china-business-and-trade-implications/.

38. *See What to Expect from the EU-China Comprehensive Agreement on Investment?*, INT'L LABOUR ORG. (Dec. 7, 2020), https://www.ilo.org/brussels/information-resources/news/WCMS_766727/lang--en/index.htm.

39. *See ILO Indicators of Forced Labour*, SPECIAL ACTION PROGRAMME TO COMBAT FORCED LABOUR, at 2, https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/publication/wcms_203832.pdf (last visited Aug. 7, 2022) ("The indicators represent the most common signs or 'clues' that point to the possible existence of a forced labour case.").

40. *Id.* at 3.

41. *Who are the Uyghurs*, *supra* note 27.

42. *Id.* Further, "[t]he detentions are part of a PRC government effort to systematically transform the thought and behavior of Uyghurs and forcefully assimilate them into Chinese society, which some observers believe may result in the destruction of Uyghur culture and identity," LUM & WEBER, *supra* note 24, at 10.

43. *Who are the Uyghurs*, *supra* note 27 ("In December 2020, research seen by the BBC showed that up to half a million people were being forced to pick cotton in Xinjiang.

Uyghur women to suppress the population and separating Uyghur children from their families.[44] In April 2022, U.S. Secretary of State Antony Blinken made a statement concerning the treatment of Uyghurs, namely that China is committing "[g]enocide and crimes against humanity."[45] U.K. Foreign Secretary Dominic Raab delivered a statement in March 2021 regarding the human rights situation in Xinjiang, China, emphasizing that the treatment of Uyghurs amounts to "appalling violations of the most basic human rights."[46]

A U.N. human rights panel in 2018 said it had "credible reports that 1 million ethnic Uighurs in China are held in what resembles a 'massive internment camp that is shrouded in secrecy.'"[47] On August 31, 2022, the U.N. Human Rights Committee issued an Assessment and Report regarding China's treatment of Uyghurs in Xinjiang.[48] According to the BBC, "[t]he Australian Strategic Policy Institute found evidence in 2020 of more than 380 of these 're-education camps' in Xinjiang, an increase of 40% on previous estimates."[49] Moreover, it has been reported:

> The state regularly subjects minority women to pregnancy checks, and forces intrauterine devices, sterilization and even abortion on hundreds of thousands . . . . Even while the use of IUDs and sterilization has fallen nationwide, it is rising sharply in Xinjiang. The population control measures are backed by mass detention both as a threat and as a punishment for failure to comply.[50]

There is evidence that new factories have been built within the grounds of the re-education camps").

44. *See* LUM & WEBER, *supra* note 31.

45. Ajeet Kumar, *Blinken Says China Continues To Commit Human Rights Abuses, Genocide In Xinjiang*, REPUBLIC WORLD (Apr. 13, 2022, 7:31 AM), https://www.republicworld.com/world-news/us-news/blinken-says-china-continues-to-commit-human-rights-abuses-genocide-in-xinjiang-articleshow.html.

46. Dominic Raab, U.K. Foreign Sec'y, Oral Statement to Parliament: *Treatment of Uyghur Muslims in Xinjiang* (Mar. 21, 2021), https://www.gov.uk/government/speeches/xinjiang-foreign-secretary-statement-to-house-of-commons-22-march-2021; *see also UK Accuses China of 'Gross' Human Rights Abuses Against Uighurs*, BBC NEWS (July 19, 2020), https://www.bbc.com/news/uk-politics-53463403.

47. Stephanie Nebehay, *U.N. Says it Has Credible Reports That China Holds Million Uighurs in Secret Camps*, REUTERS, (Aug. 10, 2018, 11:14 AM)., https://www.reuters.com/article/us-china-rights-un-idUSKBN1KV1SU.

48. *Id.*; *see* U.N. Hum. Rts. Off. of the High Comm'r, *OHCHR Assessment of Human Rights Concerns in the Xinjiang Uyghur Autonomous Region, People's Republic of China* (Aug. 31, 2022).

49. *Who are the Uyghurs*, *supra* note 27.

50. *China Cuts Uighur Births with IUDs, Abortion, Sterilization*, AP NEWS (June 29, 2020), https://apnews.com/article/ap-top-news-international-news-weekend-reads-china-health-269b3de1af34e17c1941a514f78d764c. In response, the U.S. government has implemented "targeted restrictions on trade with Xinjiang and imposing

In a view expressed at the U.N. in 2020, 38 countries joined Germany's call for the condemnation of "China's human rights abuses in the northwest region of Xinjiang, where the government is engaged in a sweeping campaign of demographic genocide against Uighur Muslims and other ethnic minorities."[51]

China argues that it is fighting the Uyghurs as terrorists who need to be detained and systematically transformed in both thought and behavior, and forcefully assimilated into Chinese society.[52] It maintains:

> the crackdown in Xinjiang is necessary to prevent terrorism and root out Islamist extremism and the camps are an effective tool for re-educating inmates in its fight against terrorism. It insists that Uyghur militants are waging a violent campaign for an independent state by plotting bombings, sabotage and civic unrest,[53] but it is accused of exaggerating the threat in

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visa and economic sanctions on some PRC officials," LUM & WEBER, *supra* note 30.

51. Zachary Basu, *More Countries Join Condemnation of China over Xinjian Abuses*, AXIOS (Oct. 8, 2020), https://www.axios.com/2020/10/08/un-statement-china-uighurs-xinjiang (showing the extensive list of countries that denounced China).

52. *See* Gerry Shih, *AP Exclusive: Uighurs fighting in Syria take aim at China*, AP NEWS (Dec. 22, 2017), https://apnews.com/article/syria-ap-top-news-riots-international-news-china-79d6a427b26f4eeab226571956dd256e.

> Since 2013, thousands of Uighurs, a Turkic-speaking Muslim minority from western China, have traveled to Syria to train with the Uighur militant group Turkistan Islamic Party and fight alongside al-Qaida, playing key roles in several battles.
>
> . . . .
>
> Uighur militants have killed hundreds, if not thousands, in attacks inside China in a decades-long insurgency that initially targeted police and other symbols of Chinese authority but in recent years also included civilians. Extremists with knives killed 33 people at a train station in 2014. Abroad, they bombed the Chinese embassy in Kyrgyzstan in September last year; in 2014, they killed 25 people in an attack on a Thai shrine popular with Chinese tourists.

Id.

53. *See* Austin Ramzy & Chris Buckley, *'Absolutely No Mercy': Leaked Files Expose How China Organized Mass Detentions of Muslims*, N.Y. TIMES (Nov. 16, 2019), https://www.nytimes.com/interactive/2019/11/16/world/asia/china-xinjiang-documents.html.

> President Xi Jinping . . . laid the groundwork for the crackdown . . . in April 2014, just weeks after Uighur militants stabbed more than 150 people at a train station, killing 31. Mr. Xi called for an all-out 'struggle against terrorism, infiltration and separatism' using the 'organs of dictatorship,' and showing 'absolutely no mercy,' . . . Beijing has sought for decades to suppress Uighur resistance to Chinese rule in Xinjiang. The current crackdown began after a surge of antigovernment and anti-Chinese violence, including ethnic riots in 2009 in Urumqi, the regional capital, and a May 2014 attack on an outdoor market that killed 39 people just days before Mr. Xi convened a leadership conference in Beijing to set a new policy course for Xinjiang.

order to justify repression of the Uyghurs.[54]

China has dismissed such claims asserting that "it is trying to reduce the Uyghur population through mass sterilizations [are] 'baseless,' and says allegations of forced labour are 'completely fabricated.'"[55]

C. International Labor Organization Labor Standards

In addition to the earlier discussed alleged violations of ILO Conventions Nos. 29 and 105, prohibiting forced labor regarding the Uyghurs, other ILO Declarations on Fundamental Principles and Rights at Work and its Follow-Up are argued to be violated or circumvented by China.[56] Among these obligations and commitments are the Freedom of Association and Protection of the Right to Organize Convention, 1948 (No. 87), and the Right to Organize and Collective Bargaining Convention, 1949 (No. 98), which promote the right to assemble and freely choose a union, which implies an independent union, and that arguably implies the need for adequate protections against anti-union discrimination.[57] While China has not ratified ILO Convention Nos. 87 or 98, China's response to criticism is that while it notes the international guidelines, it still has the legal and autonomous right to follow its own domestic laws.[58]

Under ILO Standards, "the right to organize public meetings constitutes an important aspect of trade union rights."[59] Detention "for reasons

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Id.

54. Patial RC, *Islamic World Fails to Stand Up for Uyghurs – OpEd*, EURASIA REV. (Feb. 7, 2022), https://www.eurasiareview.com/07022022-islamic-world-fails-to-stand-up-for-uyghurs-oped/.

55. *Who are the Uyghurs*, *supra* note 27.

56. *ILO Declaration on Fundamental Principles and Rights at Work*, INT'L LABOUR ORG., https://www.ilo.org/declaration/lang--en/index.htm (last visited Aug. 7, 2022) (explaining the declaration was adopted in 1998 and amended in 2022, the Declaration "is an expression of commitment by governments, employers' and workers' organizations to uphold basic human values - values that are vital to our social and economic lives. It affirms the obligations and commitments that are inherent in membership of the ILO").

57. *See id.*; *see also ILO Declaration on Fundamental Principles and Rights at Work and Its Follow-up*, INT'L LABOR ORG., [hereinafter *ILO Declaration and Its Follow Up*], https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/normativeinstrument/wcms_716594.pdf (last visited Aug. 7, 2022) (stating the Declaration protects the freedom of association and the right of workers).

58. *See generally* Michael J. Mazarr et al., *China and the International Order*, RAND CORP. (2018), https://www.rand.org/pubs/research_reports/RR2423.html. While it is also true the U.S. has not yet ratified these conventions, by contrast, the U.S. has comprehensive legal protections for such rights, *see, e.g.*, National Labor Relations Act, 29 U.S.C. §§ 151–69 (2010).

59. *Compilation of Decisions of the Committee on Freedom of Association, Trade*

connected with their activities in defence of the interests of workers constitutes a serious interference with civil liberties in general and with trade union rights . . . ."[60] The application of China's Law of 1989 on Assemblies Processions and Demonstrations regulating the demonstrations of Chinese citizens appears to prohibit legitimate labor strikes and demonstrations and, in effect, the freedom of association and assembly.[61] The effect of such domestic laws is to allow deviation away from the obligations of the ILO Conventions and the undermining of the internationally accepted labor standards by raising defenses of domestic law.[62] Members of the ILO would not dispute that national laws can provide legitimate justification for some deviation from ILO standards and non-ratified ILO Conventions.[63] However, by being a Member of the ILO, there is a commitment to respect and uphold principles and rights listed in the ILO Declaration on Fundamental Principles and Rights at Work, which include the freedom of association, even if those ILO Conventions that have not been ratified.[64] It is noteworthy that these ILO labor standards are often included as binding obligations in free trade agreements (FTAs) among parties.[65]

Union and Employers Organizations Rights and Civil Liberties, INT'L LABOUR ORG., https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:70002:0::NO::P70002_HIER_ELEMENT_ID,P70002_HIER_LEVEL:3943411,2 (last visited Aug. 1, 2023).

60. *See id.*

61. *See China: Law of 1989 on Assemblies, Processions and Demonstrations*, REF WORLD, https://www.refworld.org/docid/3ae6b592e.html (last visited Aug. 5, 2022) (noting the Chinese Constitution's need "to maintain social stability and public order").

62. *See Wang Yi: China, a Staunch Defender and Builder of International Rule of Law*, MINISTRY OF FOREGIN AFFS. OF THE PEOPLE'S REPUBLIC OF CHINA (Oct. 24, 2014, 10:33 AM), https://www.fmprc.gov.cn/mfa_eng/wjb_663304/wjbz_663308/2461_663310/201410/t20141027_468527.html ("Diplomacy is an extension of domestic affairs.").

63. *See id.* (explaining China's commitment to its own rule of law will further support its role to build an international rule of law).

64. *ILO Declaration on Fundamental Principles and Rights at Work*, *supra* note 56, at 9. (Stating that such obligations and commitment include "(1) freedom of association and the effective recognition of the right to collective bargaining; (2) the elimination of all forms of forced or compulsory labour; (3) the effective abolition of child labour; (4) the elimination of discrimination in respect to employment and occupation; and (5) a safe and healthy working environment.").

65. *See* U.S.-Korea Free Trade Agreement, Kor.-U.S., June 30, 2007, [hereinafter *KORUS*], https://ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file934_12718.pdf . With respect to fundamental labor rights, Article 19.2 of KORUS states:

> 1. Each Party shall adopt and maintain in its statutes and regulations, and practices thereunder, the following rights, as stated in the ILO Declaration on Fundamental Principles and Rights at Work and its Follow-Up (1998) (ILO Declaration): (a) freedom of association; (b) the effective recognition of the right to collective bargaining; (c) the elimination of all forms of compulsory or

D. EU-China Comprehensive Investment Agreement: Social Dimension Obligations and Limits

FTAs between and among nations are quite common:

> China's success in attracting foreign direct investment (FDI) in the past decades is unprecedented. It is currently the second largest FDI recipient in the world, which is a success partially due to China's efforts to enter into international investment instruments, such as BITs and [FTAs]. Since its first bilateral investment treaty (BIT) with Sweden in 1982, China has signed BITs with more than 130 countries.[66]

Western nations usually include labor commitments to ILO principles in their FTAs, less often in the BITs, particularly the ILO Fundamental Principles and Rights at Work Declaration.[67] On the other hand, China has not included these ILO labor provisions in its FTAs or BITs.[68]

The EU and China negotiated a draft of an EU-China CAI that was projected to provide a firmer foundation and clarify rules and procedures for the ever-growing trade and investment between the EU and China.[69] The economic benefits for each are clear and China had included ILO labor provisions in a draft CAI, perhaps as a precursor to a future EU-China FTA.[70]

> forced labor; (d) the effective abolition of child labor and, for purposes of this Agreement, a prohibition on the worst forms of child labor; and (e) the elimination of discrimination in respect of employment and occupation.

Id. Additionally, subsection 1.a of Article 19.3 pertaining to application and enforcement of labor laws states

> 1. (a) Neither Party shall fail to effectively enforce its labor laws, including those it adopts or maintains in accordance with Article 19.2.1, through a sustained or recurring course of action or inaction, in a manner affecting trade or investment between the Parties, after the date this Agreement enters into force.

Id. at Art. 19.2.1, 19.3.1(a).

66. Xu Qian, Review of *China's Treaty Policy and Practice in International Investment Law and Arbitration*, EUR. CHINESE RSCH. HUB, https://blog.uni-koeln.de/eclrhub/2022/04/20/chinas-treaty-policy-and-practice-in-international-investment-law-and-arbitration/ (last visited Aug. 1, 2023).

67. *See, e.g., KORUS, supra* note 65; *see also ILO Declaration on Fundamental Principles and Rights at Work, supra* note 56.

68. *See* Ronald C. Brown, *A New Leader in Asian Free Trade Agreements? Chinese Style Global Trade: New Rules, No Labor Protections*, 35 UCLA PAC. BASIN L.J. 1, 26 (2017) [hereinafter *A New Leader in Asian Free Trade Agreements?*]; *see also* Ronald C. Brown, *Asian and US Perspectives on Labor Rights Under International Trade Agreements Compared, in* GLOBAL GOVERNANCE OF LABOUR RIGHTS: ASSESSING THE EFFECTIVENESS OF TRANSNATIONAL PUBLIC AND PRIVATE POLICY INITIATIVES, (Axel Marx et al. eds. 2015) [hereinafter *Asian and US Perspectives on Labor Rights*].

69. *See* European Commission Press Release IP/20/2542, Key Elements of the EU-China Comprehensive Agreement on Investment (Dec. 30, 2020) [Key Elements].

70. *See* Bruce Fu & Sam Jones, *EU-China CAI: Opportunities for EU Multinationals in China*, APCO WORLDWIDE (Feb. 22, 2021), https://apcoworldwide.com/blog/eu-

The CAI draft provides for efforts toward ratification of the forced labor prohibition by China,[71] even though the EU was concerned that China's treatment of the Uyghurs was problematic. Additionally, the dispute resolution mechanism was inadequate since enforcement mechanisms under the sustainable development chapter only required efforts, not results by the Parties.[72]

> The EU-China CAI is an investment agreement which does not include trade issues and is mainly based on existing obligations under WTO law. As such, the Agreement in Principle revolves around three main issues: investments, sustainable development, and monitoring and enforcement mechanisms . . . .
>
> . . . .
>
> As for sustainable development, the Agreement is based on two pillars: labour and environment. The EU and China have agreed to effectively implement the goals of the Paris agreement and have committed to effectively implement ILO Conventions already ratified and to ratify fundamental Conventions not yet ratified, especially on the abolition of forced labour . . . .
>
> . . . .
>
> The CAI also represents a landmark as it is the first time China is committing to labour and environmental standards in an economic agreement.[73]

On May 20, 2021, while considering ratification of the CAI, the European Parliament voted to freeze the ratification when China imposed sanctions on

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china-cai-opportunities-for-eu-multinationals-in-china/; Sofia Baruzzi, *EU-China Comprehensive Investment Agreement*, CHINA BRIEFING (Sept. 18, 2021), https://www.china-briefing.com/news/eu-china-comprehensive-investment-agreement/. *See generally* Ronald C. Brown, *China-EU BIT and FTA: Building a Bridge on the Silk Road Not Detoured by Labor Standard Provisions*, 29 WASH. INT'L L.J. 61, 108 (2019).

71. *See* Key Elements, *supra* note 69 ("China also commits to working towards the ratification of the outstanding ILO (International Labour Organisation) fundamental Conventions and takes specific commitments in relation to the two ILO fundamental Conventions on forced labour that it has not ratified yet.").

72. Joerg Wuttk, *The EU-China CAI—perspectives from the European business community in China*, 20 ASIA EUR. J. 21, 21 (2022).

> The European Union Chamber of Commerce in China recognises the challenges in progressing the CAI, but remains convinced that the investment agreement is worthwhile and, in the EU's, best interests. While not the 'silver bullet' that would be the ideal, the CAI meaningfully improves market access, equal treatment, and sustainability interests and should be ratified if political tensions can be ratchetted down.

Id.; *see also* Ignacio Escondrillas Sánchez, *The EU-China Comprehensive Agreement on Investments (CAI): A Piece of the Puzzle*, GLOB. RISK INSIGHTS (Sept. 6, 2021), https://globalriskinsights.com/2021/09/the-eu-china-comprehensive-agreement-on-investments-cai-a-piece-of-the-puzzle/.

73. Sánchez, *supra* note 72.

several EU Member States for their comments on Uyghurs,[74] which followed from the EU's earlier sanctions on Chinese officials for their treatment of the Uyghurs.[75] China has since ratified ILO Conventions Nos. 29 and 105,[76] which were relevant to the reasons for the stall, but the CAI negotiations currently remain inactive.[77] Whether the CAI will be revived and perhaps

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74. "Beijing has said it will sanction several EU officials, including parliamentarians, for 'harming' China's sovereignty. The EU, the US, the UK and Canada all slapped sanctions on Beijing for abuses in Xinjiang," *China Sanctions EU Officials in Response to Uyghur Row*, DEUTSCHE WELLE (Mar. 22, 2021) [hereinafter *China Sanctions EI Officials*], https://www.dw.com/en/china-sanctions-eu-officials-in-response-to-uyghur-row/a-56948924; *see also* Robin Emmott, *EU Parliament Freezes China Deal Ratification Until Beijing Lifts Sanctions*, REUTERS (May 20, 2021, 10:51 AM), https://www.reuters.com/world/china/eu-parliament-freezes-china-deal-ratification-until-beijing-lifts-sanctions-2021-05-20/ (In response to Chinese sanctions on European human rights advocates, the EU Parliament voted to freeze the CAI negotiations. The vote passed with "599 votes in favour, 30 votes against, and 58 abstentions.").

75. Jorge Liboreiro, *MEPs Vote to Freeze Controversial EU-China Investment Deal*, EURONEWS (June 24, 2021), https://www.euronews.com/2021/05/20/european-parliament-votes-to-freeze-controversial-eu-china-investment-deal.

> The European Parliament has overwhelmingly voted to freeze the ratification of the EU-China investment deal due to the sanctions that Beijing has imposed on five members of the [European Parliament (MEP)]. In a strongly-worded resolution passed on Thursday afternoon, the Parliament also deplores what it calls the 'crimes against humanity' that are taking place against the Uyghur Muslim minority in the Xinjiang region . . . . MEPs also urged the Chinese government to ratify and implement several conventions of the International Labor Organization (ILO), including those related to forced labor, freedom of association and the right to organise. China and the United States are the only big economies that have not ratified the 1930 convention that abolishes forced labor in all its forms. China hasn't ratified either the United Nations' International Covenant on Civil and Political Rights. Reacting to the move from Brussels, the Chinese Foreign Ministry said the investment deal is a 'win-win' for both sides and asked for 'positive efforts' towards an early ratification. Spokesperson Zhao Lijian defended the Chinese countersanctions as a 'necessary, legitimate and just reaction to the EU's moves of imposing sanctions and seeking confrontation.'

Id.; *see* Phoebe Zhang, *China Ratifies Forced Labour Conventions Ahead of Visit by UN Rights Chief*, BUS. & HUM. RTS. RES. CTR. (Apr. 20, 2022), https://www.businesshumanrights.org/en/latest-news/china-ratifies-forced-labour-conventions-ahead-ofvisit-by-un-rights-chief/ (stating that on April 20, 2022, China ratified ILO Convention Numbers 29 and 105 related to forced labor).

76. Zhang, *supra* note 75.

77. *See China Ratifies Two ILO Conventions*, *supra* note 4 ("The International Labour Organization (ILO) has welcomed the decision by the *National* People's Congress of the People's Republic of China to approve the ratification of the Forced Labour Convention, 1930 (No. 29) and the Abolition of Forced Labour Convention, 1957 (No. 105)."); *see also* Baruzzi, *supra* note 70.

lead to an EU-China FTA remains to be seen.[78]

The draft CAI text provides for efforts toward ratification of the forced labor prohibition by China. Given China's recent ratification of those conventions, the focus now may be on whether compliance should be evident before or after final agreement of the CAI, and the likely effectiveness of the enforcement mechanisms.[79]

E. National Legislative Limits

"On December 23, 2021, President Joe Biden signed into law the Uyghur Forced Labor Prevention Act[80] . . . , which bars the importation into the United States of products made from forced labor in the Xinjiang region of China."[81] An overview of the reach of that law follows:

> This Act will significantly impact many multinational employers' supply chains because raw materials from this region — such as cotton, coal, chemicals, sugar, tomatoes and polysilicon (a component in solar panels) — have found their way into many global supply chains. Indeed, these materials arrive on U.S. shores directly from China, as well as via third countries, like Vietnam, which imports Xinjiang cotton for manufacturing textiles that eventually reach the United States.
>
> The United States, United Kingdom, Canada, as well as other countries, have alleged that these materials have been produced through the Chinese government's wide-scale repression of Uyghurs and other predominantly

78. *See A New Leader in Asian Free Trade Agreements?*, *supra* note 68, at 31. Yen Nee Lee, *EU-China Investment Deal is Still Possible – but Not Before 2023, Analyst Says*, CNBC (June 15, 2021, 1:41 AM), https://www.cnbc.com/2021/06/15/eu-china-investment-deal-still-possible-but-not-before-2023-analyst.html.

79. *See* Sánchez, *supra* note 72. As early as 2019, a resolution was passed in the EU Parliament against China's labor practices in Xinjiang, *see* Forced Labour and the Situation of the Uyghursin the Xinjiang Uyghur Autonomous Region, EUR. PARL. DOC. P9_TA(2020)0375 (2020) https://www.europarl.europa.eu/doceo/document/TA-9-2020-0375_EN.pdf. Continuing negotiations by Switzerland to refresh its FTA with China likewise have stalled as Switzerland's position on China's human rights record, reportedly, has become more critical, *see generally China-Swiss Trade Talks Stall Over Rights Issues,* REUTERS, https://www.reuters.com/world/europe/china-swiss-trade-talks-stall-over-rights-issues-newspapers-2022-05-29/ (last updated May 30, 2022, 6:26 AM) ("A Swiss parliamentary initiative recently passed by the National Council's Legal Affairs Committee denounced forced labour of Uyghurs in northwest China as 'a real problem.'").

80. Pub. L. No. 117-78, 135 Stat. 1525 (2021).

81. Lavanya Wijekoon et al., *U.S. Enacts Law Barring Products Made With Forced Labor in China*, LITTLER (Jan. 3, 2022), https://www.littler.com/publication-press/publication/us-enacts-law-barring-products-made-forced-labor-china. The U.S. also adopted legislation in 2020, aimed to impose visa and economic "sanctions on PRC officials . . . for human rights abuses against Uyghurs and other Muslim minority groups in Xinjiang," LUM & WEBER, *supra* note 30. *See generally* Uyghur Human Rights Policy Act of 2020, Pub. L. No. 116-145, 134 Stat. 648.

> Muslim ethnic minorities in Xinjiang. The U.S. Department of State has gone so far as to declare that this repression amounts to genocide and crimes against humanity. China has flatly denied these allegations.
>
> Critically, the Act places a novel burden on multinational employers to *overcome* a presumption that products from Xinjiang are made with forced labor. The Act is thus one of the latest in a series of various global legislative measures that have placed enhanced due diligence and other obligations on multinational employers to ensure that their supply chains are devoid of forced labor.[82]

Likewise, national restrictions on supply chain trade involving human rights violations are also present in other western countries. These hold domestic companies legally liable for their human rights practices, as well as for the human rights practices of businesses connected with their supply or value chains. For example, a patchwork of similar laws has evolved in the EU, with due diligence laws implemented in France, Germany, and the Netherlands.[83] On February 23, 2022, the EU Parliament adopted the proposed Draft on Corporate Sustainability and Due Diligence Directive (the "Draft Directive"),[84] setting out recommendations to the European Commission.[85] "The Draft Directive outlines a mandatory corporate due diligence obligation on businesses to identify, prevent, manage, remedy, and report on human rights and environmental risks and violations in their value chains."[86] Likewise, Canada, Norway, and the U.K. have addressed

82. Wijekoon et al., *supra* note 81 (internal citations omitted).

83. *See* Daniel Sharma, *Human Rights Due Diligence Legislation in Europe – Implications for Supply Chains to India and South Asia*, DLA PIPER (Mar. 26, 2021), https://www.dlapiper.com/en/middleeast/insights/publications/2021/03/human-rights-due-diligence-legislation-in-europe/.

84. European Commission Press Release IP/22/1145, Just and Sustainable Economy: Commission Lays Down Rules for Companies to Respect Human Rights and Environment in Global Value Chains (Feb. 23, 2022), https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145; *see also* Johannes Weichbrodt et al., *EU Publishes Draft Corporate Sustainability Due Diligence Directive*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 15, 2022), https://corpgov.law.harvard.edu/2022/03/15/eu-publishes-draft-corporate-sustainability-due-diligence-directive/. *See generally* Ronald C. Brown, *Due Diligence – MNCs and Human Labor Chains - Remedies: Soft Law and Hard Law*, 22 UCLA J. INT'L L. & FOREIGN AFFS. 119 (2018).

85. Kate Bresner et al., *Europe and Canada Seek to Mandate Human Rights Due Diligence and Transparency Obligations on Companies and Their Global Partners*, JD SUPRA (Oct. 28, 2021), https://www.jdsupra.com/legalnews/europe-and-canada-seek-to-mandate-human-4289237/ ("On March 10, 2021, the EU Parliament adopted the Draft Directive on Corporate Due Diligence and Corporate Accountability (the 'Draft Directive'), setting out recommendations to the European Commission."); *see* Corporate Due Diligence and Corporate Accountability, EUR. PARL. DOC. P9_TA(2021)0073 (2021), https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.pdf.

86. *See* Michael R. Littenberg et al., *European Commission (Finally) Proposes*

the issue.

Canada has also recently started to seize goods from China it identified as being made with forced labor, and debate has already begun on imposing a U.S.-style burden of proof on importers. Further, the U.K. government has stated that it seeks to amend the U.K. Modern Slavery Act of 2015 to impose similar corporate obligations on U.K. companies, including levying hefty fines on companies that cannot show their supply chains are not from forced labor tied to Xinjiang.[87]

III. LEGAL STANDARDS AFFECTING UYGHURS

A. U.N., International Labor Organization, and National Laws

Labor and human rights come in many forms and protecting them has always been a work in progress.[88] There are a variety of U.N. treaties concerning the protection of labor and human rights which seek to reach many different types of abuses including forced labor.[89] However, one of

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Mandatory Human Rights and Environmental Due Diligence Directive – A Deep Dive Q&A on the Commission Proposal, ROPES & GRAY (Oct. 28, 2022), https://www.ropesgray.com/en/newsroom/alerts/2022/February/European-Commission-Finally-Proposes-Mandatory-Human-Rights.

87. Wijekoon et al., *supra* note 81 (internal citations omitted); *see* Michael R. Littenberg & Sarah Lambert-Porter, *Proposed Amendments to the UK Modern Slavery Act Introduced in Parliament*, ROPES & GRAY (June 28, 2021), https://www.ropesgray.com/en/newsroom/alerts/2021/June/Proposed-Amendments-to-the-UK-Modern-Slavery-Act-Introduced-in-Parliament; *see* Bresner et al., *supra* note 85.

> [O]n June 10, 2021, Germany adopted the *Act on Corporate Due Diligence Obligations in Supply Chains* (the 'German Act'). The purpose of the German Act is to impose corporate due diligence obligations on prescribed businesses with respect to human rights and environmental risks . . . . The annual report must state: (1) Whether the business has identified any human rights and environment-related risks or violations of a human rights-related or environment-related obligation, and if so, which ones; (2) What the business has done to fulfil its due diligence obligations with reference to the measures described in Sections 4 to 9 of Division 2 of the German Act, including the elements of the policy statement required under Section 6(2), and the measures taken by the business as a result of complaints under Sections 8 or 9(1); (3) How the business assesses the impact and effectiveness of the measures; and (4) What conclusions it draws from the assessment for future measures.

Bresner et al., *supra* note 85 (internal citations omitted).

88. *UDHR*, *supra* note 15. The UDHR "was proclaimed by the UN General Assembly in Paris on 10 December 1948 (General Assembly resolution 217 A) as a common standard of achievements for all peoples and all nations," *id.*

89. *Ratification Status for China*, U.N. HUM. RTS. OFF. OF THE HIGH COMM'R, https://tbinternet.ohchr.org/_layouts/15/TreatyBodyExternal/Treaty.aspx?CountryID=36&Lang=EN.

CAT - Convention against Torture and Other Cruel Inhuman or Degrading

the realities has been that viewing violations of these rights, including those of the Uyghurs, "through the lens of international human rights treaties is said to be only of moderate utility since the treaty violations do not in and of themselves result in a direct and legal remedy."[90] This is discussed in some detail in a recent analysis of possible legal remedies with reference to possible treaty violations regarding treatment of the Uyghurs.[91]

The definition of forced labor appears to apply to the work conditions of the Uyghurs in China.[92] Human rights groups assert that legal remedies

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> Treatment or Punishment; CAT-OP - Optional Protocol of the Convention against Torture; CCPR - International Covenant on Civil and Political Rights; CCPR-OP2-DP - Second Optional Protocol to the International Covenant on Civil and Political Rights aiming to the abolition of the death penalty; CED - Convention for the Protection of All Persons from Enforced Disappearance; CED, Art.32 - Interstate communication procedure under the International Convention for the Protection of All Persons from Enforced Disappearance; CEDAW - Convention on the Elimination of All Forms of Discrimination against Women; CERD - International Convention on the Elimination of All Forms of Racial Discrimination; CESCR - International Covenant on Economic, Social and Cultural Rights; CMW - International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families; CRC - Convention on the Rights of the Child CRC-OP-AC - Optional Protocol to the Convention on the Rights of the Child on the involvement of children in armed conflict; CRC-OP-SC - Optional Protocol to the Convention on the Rights of the Child on the sale of children child prostitution and child pornography; CRPD - Convention on the Rights of Persons with Disabilities.

Human Rights Dashboard, *supra* note 6.

90. *See* Lim, *supra* note 14, at 107.

91. *See id.* ("The human rights treaties to which China is a state party and that this section will cover are: 1) the [CEDAW], 2) the [CERD], 3) the [ICESCR], 4) the [CRC], and 5) the [CRPD])." *See also* Stein, *supra* note 15, at 7–8.

92. *ILO Standards On Forced Labour: The New Protocol and Recommendation at a Glance*, INT'L LABOUR ORG. (2016), at 5, https://www.ilo.org/wcmsp5/groups/public/@ed_norm/@declaration/documents/publication/wcms_508317.pdf.

> Forced labour can be understood as work that is performed involuntarily and under the menace of any penalty. Article 2(1) of Convention No. 29 defines 'forced or compulsory labour' as 'all work or service which is exacted from any person under the menace of any penalty and for which the said person has not offered himself voluntarily'. This definition consists of three elements: 1. Work or service: 'All work or service' refers to all types of work, service and employment, occurring in any activity, industry or sector, including in the informal economy. Forced labour can occur in both the public and private sectors. 2. Menace of any penalty: The 'menace of any penalty' refers to a wide range of penalties used to compel someone to perform work or service, including penal sanctions and various forms of direct or indirect coercion, such as physical violence, psychological threats or the non-payment of wages. The 'penalty' may also consist of a loss of rights or privileges (such as a promotion, transfer, or access to new employment). 3. Involuntariness: The terms 'offered voluntarily' refer to the free and informed consent of a worker to enter into an

beyond the usual ILO enforcement mechanisms should be used.[93] It is further argued that the term "forced labor" "is defined and prohibited by the Forced Labor Convention [and] constitutes a *jus cogens* norm, and thus binds the international community."[94] With that understanding, the Canadian Supreme Court upheld the possibility of corporate liability from overseas forced labor.[95]

On February 28, 2020, a five-justice majority of the Supreme Court of Canada ruled that Canadian corporations can be sued in Canada for breaches of customary international law committed abroad. "The plaintiffs claimed damages from Nevsun Resources Ltd. (Nevsun), a Canadian corporation, for alleged human rights abuses in a mine in Eritrea operated by a majority-owned Eritrean [Africa] indirect subsidiary."[96]

Criminal penalties are also possible under claims of "crimes against humanity and forced labor."

> The first term—crimes against humanity—is an umbrella term in that it comprises multiple crimes. The Rome Statute, which is the foundational document for the International Criminal Court, clearly defines crimes against humanity and provides a direct legal remedy. Other experts already established that Chinese atrocities constitute the crimes against

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> employment relationship and his or her freedom to leave the employment at any time. For example, an employer or recruiter could interfere with this freedom by making false promises to induce a worker to take a job that he or she would not otherwise have accepted.

Id.

93. *See, e.g.*, Lim, *supra* note 14, at 127–28.

94. *Id.* at 112. It is proposed that the following means of recourse might be available under international law: "1) suit before the International Criminal Court, 2) suit before the International Court of Justice, and 3) suit before a third-party national court exercising universal jurisdiction," *id.* at 94. A recent decision from the Supreme Court of Canada, the "ILO has similarly stated that the prohibition on forced labor has attained *jus cogens status*. The prohibition on forced labor, just like the prohibition on crimes against humanity, represents a *jus cogens* norm and can thus furnish an independent cause of action," *id.* at 128; *see also* Jacqueline Code et al., *Supreme Court of Canada Opens Door to Liability for Alleged Human Rights Abuses Abroad*, OSLER (Mar. 4, 2020), https://www.osler.com/en/resources/governance/2020/supreme-court-of-canada-opens-door-to-liability-for-alleged-human-rights-abuses-abroad?utm_source=Mondaq&utm_medium=syndication&utm_campaign=LinkedIn-integration ("Customary international law, in the majority's view, is based on internationally accepted norms. A norm arises when (1) it is a general (but not necessarily universal) state practice, and (2) there is an accompanying belief that such practice gives rise to a legal right or obligation (*opinio juris*). Some norms, called *jus cogens* or peremptory norms, are so fundamental that no derogation from them is permitted. Prohibitions against slavery, forced labour, and cruel, inhuman and degrading treatment have attained *jus cogens* status.").

95. *See* Code et al., *supra* note 94.

96. *Id.*

> humanity of imprisonment or other severe deprivation of physical liberty, persecution, and enforced disappearance. Chinese actions in Xinjiang also constitute the specific crimes against humanity of forced sterilization, apartheid, and torture. The prohibition on crimes against humanity, in addition to being codified in the Rome Statute, also represents a *jus cogens* norm, which means that it binds all members of the international community and permits no derogation. The second term—forced labor—is defined and prohibited by the Forced Labor Convention. This term constitutes a *jus cogens* norm, and thus binds the international community. China's government is guilty of perpetuating a system of forced labor. Both the prohibitions on crimes against humanity and forced labor are cast as high utility terms since they have attained *jus cogens* status and thereby provide a clear path to a remedy.[97]

Even though China has now ratified ILO Conventions against forced labor, its alleged sustained practices against the Uyghurs still appear to violate the UDHR against forced labor[98] and the ICESCR[99] through its ethnic discrimination of the Uyghurs' right to self-determination, thereby subverting its professed international commitments through domestic law and alleged practices.[100]

> By cracking down on Uyghur language rights, while simultaneously mandating that Uyghurs speak Mandarin Chinese, China has also exhibited a preference for one ethnic group over another.
>
> . . . .
>
> Article I declares that all peoples have the right to 'self-determination' through the ability to 'freely determine their political status and freely pursue their economic, social, and cultural development.' China's rule of Xinjiang has resulted in a 'series of policies that Uyghurs would not have chosen had they been able to govern themselves.' Moreover, China has arguably instituted apartheid in Xinjiang by creating and maintaining a regime wherein Uyghurs and other minority ethnic groups are systematically oppressed. A system of apartheid violates Article I of the

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97. Lim, *supra* note 14, at 111–12.

98. *See UDHR*, *supra* note 15, at Art. 4. Article 4 of the UDHR provides that "[n]o one shall be held in slavery or servitude; slavery and the slave trade shall be prohibited in all their forms," *id.*

99. *See ICESCR*, *supra* note 6. *China Ratifies Convention on Human Rights*, CHINA.ORG (Feb. 28, 2001), http://www.china.org.cn/english/2001/Mar/8285.htm. (stating that China ratified the ICESCR).

100. "China signed the [ICCPR], on October 5, 1998, but has yet to ratify it, despite repeated promises to do so. Human Rights Watch believes that there are no credible reasons for the Chinese government to further delay ratification, absent which the government is not fully bound to uphold the treaty's protections," *China: Ratify Key International Human Rights Treaty*, HUM. RGTS. WATCH (Oct. 8, 2013, 3:59 PM) https://www.hrw.org/news/2013/10/08/china-ratify-key-international-human-rights-treaty. *See generally ICESCR*, *supra* note 6.

> ICESCR by preventing certain peoples from enjoying rights of self-determination.[101]

In modern times, the UDHR sets out, for the first time, fundamental human rights to be universally protected, ranging from free association to prohibiting forced labor.[102] One of the leading U.N. Covenants aimed at protecting human rights is the ICCPR.[103] Although China signed the ICCPR on October 5, 1998, it has yet to ratify the convention.[104] As stated previously, in Article 21, the ICCPR provides for peaceful assembly and Article 22 provides that everyone "shall have the right to freedom of association with others, including the right to form and join trade unions for the protection of his interests."[105] Additionally, the Chinese Trade Union Law denies Chinese workers the right to organize independent unions.[106]

The ICESCR was signed by China in 1997 and subsequently ratified in 2001.[107] Article 8 of the Convention recognizes the right of workers to form

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101. Lim, *supra* note 14, at 108–09 (internal footnotes omitted); *see also ICESCR*, *supra* note 6, at Art. 1 (stating people are free to determine their own economic, cultural, and political development).

102. *See Ratification Status for China*, *supra* note 89, at 1–3; *Human Rights Dashboard*, *supra* note 6, at 1.

> A series of international human rights treaties and other instruments adopted since 1945 have expanded the body of international human rights law. They include the Convention on the Prevention and Punishment of the Crime of Genocide (1948), the International Convention on the Elimination of All Forms of Racial Discrimination (1965), the Convention on the Elimination of All Forms of Discrimination against Women (1979), the Convention on the Rights of the Child (1989) and the Convention on the Rights of Persons with Disabilities (2006), among others.

UDHR, *supra* note 15; *see also Human Rights*, UNITED NATIONS, https://www.un.org/en/global-issues/human-rights (last visited Aug. 7, 2022) (However, China has not ratified all of them).

103. *See ICCPR*, *supra* note 6, at 1.

104. *China: Ratify Key International Human Rights Treaty*, *supra* note 100, at 2.

> China is the only country among the permanent members of the UN Security Council not to have joined the ICCPR which guarantees essential rights ranging from the right to trial before an independent and impartial court to freedom of expression and political participation through regular and free elections. States parties to the ICCPR are subject to a periodic examination by the UN Human Rights Council that assesses progress and deficiencies in the implementation of the treaty's obligations.

Id.; see *Human Rights Dashboard*, *supra* note 6.

105. *See ICCPR*, *supra* note 6 at Art. 21, 22. (stating Articles 21 and 22 provide key provisions protecting Unions).

106. *China's Trade Union Law*, *supra* note 25, at 2; *see also HR* IN ASIA, *supra* note 16, at 1 ("In China, all trade unions must be affiliated with the All-China Federation of Trade Union.").

107. *Ratification Status for China*, *supra* note 89.

or join trade unions and protects the right to strike.[108] China has placed a reservation on this clause, allowing it to be interpreted in a manner consistent with its laws and constitution.[109]

These standards are promulgated by the UN Agency International Labour Organization (ILO)[110] and are legally binding international treaties,[111] which include eight fundamental rights, of which China as a member has ratified six, most recently ILO Convention Numbers 29 and 105 on forced labor.[112] They protect workers' rights to trade unions and the right to strike.[113] Ratifications of the fundamental conventions are uneven, but the ratification of Convention Numbers 29 and 105 are high.[114]

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108. *See ICCPR*, *supra* note 6, at 5 (providing rights and explicit obligations to follow).

109. *See Human Rights Dashboard*, *supra* note 6; *see also* IRISH TIMES, *supra* note 6.

110. "[T]he only tripartite U.N. agency, since 1919 the ILO brings together governments, employers and workers of 187 member States, to set labour standards, develop policies and devise programmes promoting decent work for all women and men," *About the ILO*, INT'L LABOUR ORG., https://www.ilo.org/global/about-the-ilo/lang--en/index.htm (last visited Aug. 7, 2022).

111. *See International Labour Law*, UNIV. MELBOURNE, https://unimelb.libguides.com/c.php?g=948167&p=6871091 (last visited Aug. 7, 2022).

> [I]nternational labour standards are a comprehensive set of legal instruments that establish basic principles and rights at work, with a goal to improve working conditions on a global scale. The Conventions and Recommendations of the ILO form the international labor standards. Conventions are legally binding international treaties that may be ratified by member states. Recommendations are non-binding guidelines.

Id.

112. *See Ratifications for China*, *supra* note 31 (showing that China has not ratified Conventions 87 and 98); *see* Press Release, Int'l Labour Org., ILO Welcomes China's Move Towards the Ratification of Two Forced Labour Conventions, U.N. Press Release (Apr. 21, 2022); *see also* Phoebe Zhang, *China Ratifies Forced labour Conventions Ahead of Visit by UN Rights Chief*, S. CHINA MORNING POST (Apr. 20, 2022), https://www.business-humanrights.org/en/latest-news/china-ratifies-forced-labour-conventions-ahead-of-visit-by-un-rights-chief/.

113. *Labour Legislation Guidelines Chapter V Substantive Provisions of Labour Legislation: The Right to Strike*, INT'L LABOUR ORG. (Dec. 10, 2001), https://www.ilo.org/static/english/dialogue/ifpdial/llg/noframes/ch5.htm#:~:text=The%20right%20to%20strike%20is,social%20interests%20of%20their%20members ("The right to strike is recognized by the ILO's supervisory bodies as an *intrinsic corollary of the right to organize protected by Convention No. 87*, deriving from the right of workers' organizations to formulate their programmes of activities to further and defend the economic and social interests of their members.").

114. *Ratifications of C029 - Forced Labour Convention, 1930 (No. 29)*, INT'L LABOUR ORG., https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:11300:0::NO:11300:P11300_INSTRUMENT_ID:312174:NO (last visited Jan. 22, 2023) (showing that C029 has 180 ratifications); *Ratifications of C105 - Abolition of Forced Labour Convention, 1957 (No. 105)*, INT'L LABOUR ORG.,

Table 1: ILO Fundamental Conventions and Ratification by China[115]

ILO Convention Number	ILO Fundamental Conventions	Ratification by China
C029	Forced Labour Convention, 1930	August 12, 2022
C087	Freedom of Association and Protection of the Right to Organise Convention, 1948	Not ratified
C098	Right to Organise and Collective Bargaining Convention, 1949	Not ratified
C100	Equal Remuneration Convention, 1951	November 2, 1990
C105	Abolition of Forced Labour Convention, 1957	August 12, 2022
C111	Discrimination (Employment and Occupation) Convention, 1958	January 12, 2006
C138	Minimum Age Convention, 1973	April 28, 1999
C182	Worst Forms of Child Labour Convention, 1999	August 8, 2002

The enforcement of ILO Conventions comes under the bureaucratic supervision of the ILO,[116] which is committed to the full implementation of

https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:11300:0::NO:11300:P11300_INSTRUMENT_ID:312250:NO (last visited Jan. 22, 2023) (showing that C105 has 178 ratifications).

115. *See Ratifications for China*, *supra* note 36.

116. *Monitoring Compliance with International Labour Standards: The Key Role of the ILO Committee of Experts on the Application of Conventions and Recommendations*, INT'L LABOUR ORG. 10-11 (2019), [hereinafter *Monitoring Compliance with International Labour Standards*], https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---normes/documents/publication/wcms_730866.pdf.

> Within the ILO supervisory system, the Committee of Experts on the Application of Conventions and Recommendations (CEACR or Committee of Experts) is an independent body responsible for conducting the technical examination of the compliance of member States with provisions of ratified Conventions (and Protocols) . . . The ILO constitutional provisions relating to supervision of the application of ratified Conventions – the obligation to make annual reports on measures taken to give effect to ratified Conventions and the procedures for the presentation of representations and complaints – have been in place since they were first set out in the 1919 Constitution . . . .

the ratified conventions and the ILO Declaration on Fundamental Principles and Rights at Work.[117] This infrastructure consists of country status/compliance reports required of ratified and non-ratified conventions,[118] complaint procedures for violations of ratified conventions and for freedom of association violations including for non-ratifying

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Id.

117. *ILO Declaration on Fundamental Principles and Rights at Work*, *supra* note 56.

118. There is a requirement for members to submit reports at regular intervals for non-ratified conventions and annually for ratified conventions.

> Under Article 19 of the ILO Constitution, member States are required to report on non-ratified Conventions and on Recommendations at regular intervals, at the request of the Governing Body, indicating the extent to which effect has been given or is proposed to be given to those instruments. On the basis of article 19, the Committee of Experts publishes an in-depth annual General Survey on member States' national law and practice, on a subject chosen by the Governing Body. *Regular Reports on Ratified Conventions*: Member States must report regularly to the Committee of Experts on the Application of Conventions and Recommendations (CEACR) on the measures which they have taken to give effect to ratified ILO conventions (Article 22 of the ILO Constitution). Additionally, Member States have to present the state of domestic law and practice and possible steps of implementation with regard to *non-ratified conventions* and recommendations.

The ILO Supervisory System – Reporting, UNIV. OF MELBOURNE, https://unimelb.libguides.com/c.php?g=948167&p=6871091 (last visited Aug. 7, 2022) (some emphasis added); *see International Labour Law*, *supra* note 111 (describing members' requirement to submit reports at regular intervals for non-ratified conventions and annually for ratified conventions).

> *Complaints over the Application of Ratified Conventions*: The complaints procedure (Articles 26 to 34 of the ILO Constitution) allows for the consideration of complaints against a Member State by: another Member State of the same convention, a delegate to the International Labour Conference (of Member States), or the ILO Governing Body. A Commission of Inquiry may be formed to investigate the allegation. This Commission carries out a full investigation of the complaint, reports on all questions of fact, and makes suggestions as to the steps to be taken. The Commission's report is published, and the governments concerned must inform the Director-General whether they accept the Commission's recommendations or intend to refer the complaint to the International Court of Justice . . . . *Special procedure for complaints regarding freedom of association*: Independently of the Representation and Complaints procedures, the Committee on Freedom of Association (CFA) examines complaints about violations of freedom of association, *whether or not the country concerned had ratified the relevant conventions*. Complaints may be brought against a member state by employers' and workers' organisations. The Committee may issue a report and make recommendations to the State if it decides there has been a violation. To date, the CFA has examined over 3,000 cases.

The ILO Supervisory System - Representations & Complaints, UNIV. OF MELBOURNE, https://unimelb.libguides.com/c.php?g=948167&p=6871091 (last visited Aug. 7, 2022) (some emphasis added).

members, and training workshops.[119] There is a requirement for members to submit reports at regular intervals for *non-ratified* conventions and annually for ratified conventions.[120] While the ILO generally lacks the coercive power of legal enforcement, it has used its power of persuasion[121] with some success over the years.

> Contrary to the critique that international legal monitoring bodies often receive, the CEACR [ILO Committee of Experts on the Application of Conventions and Recommendations], within the comprehensive ILO supervisory system, has demonstrated that relentless supervision through constructive dialogue on the application of standards can have real, practical and tangible effects in domestic jurisdictions, and thus on the daily lives of working men and women. In this regard, if the success or failure of the ILO's supervisory system were to be measured in terms of the results obtained and their permanence, the number of cases of progress recorded by the CEACR can serve to demonstrate that the supervisory system has largely fulfilled its functions in recent decades.[122]

B. National Legislation Impacting International Commerce with Uyghurs

In the U.S., corporate liability for dealing directly or indirectly with Uyghur forced labor in China has been limited by current interpretations of

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119. *Monitoring Compliance with International Labour Standards*, *supra* note 116, at 9 (indicating that the ILO's system of promoting compliance is highly regarded at the international level).

> But from the very beginning, it has been clear that without effective implementation of such standards, this objective would not be achieved. The Organization therefore took this as its central concern and progressively developed various supervisory bodies to help ensure effective implementation of the instruments adopted . . . . The supervisory mechanisms of the ILO are multifaceted and anchored in the Organization's standards and principles. While various monitoring mechanisms exist in the context of international and regional organizations, the ILO's integrated system of promoting compliance with labour standards is regarded as unique and particularly comprehensive at the international level.

Id.

120. *See Conventions and Recommendations*, INT'L LABOUR ORG., https://www.ilo.org/global/standards/introduction-to-international-labour-standards/conventions-and-recommendations/lang--en/index.htm (last visited Aug. 7, 2022).

121. *See, e.g.*, Ronald C. Brown, *International Labor Standards Versus China's Domestic Law Barriers*, 8 INT'L LAB. RTS. CASE L. 108 (2022).

122. *Monitoring Compliance with International Labour Standards*, *supra* note 116, at 93. *See generally How International Labour Standards Are Used*, INT'L LABOUR ORG., https://www.ilo.org/global/standards/introduction-to-international-labour-standards/international-labour-standards-use/lang--en/index.htm (last visited Aug. 7, 2022).

the Alien Tort Claims Act,[123] although arguments exist to either use or bypass the law.[124]

A new law in the U.S., effective June 2022, specifically addresses the Uyghur issue in China — the UFLPA.[125] This Act requires, among other obligations, that the U.S. Customs and Border Protection apply a presumption that any products manufactured in the Xinjiang region, or by any entity in the lists,[126] are barred from importation into the U.S.[127] Due diligence obligations are imposed as the Act also instructs its administrating agency to issue guidance on "due diligence, effective supply chain tracing, and supply chain management measures" aimed at avoiding the importation of goods produced with forced labor in the XUAR, within 180 days of the UFLPA's enactment.[128] Additionally, the Act creates sanctions that may include identifying and publishing lists of the offenders and permits

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123. 28 U.S.C. § 1350 (1948); *see also* Sam Stein, *The Alien Tort Claims Act in Danger: Implications for Global Indigenous Rights*, CULTURAL SURVIVAL, (June 27, 2003) https://www.culturalsurvival.org/news/alien-tort-claims-act-danger-implications-global-indigenous-rights; STEPHEN P. MULLIGAN, CONG. RSCH. SERV., R44947, THE ALIEN TORT STATUTE: A PRIMER (2022) (providing that the Supreme Court's *Sosa*, *Kiobel*, *Jesner*, and *Nestlé* decisions "have led commentators to debate whether the [Alien Tort Claims Act] remains a viable mechanism to provide redress for human rights abuses in U.S. courts."). *See generally* Nestlée USA, Inc. v. Doe, 141 S. Ct. 1931 (2021); Monika Mehta & Jeffrey Vogt, Nestle v. Doe*: Supreme Court Deals Setback to Forced Child Laborers, but US Corporations Lose Bid for Alien Tort Statute Immunity*, 8 INT'L LAB. RTS. CASE L. 63 (2022).

124. *See Why Corporations Should Be Held Liable for Crimes Against Humanities in Xinjiang: Seeking Criminal Solutions*, 106 IOWA L. REV. 107, 107 (2021) (discussing, for example, how corporate civil and criminal liability can be used to motivate corporations not to perpetrate, aid or abet human rights abuses).

125. Pub. L. No. 117-78, 135 Stat. 1525 (2021).

126. *See* Wijekoon et al., *supra* note 81.

> Of importance for companies, this strategy involves the Task Force's identifying and publishing the following lists: entities in the Xinjiang region that produce goods with forced labor; entities that work with the Chinese government to 'recruit, transport, transfer, harbor or receive forced labor' in the region; products that are produced by the above entities; entities that export the above products; and facilities and entities that 'source material' from the region.

Id.

127. It is argued that "[t]his Act will significantly impact many multinational employers' supply chains because raw materials from this region - such as cotton, coal, chemicals, sugar, tomatoes and polysilicon (a component in solar panels) - have found their way into many global supply chains," *see id.*; *see also Can American Firms Rid Their Supply Chains of Xinjiang Goods?*, ECONOMIST (Jan. 1, 2022), https://www.economist.com/business/2022/01/01/can-american-firms-rid-their-supply-chains-of-xinjiang-goods.

128. Uyghur Forced Labor Prevention Act, Pub. L. No. 117-78 § 2(d)(6)(A), 135 Stat. 1525, 1528 (2021).

sanctions against any foreign person, including Chinese governmental officials, who are involved in forced labor in the Xinjiang region.[129] "These sanctions may include asset blocking, U.S. visa restrictions, and criminal and civil penalties."[130]

C. EU-China Comprehensive Agreement on Investment

The current issue confronting the EU-China draft CAI, after seven years of negotiation and now at a stalemate, is whether China's recent ratification of ILO Convention No. 29 prohibiting forced labor will bring a thaw to the stalled negotiations.

> The European Parliament halted . . . ratification of [the CAI] until Beijing lifts sanctions on EU politicians . . . .
>
> Beijing imposed sanctions . . . on 10 EU politicians, as well as think-tanks and diplomatic bodies, in response to Western sanctions against Chinese officials accused of the mass detentions of Muslim Uyghurs in northwestern China.
>
> China's sanctions include five members of the EU assembly and its human rights sub-committee.[131]

On December 30, 2020, the EU and China announced their agreement in principle for the EU-China CAI.[132] On May 20, 2021, the EU froze the China deal ratification until Beijing lifts sanctions.[133] There are currently 25 BITs between China and EU member States,[134] each containing varying degrees of investment protection.[135] The CAI will standardize the level of protection for both the EU and China.[136] The current draft CAI labor provisions are as

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129. Wijekoon et al., *supra* note 81.

130. *Id.*

131. Emmott, *supra* note 74; *see also China Sanctions EI Officials*, *supra* note 74.

132. European Commission Press Release IP/20/2541, EU and China Reach Agreement in Principle on Investment (Dec. 30, 2020) [hereinafter *European Commission Press Release on CAI*].

133. Emmott, *supra* note 74.

134. *See* Gisela Grieger, *EU-China Comprehensive Agreement on Investment: Levelling the Playing Field with China*, EUR. PARLIAMENTARY RSCH. SERV. 4 (Sept. 2020), https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/679103/EPRS_BRI(2021)679103_EN.pdf (providing a graphical comparison of the 25 BITs between China and EU member states).

135. Andrew Cannon et al., *Updates on Potential EU-China Comprehensive Agreement on Investment (with a Focus on Investment Protection and ISDS) – New Wine in New Bottles?*, HERBERT SMITH FREEHILLS (Jan. 29, 2021), https://hsfnotes.com/publicinternationallaw/2021/01/29/updates-on-potential-eu-china-comprehensive-agreement-on-investment-with-a-focus-on-investment-protection-and-isds-new-wine-in-new-bottles/.

136. *Id.*

follows:

> Each Party shall strive to ensure that its laws and policies provide for and encourage high levels of labour protection and shall strive to continue to improve those laws and policies and their underlying levels of protection.[137]
>
> . . . .
>
> Each Party, in accordance with its obligations assumed as a member of the International Labor Organization ("ILO"), and its commitments under the ILO Declaration on Fundamental Principles and Rights at Work and its Follow-up, shall respect, promote and realize, in good faith and in accordance with the ILO Constitution, the principles concerning the fundamental rights which are the subject of the fundamental ILO Conventions.[138]
>
> Each Party is, in accordance with the commitments of the members of the ILO and the 2019 ILO Centenary Declaration for the Future of Work, committed to effectively implement the ILO Conventions it has ratified and work towards the ratification of the ILO fundamental Conventions. *In particular, in this regard, each Party shall make continued and sustained efforts on its own initiative to pursue ratification of the fundamental ILO Conventions No 29 and 105, if it has not yet ratified them. The Parties will also consider the ratification of the other Conventions that are classified as 'up to date' by the ILO.*[139]
>
> . . . .
>
> In accordance with their commitment to enhance the contribution of investment to the goal of sustainable development, including its labour aspects, the Parties agree to promote investment policies which further the objectives of the Decent Work Agenda, in accordance with the 2008 ILO Declaration on Social Justice for a Fair Globalisation, and the 2019 ILO Centenary Declaration for the Future of Work, including a human-centred approach to the future of work, adequate minimum wages, social protection and safety and health at work.[140]

The CAI provides for a State-to-State dispute resolution mechanism with implementation of commitments to be monitored at the level of Executive Vice President on the side of the EU and Vice Premier on China's side.[141] Moreover, the "[a]greement also creates a specific working group to follow the implementation of sustainable development related matters, including on

137. *EU-China Investment Agreement*, EUR. COMM'N 2 (Jan. 22, 2021) [hereinafter *CAI*], https://circabc.europa.eu/ui/group/09242a36-a438-40fd-a7af-fe32e36cbd0e/library/53e93529-6c9e-4120-a0d4-9d43f2a84091/details.

138. *Id.* at 5.

139. *Id.* (emphasis added).

140. *Id.*

141. *European Commission Press Release on CAI*, *supra* note 132.

labour and climate."[142]

There are no Investor-State Dispute Settlement provisions in the draft CAI. Instead, in the Agreement in Principle, there is an expression of commitment by both parties to seek to reach agreement on this topic in future.[143] The Agreement in Principle states that:

> The package deal reached today includes a commitment by both sides to try to complete negotiations on investment protection and investment dispute settlement within 2 years of the signature of the CAI. The common objective is to work towards modernised protection standards and a dispute settlement that takes into account the work undertaken in the context of UNCITRAL [the United nations Commission on International Trade Law] on a Multilateral Investment Court. The EU's objective remains to modernise and replace the existing Member States' Bilateral Investment Treaties with China.[144]

The draft Agreement provides that Parties will "make sustained and continuous efforts" to ratify ILO conventions on forced labor.[145] A question

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142. *Id.*

143. The U.S. experience on dispute resolution mechanisms for its recent FTA with Mexico and Canada is as follows:

> The USMCA includes two mechanisms to enforce the labour rights obligations of the agreement. The first, set out in Chapter 23,1 seeks to improve the effectiveness of the existing state-to-state labour dispute settlement mechanism that was in the labour side agreement of NAFTA. The renegotiated Labour Chapter modifies the labour rights included in the agreement, explicitly adding protection for workers against violence, and includes a ban on forced labour. It also opens the dispute resolution mechanism to cases on freedom of association and the right to bargain collectively, which now qualify for fines and trade sanctions under Chapter 31 . . . . One crucial difference between this new mechanism (the RRLM) and that of the Labour Chapter is the line of responsibility for solving labour rights violations. In Chapter 23, the labour dispute process focuses on government actions or lack of enforcement that has led to labour rights violations, which are to be resolved through state-to-state negotiation, and ultimately through changes by governments to labour policies and enforcement. The rapid response mechanism instead sets the standard of labour rights violations as a denial of rights on the part of employers, rather than governments. It establishes a procedure to verify claims of a denial of rights at the workplace. In such cases, trade sanctions could be applied to exported goods made at the facility under review, and last until the dispute is resolved.

Cf. Briefing Paper: Labour Rights Enforcement in the USMCA, MAQULA SOLIDARITY NETWORK 3 (July 2020); Eric Gottwald et al., *Wrong Turn for Workers' Rights: The US-Guatemala CAFTA Labor Arbitration Ruling – And What to Do About It*, INT'L LAB. RTS. FOR. (Apr. 12, 2018), https://laborrights.org/publications/wrong-turn-workers%E2%80%99-rights-us-guatemala-cafta-labor-arbitration-ruling-%E2%80%93-and-what-do (discussing shortcomings of dispute resolution provisions).

144. Cannon et al., *supra* note 135.

145. *European Commission Press Release on CAI*, *supra* note 132.

rises whether China's subsequent ratification will be enough to undo the freeze. Besides the political decision necessary to undo the reciprocal ban on visa restrictions on Chinese and EU parties, the lingering issues of meaningful enforcement and dispute resolution mechanisms for the sustainable development chapter remain in flux.

IV. ANALYSIS

In addressing the labor and human rights issues of China's treatment of the Uyghurs in Xijiang, in addition to the existing and future dispute resolution provisions in the CAI, the paths of redress also lie in existing and evolving international and national legal tools, summarized earlier and highlighted below.

At the international level, the U.N. leads the way in bringing states together under international treaties voluntarily entered into, dealing with issues of labor and human rights standards.[146] Slowly a global consensus arises, but enforcement can be bureaucratically cumbersome and often impracticable and impeded by inconsistent sovereign laws. Diplomacy, exposure, and indirect pressures are often used against violating sovereign states to attempt compliance, but they seldom are enabled to use legal compulsion. The U.N. Human Rights Committee on August 31, 2022, issued an Assessment and Report regarding China's treatment of Uyghurs in Xinjiang.[147]

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146. *See UDHR*, *supra* note 15; *see also ILO Declaration on Fundamenal Principles and Rights at Work* (1998), https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/normativeinstrument/wcms_716594.pdf.

147. *See* U.N. Hum. Rts. Off. of the High Comm'r, OHCHR Assessment of Human Rights Concerns in the Xinjiang Uyghur Autonomous Region, People's Republic of China 3–4 (Aug. 31, 2022) https://www.ohchr.org/sites/default/files/documents/countries/2022-08-31/22-08-31-final-assesment.pdf

> The assessment contained in this document is based on China's obligations under international human rights law, contained principally in the human rights treaties to which China is a State Party, in particular the Convention on the Elimination of All Forms of Racial Discrimination (CERD), the Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment (CAT), the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW), the Convention on the Rights of the Child (CRC), the International Covenant on Economic, Social and Cultural Rights (CESCR) and the Convention on the Rights of Persons with Disabilities (CRPD). China has also signed, though not yet ratified, the International Covenant on Civil and Political Rights (ICCPR). As a result, it is obliged as a matter of law to refrain from any acts that would defeat the object and purpose of this treaty . . . Serious human rights violations have been committed in XUAR in the context of the Government's application of counter-terrorism and counter-'extremism' strategies. The implementation of these strategies, and

The ILO, which is an agency of the U.N., also by consensus of its global members, promulgates standards of labor and human rights.[148] It likewise has a bureaucratic enforcement mechanism that includes reports, inspections, and public exposure. In the end, inconsistent sovereign laws too often prevail, even when there is a ratified ILO Convention implemented by national laws. This will be tested further with China's recent ratification of the prohibition of forced labor.

Joint or multiple treaties between or among states in the form of BITs or FTAs are a cooperative approach providing economic incentives, with included sections providing social dimension provisions seeking to establish improved labor and environmental standards, with the former tied to commitments to ILO standards. Their shortcomings have been weak or ineffective enforcement mechanisms.[149]

Lastly, there are national responses to alleged violations of labor and human rights standards, providing economic penalties for violators. These are illustrated by national laws in some European countries, requiring corporate reports of due diligence on labor and human rights issues as related to international interactive commercial activity, especially with international supply chains.[150] And, in the case of Canada, corporate liability is provided for entities dealing with states or parties engaged in those violations.[151] Finally, in the U.S., the recent UFLPA directly prohibits and penalizes those engaging with states or parties of violators attempting entry into the U.S. with products manufactured by Uyghurs in China.[152]

Even though China has now ratified the ILO Conventions against forced labor, its alleged sustained practices against the Uyghurs still appear to

> associated policies in XUAR has led to interlocking patterns of severe and undue restrictions on a wide range of human rights. These patterns of restrictions are characterized by a discriminatory component, as the underlying acts often directly or indirectly affect Uyghur and other predominantly Muslim communities.

Id.

148. *See id.* at 3.

149. *See* Brown, *supra* note 70 (discussing how some of the trade agreements China has entered into have "watered-down provisions [that] are arguably not written to be enforceable except through mutual consultation and agreement.").

150. *See* Ronald C. Brown, *Due Diligence "Hard Law" Remedies for MNC Labor Chain Workers*, 22 UCLA J. INT'L L. & FOREIGN AFFS. 119, 124 (2018).

151. *See id.* at 130.

152. *See* Ronald C. Brown, *Up and Down the Multinational Corporations' Global Labor Supply chains: Making Remedies that Work in China* 34 UCLA PAC. BASIN L. J. 103 (2017); *see also* Brown, *supra* note 150, at 129–30.

violate the UDHR[153] against forced labor and the ICESCR[154] through ethnic discrimination of the Uyghurs' right to self-determination and thereby result in the subversion of its professed international commitments with domestic law and practices. This could be referred to as international law with Chinese characteristics.

V. CONCLUSION

In dealing with the Uyghur labor and human rights issue in China, perhaps the best approach is to continue the momentum toward protection and enforcement of labor and human rights standards by whatever means are available, including more national legislation, and enhanced and effective treaty dispute resolution mechanisms.

China is not alone in not ratifying some treaties or provisions therein or setting exceptions and reservations in international labor and human rights treaties, but it may be more prominent in using them in a way that tends to undermine or erode the purpose of the treaties. And, as in the case of the U.S., other nations often have laws that protect the unratified or excepted areas of targeted rights, such as in union rights or anti-discrimination.[155]

Until there are more effective international remedies for labor and human rights protections, national and regional arrangements could be used more effectively. For example, with regional FTAs or BITs, like the EU-China CAI, there are two paths for the future of the CAI. One option is to resume negotiations and finalize the CAI with a more robust and effective enforcement mechanism for labor and human rights obligations in the final draft. The second option is to negotiate an early ratification of the CAI, followed by strong negotiations for an EU-China FTA with meaningful and enforceable labor and human rights provisions which include strong and effective dispute resolution mechanisms. [156]

In the long term, perhaps the most practical and effective approach is to combat the alleged abuses of Uyghurs by national legislation targeting exports originating from the Uyghurs in Xinjiang with bans or meaningful due diligence barriers. This changes the focus from seeking to compel China to change its policies or trying to enforce international obligations, to an approach taken by states that are trading with China in Uyghur commerce, to convince China to make changes in its own self-interest.

153. *See UDHR*, *supra* note 15.

154. *See ICESCR*, *supra* note 6.

155. *See* Brown, *supra* note 152, at 110, 113, 125, 129–30.

156. *See id.* at 110, 113.

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ALGORITHMIC FINANCIAL REGULATION: LIMITS OF COMPUTING COMPLEX ADAPTIVE SYSTEMS

SHUPING LI*

This article examines the potential of and limits to the use of machine learning for financial regulation. Ideally, if we could fully understand the financial system and agree on long- and short-term regulatory goals, we would be able to write code that carries out the computation that extracts proper representations from the data and makes correct regulatory decisions. We cannot do this yet because of limited sources of data, the bias brought by human beings and algorithmic models, and the difficulty of improving uninterpretable models. Furthermore, since law is a combination of merits and facts, there are difficulties in establishing the ground truth, modeling complex financial systems, and attaining fair outcomes simply based on statistics. Statistics, as a method of inductive learning, can only recognize patterns from existing data. From a methodological perspective, this represents a paradigm shift from observational study (deduction) to data analytics (induction). However, in the financial field, there is a fundamental difference between measurable risks and unknowable uncertainty in the future, which significantly affects the reliability of models to determine regulation based on estimated risks. Therefore, algorithmic models cannot make reliable suggestions about unusual situations, nor deal with complex problems that lack sufficient training data. In cases of algorithmic regulation, despite the predetermined regulatory goals, specific standards should remain adaptive to new data collected from the regulated environment, so as to mitigate bias generated from historical data and the initial model setting.

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I. INTRODUCTION

Machine learning — using data and algorithms to build computers that improve automatically[1] — is expected to increase regulatory efficiency, uniformity, effectiveness, and could promote financial inclusion. Machine learning can be used to achieve many financial goals, including fraud and crime detection, risk management, and market prediction.[2] Each task works in concert with a particular model, or a combination of machine learning models. It adds tremendous power to improve regulatory efficiency and financial inclusion with advanced analytical, monitoring, and simulation skills of financial markets. The algorithms are designed to extract useful knowledge from the data, identify risks and anomalies in real-time, help understand interconnectedness in the financial system, simulate failure and remediation scenarios, and provide early warnings and possible solutions.[3]

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1. *See generally* Michael I. Jordan & Tom M. Mitchell, *Machine Learning: Trends, Perspectives, and Prospects*, 349 SCIENCE 255 (2015).

2. *See generally id.*

3. Okiriza Wibisono et al., *The Use of Big Data Analytics and Artificial Intelligence in Central Banking*, IFC BULLETINS, BANK FOR INT'L SETTLEMENTS (2019).

In the financial field, computers analyzing data can identify liquidity issues in banks, and predict the level of non-performing loans based on macroeconomic indicators, bank-specific information, and historical data.[4] A bank may want to use classification models[5] to categorize customer credit lending risk and use loan applications to predict the likelihood of customer default. Anomaly-detection algorithms look for unusual examples in a dataset.[6] One particular use is to detect fraudulent transactions on a credit card account. Summarization models attempt to find and present salient features in data,[7] including both simple statistical summaries (e.g., a total sum spent by an individual or entity) and higher-level analysis (e.g., a list of key facts about an individual gleaned from all web postings that mention her). In other aspects, natural language processing helps supervisors analyze unstructured data, such as text, audio, and video, allowing interpretation of annual reports, audits, and financial assessments.[8] More advanced deep learning models allow for multiple processing layers to learn from data with multiple levels of abstraction.[9] These models can recognize and learn subtle structural patterns from vast amounts of unstructured data, learning not only known unknowns, but also unknown unknowns.

This Article explores how far algorithms, in particular machine learning, can be used for financial regulation. The debate mainly focuses on two themes: accuracy and legitimacy.[10] Accuracy is the number of correctly predicted outcomes. Legitimacy is the social acceptance of such applications, taking into account fairness, accuracy, transparency, and other factors. In some cases, machine learning models are not sufficiently accurate to justify their use, or their use is not legitimate because it fails to respect individual autonomy. For example, sanctions for crimes like money

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4. *See Bringing Artificial Intelligence to Banking Supervision*, EUR. CENT. BANK, https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl191113_4.en.html (last visited Sept. 2, 2023).

5. *See generally* Sotiris B. Kotsiantis et al., *Supervised Machine Learning: A Review of Classification Techniques*, 160 EMERGING A.I. APPLICATIONS IN COMPUT. ENG'G (2007).

6. *See generally* Gutha Jaya Krishna & Vadlamani Ravi, *Anomaly Detection Using Modified Differential Evolution: An Application to Banking and Insurance*, 35 Springer 102 (2019).

7. *See* Amir Gandomi & Murtaza Haider, *Beyond the Hype: Big Data Concepts, Methods, and Analytics*, 35 INT'L J. INFO. MGMT. 137, 140 (2015).

8. *See* Gobinda G. Chowdhury, *Natural Language Processing*, 37 ANN. REV. INFO. SCI. AND TECH. 51, 51 (2003).

9. *See* Yann LeCun et al., *Deep Learning*, 521 NATURE 436, 436 (2015).

10. Barbara D. Underwood, *Law and the Crystal Ball: Predicting Behavior with Statistical Inference and Individualized Judgment*, 88 YALE L.J. 1408, 1409 (1979).

laundering and financial terrorism cannot solely rely on decisions of a deep learning model, because "predictions of criminal behavior are not accurate enough to use as a basis for a decision about a matter as important as liberty."[11] In other cases, predicting an individual's default probabilities as part of the credit risk evaluation "seems to reduce him to a predictable object rather than treating him as an autonomous person."[12]

Section II introduces how machine learning can be used for financial regulation, such as fraud detection, risk management, and market forecasting. Section III points out the challenges — limited data source, bias, and explainability — brought by machine learning that are new to the regulators. Section IV further examines the legitimacy of the errors and partiality of algorithmic results. Section V provides suggestions on how regulators could use machine learning models for financial regulation, by increasing data sources, debiasing through human review, disclosing necessary information, and using interpretable models.

Section VI concludes that, based on the current economic and computation capabilities, it is unlikely that machine learning models can simulate the whole financial system nor the legal system. If algorithmic models are to be used for financial regulation, they can only serve as an important reference, assisted by human oversight. For greater reliance and areas of application, the theoretical foundations of the model should be clearly understood. There should be adequate data for training the model and minimizing bias.

II. ALGORITHMIC MODELS USED FOR FINANCIAL REGULATION

A. Fraud Detection

The first useful application of machine learning is fraud detection. Trained by customer and merchant data, machine learning models can find hidden and implicit patterns in data and detect possible fraud scenarios.[13] The model scans suspicious transactions to differentiate positive alerts from transactions that require additional investigation. These models are built to detect money laundering, insurance scams, banking and credit card payment

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11. *Id.* at 1410.

12. *Id.* at 1414.

13. *See* ALTEXSOFT, FRAUD DETECTION: HOW MACHINE LEARNING SYSTEMS HELP REVEAL SCAMS IN FINTECH, HEALTHCARE, AND ECOMMERCE 4 (2020), https://www.altexsoft.com/whitepapers/fraud-detection-how-machine-learning-systems-help-reveal-scams-in-fintech-healthcare-and-ecommerce/ (explaining that data scientiests build robust fraud detection systems by applying unsupervised learning models).

fraud, loan application fraud, and more serious financial terrorism.[14] For instance, IBM Safer Payments has been deployed by many national payment systems to score the fraud risk for authorization requests in real-time.[15] This score is passed to banks, issuers, and acquirers that combine the risk score with customer information to form a final decision on deciding fraudulent transactions.[16] In 2018, a European payment services company stated that Safer Payments has saved them upwards of $115 million in net fraud losses.[17]

The focus of behavior analysis is payment transactions, whether wire transfers, bill payments, loan draws, automated clearinghouse activities, or other transactions. Machine learning models will create detailed customer risk profiles for personalized risk assessment. Each transaction can be scored based on the corresponding level of fraud and illegality risks.[18] The model will be updated as new data and results from human investigation into identified suspicious transactions are looped back to the model for smarter future detections.[19]

Such risk prediction inputs can be adopted to enhance anti-money laundering (AML) decision models in "e-commerce transactions, mobile banking, loan applications and recurring banking payments."[20] "[R]eal-time AML assessment of customer fraud risk . . . can be conducted during the customer on-boarding process."[21] This will need customer-specific follow-up information,[22] such as beneficial ownership, previous sanctions, politically-exposed-person status, and adverse media scanning. Financial institutions could also use personal information such as a customer's ID,

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14. *See generally* Zhiyuan Chen et al., *Machine Learning Techniques for Anti Money-Laundering (AML) Solutions in Suspicious Transaction Detection: A Review*, 57 KNOWLEDGE & INFO. SYS. 245 (2018); Martin Jullum et al., *Detecting Money Laundering Transactions with Machine Learning*, 23 J. MONEY LAUNDERING CONTROL 173 (2020); Jingguang Han et al., *Artificial Intelligence for Anti-Money-Laundering: A Review and Extension*, 2 DIGIT. FIN. 211 (2020); Thanh Thi Nguyen et al., Deep Learning Methods for Credit Card Fraud Detection (Dec. 7, 2020) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/2012.03754.

15. *See generally IBM Safer Payments*, IBM, https://www.ibm.com/products/safer-payments (last visited Apr. 19, 2023).

16. *See id.*

17. *See id.*

18. *See* Yusuf G. Şahin & Ekrem Duman, *Detecting Credit Card Fraud by Decision Trees and Support Vector Machines*, IMECS (2011).

19. Hong Kong Monetary Auth., *Reshaping Banking with Artificial Intelligence*, PWC 1, 53 (2020).

20. *Id.*

21. *Id.*

22. *Id.*

photo, address, and phone number to assess credibility. These illegal behaviors can be combined in an anomaly detection model.[23]

B. Risk Management

Risk management and control lies at the heart of modern financial regulation. Risk is a combination of harm and severity that will potentially occur in the future. Machine learning models can be used to evaluate credit risk,[24] market risk, liquidity risk, governance risk, operational risk, insurance risk, reputation risk, and systemic risk.[25]

Initially, regulators receive thousands of documents collected from financial service providers, such as minutes of board meetings, internal audit reports, and other management reports.[26] These documents contain key information related to audit and compliance risks. Document analysis can be used to classify large numbers of documents in a fast and accurate manner to detect relevant information for regulatory purposes. Electronic document management, natural language processing, and text mining techniques can be used for automated data reporting, electronic record keeping, and establishing central repositories.[27]

Next, regulators conduct risk evaluation to help set capital, liquidity and portfolio requirements. For instance, important measures in banking evaluation, according to Basel III, include interest rate risk, credit risk, operational risk, and risks associated with securitization and counterparty failure.[28] In evaluating a customer's default risk, deep learning models incorporate data such as transaction history, market trends, and customer

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23. *See* Mohiuddin Ahmed et al., *A Survey of Anomaly Detection Techniques in Financial Domain*, 55 FUTURE GENERATION COMPUT. SYS. 278, 279 (2015).

24. *See* Rong-Zhen Xu & Meng-Ke He, *Application of Deep Learning Neural Network in Online Supply Chain Financial Credit Risk Assessment*, COMPUT. INFO. & BIG DATA APPLICATIONS, April 2020, at 224, 224; Paolo Giudici et al., *Network Based Scoring Models to Improve Credit Risk Management in Peer to Peer Lending Platforms*, FRONTIERS IN A.I., May 2019, at 1, 3.

25. *See* Sharyn O'Halloran & Nikolai Nowaczyk, *An Artificial Intelligence Approach to Regulating Systemic Risk*, FRONTIERS IN A.I., May 2019, at 1, 13.

26. *See generally EDGAR*, SEC, https://www.sec.gov/edgar/search/ (last visited Jan. 19, 2024).

27. *See* Ray Meiring, *Tax Accounting Firms Can Use ChatGPT and Other AI to Drive Profit*, BLOOMBERG TAX (Feb. 24, 2023, 4:45 AM), https://wsauth.bloombergindustry.com/wsauth/blawauth?stchk=1&target=https%3A%2F%2Fwww.bloomberglaw.com%2Fcitation%2FBNA%2520000001864b73dd43a1f7ef7b6aa40001%3Fbna_news_filter%3Dtax-insights-and-commentary.

28. *See* BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, HIGH-LEVEL SUMMARY OF BASEL III REFORMS 1 (2017) https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

credit history, as well as alternative data such as a borrower's employment history, demographics, expenses, payment transactions, social media, and credit card statements. This approach outperforms standard credit scoring models by simplifying the risk management process while taking into account more useful information.[29]

These individual assessments could serve for further systemic risk analysis.[30] Systemic risk is the possibility that "an event will trigger a loss of economic value or confidence in, and attendant increases uncertainty about, a substantial portion of the financial system that [can] have significant adverse effects on the real economy."[31] To evaluate the risks, data across markets, institutions, and products can be integrated and analyzed. Since 2013, the Hong Kong Monetary Authority has collected derivatives data through the Hong Kong Trade Repository, in order to understand the chain of exposures between institutions.[32] The objective is to assess the financial stability of the market and identify potential risks. Big data analysis can detect interconnectedness in a system by mapping the global value chain across countries, sectors and institutions.[33] Quantitative risk management models can be used to describe the fluctuations in the value of portfolios of assets and liabilities over future periods, evaluate whether institutions are adequately capitalized, and calculate network buffers when material uniform risk exposures emerge across a financial system.[34]

In the future, regulators can use quantum computing to have a more accurate and timely assessment of securities and loan portfolio risks, which can be powered by live data streams such as real-time equity prices.[35]

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29. *See* Stefania Albanesi & Domonkos F. Vamossy, *Predicting Consumer Default: A Deep Learning Approach* 2–3 (Nat'l Bureau of Econ. Rsch., Working Paper No. 26165, 2019).

30. *See* BANK FOR INT'L SETTLEMENTS, REPORT ON OTC DERIVATIVES DATA REPORTING AND AGGREGATION REQUIREMENTS, 8 (2012) (commenting that "concepts for identifying and measuring systematic risk arising from major financial institutions are still under development . . . .").

31. *Id.* (quoting G10, Report on Consolidation in the Financial Sector).

32. Monetary Mgmt. Dep't, *A First Analysis of Derivatives Data in the Hong Kong Trade Repository*, H.K. MONETARY AUTH. Q. BULL., June 2015, at 1, 4.

33. *See* Evrim Bese Goksu & Bruno Tissot, *Systemic Institutions for the Analysis of Micro-Macro Linkages and Network Effects*, 4 J. MATHEMATICS & STAT. SCI. 129, 129–30 (2018).

34. *See* Gary Gensler & Lily Bailey, Deep Learning and Financial Stability 6–7 (Nov. 1, 2020) (unpublished manuscript) (on file with SSRN).

35. *See* Român Orús et al., *Quantum Computing for Finance: Overview and Prospects*, 4 REVS. IN PHYSICS, Nov. 2019, at 10.

C. Market Forecasting

Machine learning can be used for forecasting market changes as a more proactive approach to regulation. Many financial phenomena nowadays have different causations, manifestations, and impacts from traditional ones. To identify the point and measure for regulatory intervention, economic forecasting is necessary to predict risk emergence and potential impacts.[36] Market forecasting primarily involves a prediction of price and risks under different circumstances, such as inflation,[37] exchange rate,[38] volatility trading,[39] stock market price,[40] market trends,[41] and price changes of financial products.[42] The datasets for risk assessment include credit data, consumer data, and financial reports. Regulators can use predictive analytics to monitor algorithmic trading of stocks, assess business risks for loan approvals, and help manage credit and investment portfolios for financial institutions.[43] Specific methods include time-series analysis of the past behavior of an entity or individual,[44] taking into account social, political and

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36. *See id.* at 2.

37. *See* Linyun Zhang & Jinchang Li, *Inflation Forecasting Using Support Vector Regression*, 2012 FOURTH INT'L SYMP. ON INFO. SCI. & ENG'G 136, 136 (2012) (providing that inflation forecasting is critical for financial planning).

38. *See* Paolo Tenti, *Forecasting Foreign Exchange Rates Using Recurrent Neural Networks*, 10 APPLIED A.I. 567, 568 (1996).

39. *See generally* Manuel R. Vargas et al., *Deep Learning for Stock Market Prediction from Financial News Articles*, *in* 2017 IEEE INT'L CONF. ON COMPUTATIONAL INTEL. & VIRTUAL ENV'TS OR MEASUREMENT SYSS. & APPLICATIONS (2017); Peter Tino et al., *Financial Volatility Trading Using Recurrent Neural Networks*, 12 IEEE TRANSACTIONS ON NEURAL NETWORKS 865 (2001).

40. *See generally* Tsung-Jung Hsieh et al., *Forecasting Stock Markets Using Wavelet Transforms and Recurrent Neural Networks: An Integrated System Based on Artificial Bee Colony Algorithm*, 11 APPLIED SOFT COMPUTING 2510 (2011); Vargas et al., *supra* note 39.

41. *See* Rahul Katarya & Anmol Mahajan, *A Survey of Neural Network Techniques in Market Trend Analysis*, *in* 2017 INT'L CONF. ON INTELLIGENT SUSTAINABLE SYSS. 873, 873 (2017).

42. *See* Avraam Tsantekidis et al., *Using Deep Learning to Detect Price Change Indications in Financial Markets*, 2017 25TH EUR. SIGNAL PROCESSING CONF. 2511 (2017); *see also* Ahmet Murat Ozbayoglu et al., *Deep Learning for Financial Applications: A Survey*, APPLIED SOFT COMPUTING, Aug. 2020, at 1, 1.

43. *See* Ozbayoglu et al., *supra* note 42, at 2.

44. *See generally* Jie Wang et al., *Financial Time Series Prediction Using Elman Recurrent Random Neural Networks*, 2016 COMPUTATIONAL INTL. & NEUROSCIENCE, 2016, at 1; Omer Berat Sezer et al., *Financial Time Series Forecasting with Deep Learning: A Systematic Literature Review: 2005–2019*, 90 APPLIED SOFT COMPUTING, 2020, at 1.

economic factors.[45] Data from news articles, financial reports, or blogs by commentators[46] can be used for financial sentiment analysis and market prediction.[47] Other methods include quantile regression forests,[48] support vector regressions,[49] and recurrent neural networks.[50]

In evaluating market risks, machine learning models may provide economic suggestions on when and how central banks should use their lender of last resort tools. The central bank must identify illiquid but solvent banks, and lend to them with a penalty charge, in view of the risks and market trend.[51] In this process, clustering models can help identify potential financial disruptors. Cluster analysis "seeks correlated sources of risk that may not be obvious to quantitative risk models or fundamental analysts."[52] The goal is to create groups of items that are simultaneously close to and distant from each other.

Another regulatory task is stress testing — the assessment of a financial institution's potential vulnerability (typically profitability, liquidity, and capital adequacy) to stressed business conditions.[53] Stress testing is

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45. *See* Vargas et al., *supra* note 39, at 1.

46. *See generally* Baohua Wang et al., *A Novel Text Mining Approach to Financial Time Series Forecasting*, 83 NEUROCOMPUTING 136, 137 (2012); Frank Z Xing, et al., *Natural Language Based Financial Forecasting: A Survey*, 50 A.I. REV. 49, 51 (2018).

47. *See* Qili Wang et al., *Combining the Wisdom of Crowds and Technical Analysis for Financial Market Prediction Using Deep Random Subspace Ensembles*, 299 NEUROCOMPUTING 51, 51 (2018); Lei Shi et al., *Deepclue: Visual Interpretation of Text-Based Deep Stock Prediction*, 31 IEEE TRANSACTIONS ON KNOWLEDGE & DATA ENG'G 1094 (2018).

48. *See generally* Roger Koenker & Kevin F. Hallock, *Quantile Regression*, 15 J. ECON. PERSPS. 143 (2001); Dadabada Pradeepkumar & Vadlamani Ravi, *Forecasting Financial Time Series Volatility Using Particle Swarm Optimization Trained Quantile Regression Neural Network*, 58 APPLIED SOFT COMPUTING (2017).

49. *See generally* Zhang Xiang-rong et al., *Multiple Kernel Support Vector Regression for Economic Forecasting*, 17TH INT'L CONF. ON MGMT. SCI. & ENG'G 129 (2010); Linyun Zhang & Jinchang Li, *Inflation Forecasting Using Support Vector Regression,* IEEE COMPUT. SOC'Y 136 (2012).

50. *See generally* Chung-Ming Kuan & Tung Liu, *Forecasting Exchange Rates Using Feedforward and Recurrent Neural Networks*, 10 J. APPLIED ECONOMETRICS 347 (1995); Danko Brezak et al., A Comparison of Feed-Forward and Recurrent Neural Networks in Time Series Forecasting (IEEE 2012).

51. *See* Brian F. Madigan, Dir., Div. of Monetary Affs., Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis (Aug. 21, 2009).

52. Peter Chocian & Nelson Yu, *Cluster Analysis: Managing Risks You Didn't Know You Had,* ALLIANCE BERSTEIN (Sept. 20, 2019), https://www.alliancebernstein.com/library/Cluster-Analysis-Managing-Risks-You-Had.htm.

53. *See* Claudio Borio et al., *Stress-Testing Macro Stress Testing: Does It Live up to*

commonly used for assessing the risks of the banking system.[54] Apart from the risks associated with banks, macroeconomic scenarios must be considered. These include domestic and international economic downturn, the downturn of the real estate market, decline in the value and market liquidity of financial collateral, increases in classified loans and provisioning levels, default of major counterparties, and deterioration in the quality of consumer lending. Deep learning methods could generate plausible and adverse economic scenarios for banks, assessing risks independent of banks' own valuation model.[55] Likewise, regulation test models can "simulate the likely impact of new policies before legislation [is enacted] and the practical impact of existing regulation, including conflicts between regulators."[56] Both difficulties lie in establishing counterfactual inferences, which hypothesize changes to the actual market situations.[57]

Overall, there are many elements in common between the law and machine learning, so that the latter can be used for making regulatory decisions and even court judgments. They both rely upon information and data, especially historical data and precedent cases. They make decisions based on the knowledge generated from this data, the interpretation of facts, and some given values or standards. Nevertheless, machine learning models sometimes fall short of recognizing the real world for internal and external reasons, namely model design and situational complexity.[58]

III. CHALLENGES ON THE LEGITIMACY OF REGULATION

There are two things machine learning techniques heavily rely on: data and model design. The problems are often a lack of training data, implicit bias in datasets and model design, model overfittings that exacerbate the bias, and inexplainability that impedes the improvement of model accuracy.

Expectations?, 12 J. FIN. STABILITY, 3, 4 (2014).

54. *See, e.g.*, H.K. MONETARY AUTH., SYSTEMICALLY IMPORTANT BANKS SUPERVISORY POLICY MANUAL 6 (2015).

55. *See* Nikhil Malik et al., *Can Banks Survive the Next Financial Crisis?*, AN ADVERSARIAL DEEP LEARNING MODEL FOR BANK STRESS TESTING, June 2018, at 1, 2.

56. U.K. GOV'T OFF. FOR. SCI., FINTECH FUTURES: THE UK AS A WORLD LEADER IN FINANCIAL TECHNOLOGIES (2015).

57. *See generally* Shusen Liu et al., Generative Counterfactual Introspection for Explainable Deep Learning (Jul. 6, 2019) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1907.03077; Valerie A. Thompson & Ruth M. J. Byrne, *Reasoning Counterfactually: Making Inferences about Things That Didn't Happen*, 28 J. EXPERIMENTAL PSYCH.: LEARNING, MEMORY, & COGNITION 1154 (2002).

58. *See generally* Susan Athey, *Beyond Prediction: Using Big Data for Policy Problems*, 355 SCI. 483 (2017).

A. Limited Data

All machine learning models depend on datasets to train and optimize their function and parameters. Ideally, the training data should be representative enough to reach a sound conclusion. Only sufficient historical examples of the phenomenon will help identify the inducing factors and predict future occurrence.[59] Models trained out of dirty data (with noise and perturbation), biased data, or even too little data can hardly be convincing. Practically, machine learning models do not always have access to adequate data resources and thus will fall short of the accuracy requirements.[60]

First of all, existing data is difficult to collect and use, because of their separate existence and disparate formats. In AML regulation, the money is often run through a legitimate cash-based business owned by the criminal organization or its confederates.[61] The supposed legitimate business deposits the money, which the criminals can then withdraw. Money launderers may deposit cash into foreign countries in smaller increments to avoid suspicion or use illicit cash to buy other cash instruments. Launderers will sometimes invest the money with dishonest brokers who are willing to ignore the rules in return for large commissions. Such activities are quite hidden so that the chain of transactions cannot be easily detected by the machine learning models.[62]

In prudential regulation, regulators need to know information about the institutions' liabilities, consolidated positions, and the nature of their maturity mismatch. In addition, regulators need to understand the build-up of risk within the financial system, the nature of the linkages between participants in the markets and between different types of risks, and the nature of maturity mismatches that exist on banks' balance sheets and within and between currencies. A particular challenge is to understand the relationship between macro-economic developments at global and domestic levels, their relationships with movements in the financial markets, as well as the impacts on the stability of individual financial institutions, and

59. *See id.* at 484.

60. *See* Partha Shukla, *Dealing With Limited Datasets in Machine Learning*, ANALYTICS VINDHYA (Jan. 09, 2023), https://www.analyticsvidhya.com/blog/2022/12/dealing-with-limited-datasets-in-machine-learning/.

61. *See* PK Doppalapudi et al., *The Fight Against Money Laundering: Machine Learning is a Game Changer*, MCKINSEY & CO. (Oct. 07, 2002), https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/the-fight-against-money-laundering-machine-learning-is-a-game-changer.

62. *See id.*

financial stability as a whole.[63]

Secondly, some data cannot be obtained, such as internal accounting and transaction records of private companies. In the assessment of credit risks and consumer profiles, the data used to train the machine-learning algorithm may not fully represent the range of customers that will apply for loans.[64] The bank data may not provide good estimations for customer groups that have historically not applied for loans, or when the bank had screened out the record before the current application. For most asset-backed securities and collateralized debt obligations, there is only limited short-term data for evaluating the risks and creditworthiness of these products.[65] Moreover, as people learn how the model works, the high-risk borrowers can learn to mimic the behavior of lower-risk borrowers before applying for a loan. At the systemic level, integrated risk management can be a very complex and tedious process. As central banks and regulatory authorities focus on *avoiding* monetary dysfunction, financial instability, and bank failures, there is not much of a trackable record available.[66]

When evaluating banks that are important to the overall financial system, we consider certain numbers. These numbers include the total amount of money the bank has (size), the amount of money it lends to other banks (connections within the banking system), the amount of money it lends to financial companies (connections with the overall financial system), and the amount of money it lends to customers (customer deposits). In such circumstances, data about the corporate structure are often difficult to acquire for model training. The legal nature of the corporation, as a nexus of contracts,[67] makes it difficult for a deep learning model to comprehend and identify. The name of a company, such as "Citigroup," does not necessarily reveal its number and composition of entities, over which the central office has varying degrees of control via ownership of shares and

63. *See* R. Barry Johnston et al., *Addressing Information Gaps*, SPN/09/06 (Mar. 26, 2009).

64. *Cf. id.*

65. *See Collaterized Debt Obligations: Advantages and Disadvantages*, MGMT. STUDY GUIDE, https://www.managementstudyguide.com/collateralized-debt-obligations-advantages-and-disadvantages.htm (last visited Jun. 26, 2023).

66. David Green, *The Relationship Between Micro-Macro-Prudential Supervision and Central Banking*, *in* FINANCIAL REGULATION AND SUPERVISION: A POST-CRISIS ANALYSIS 57–68 (Eddy Wymeersch et al. eds., 1st ed. 2012).

67. *See generally* William W. Bratton Jr., *Nexus of Contracts Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1988); Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819 (1998).

contracts between companies. In U.S. accounting, variable interest entities refer to any subsidiaries not controlled via voting shares.[68] A typical example would be special purpose vehicles, which may be contrived for a variety of specific transactions. Thus, it is hard to assimilate all the varying interests a firm may have in other entities it has power or control over.

Meanwhile, the chain of transactions can be very long, and the number of parties involved can be difficult to determine. Many forms of financial relationships,[69] such as those between banks and shadow banks,[70] contribute to the interconnectedness of the financial sphere and to potentially damaging contagion.[71] An individual securitization structure can be relatively simple. However, a chain of transactions would make the situation much more complex. The financial institution in the position to originate a home loan may not be able to hold the "risks and expected returns on that loan."[72] It is difficult to ensure that the originating bank remains diligent in determining whether to extend a particular loan when it is not directly exposed to its subsequent performance. A deep learning model may not be able to grasp the series of transactions to make a judgment.[73]

Thirdly, in some circumstances, it is not clear what data is needed to train models. The global financial crisis revealed serious information gaps between the regulator and the real market. It was then realized that systemic

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68. Jiang Bian & P. Rupert Russell, *Reporting Obligations of Variable Interest Entities*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 9, 2018), https://corpgov.law.harvard.edu/2018/09/09/reporting-obligations-of-variable-interest-entities/ ("The term 'variable interest entity . . . refers to an entity in which a public company has a variable interest that is not based on having the majority of voting rights.").

69. *See generally* Meghana Ayyagari et al., *Formal Versus Informal Finance: Evidence from China*, 23 REV. FIN. STUD. (2010) (citing China's increased use of informal financial operations in contrast with the formal U.S. model of wealthy private investors funding into venture capital funds).

70. *See generally* Greg Buchak et al., *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23288, 2018); Roland Meeks et al., *Shadow Banks and Macroeconomic Instability*, 49 J. MONEY, CREDIT & BANKING 1483 (2017); Lucyna A Górnicka, *Banks and Shadow Banks: Competitors or Complements?*, 27 J. FIN. INTERMEDIATION 118 (2016).

71. *See* Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 664 (2012). *See generally* Matthew Elliott et al., *Financial Networks and Contagion*, 104 AM. ECON. REV. 3115 (2014); Paul Glasserman & H. Peyton Young, *How Likely Is Contagion in Financial Networks?*, 50 J. BANKING & FIN. 383 (2015); Paul Glasserman & H. Peyton Young, *Contagion in Financial Networks*, 54 J. ECON. LIT. 779 (2016); Martin Summer, *Financial Contagion and Network Analysis*, 5 ANN. REV. FIN. ECON. 277 (2013).

72. *See* Judge, *supra* note 71, at 671.

73. *See id.* at 687.

risk assessment requires knowledge about the contagion mechanism "through which shocks propagate from one element of the financial system to another."[74] Transaction links between financial and non-financial institutions create exposures at the systematic, cross-border level, as well as within specific sectors or conglomerates.[75] Additionally, links between measures of institutional health, like leverage and liquidity, are changed by accounting rules and regulatory requirements.[76] Other financial activities that transmit risk include complex structured products, off-balance sheet vehicles, trading books of banks' balance sheets, and insurance companies.[77]

The problem is that because contracts are private, only transacting parties know the conditions and contents of their contract. Unless mandatory disclosure is required, regulators cannot know the main actors in or the details of a transaction; such opacity limits competition regarding time and cost.[78] Moreover, corporate financial situations are not always clear to regulators or the public. As corporate structures are often complex, so too are their solvency and liquidity situations.

This weakness of data access and knowledge-delivery has been summarized by economists stating that "[i]f the data were perfect, collected from well designed randomized experiments, there would be hardly room for a separate field of econometrics."[79] One of the primary tasks of empirical researchers in law and economics is to look to the ideal of a randomized experiment to justify causal inference.[80] Nonetheless, such experiments and data are not easy to collect. Both traditional statistical and advanced machine learning models poorly identify new patterns or future events. Market events like recessions or terror attacks often look different and vary in frequency.[81]

At a fundamental level, data is inadequate to describe the whole financial system, even if the data is comprehensive and correct. A centralized authority or planning always lacks the information to know market

74. Miquel Dijkman, *A Framework for Assessing Systemic Risk* 2 (The World Bank, Working Paper No. 5282, 2010).

75. Green, *supra* note 66, at 4.

76. *See generally* WORKING GROUP OF THE FINANCIAL STABILITY FORUM, THE ROLE OF VALUATION AND LEVERAGE IN PROCYCLICALITY (2009).

77. *See* Johnston et al., *supra* note 64, at 4.

78. *See id.*

79. ZVI GRILICHES, HANDBOOK OF ECONOMETRICS (Zvi Griliches and Michael D. Intriligator eds., 1986).

80. *See generally* Susan Athey & Guido W. Imbens, THE ECONOMETRICS OF RANDOMIZED EXPERIMENTS 1 (2016).

81. *See generally* BRUCE SCHNEIER, DATA AND GOLIATH: THE HIDDEN BATTLES TO COLLECT YOUR DATA AND CONTROL YOUR WORLD (2015).

situations.[82] Knowledge and information are infinite in the social world, not only because of the infinite information delivered through biological or technical medium (language, vision, and action), but also the variant psychological reactions. Words, prices, and numbers are merely "signs and symbols needed for the operation of working rules."[83] Numerical data like price and quantity are not "sufficient to coordinate individual judgments about innovative activities (as distinguished from adaptive responses to repeated patterns)."[84]

Price is a compound result of intrinsic value, supply, demand, macro environment, and market expectations,[85] and is affected by procyclical movements, panics, and misplaced judgments.[86] In a stress test, the design of stress scenarios requires estimating the impact of economic downturns on a bank's asset quality and values, profitability, liquidity and funding gaps, and capital adequacy for dealing with adverse changes in some relevant macroeconomic variables,[87] such as GDP growth, unemployment rate, interest rates, bankruptcy rates and asset prices. The assessment should also consider credit conversion factors which reflect the degree of risk that the contingent exposure will turn into an actual exposure.[88] This is beyond mere empirical evidence, but sometimes a matter of psychological intuition, just as morality is ultimately emotional consensus, given Bentham's definition that happiness is a psychological experience.[89]

B. Bias

Bias is the disproportionate weight given in favor of or against an idea or a thing, in a way that is partial, prejudicial, and unfair. A classification model is biased if its decision changes after being exposed to additional sensitive

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82. *See Centrally Planned Economy*, INVESTOPEDIA (Jan. 29, 2020), https://www.investopedia.com/terms/c/centrally-planned-economy.asp.

83. John R. Commons, LEGAL FOUNDATIONS OF CAPITALISM 9 (Univ. of Wis. Press 1959) (1924).

84. AMAR BHIDE, A CALL FOR JUDGMENT: SENSIBLE FINANCE FOR A DYNAMIC ECONOMY 63 (2010).

85. *See generally* MILTON FRIEDMAN, PRICE THEORY: A PROVISIONAL TEXT 9, 10 (1962); R. L. HALL & C. J. HITCH, *Price Theory and Business Behaviour*, 2 OXFORD ECON. PAPERS 12 (1939).

86. *See* Robert E. Lucas Jr., *An Equilibrium Model of the Business Cycle*, 83 J. POL. ECON. 1113, 1113 (1975).

87. *See* H.K. MONETARY AUTH., *supra* note 54, at 2.

88. *See id.* at 11–13.

89. *See* Jeremy Bentham, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION 50 (Clarendon Press 1789).

feature inputs, because an algorithm is only as good as the data it works with.[90] The model may entrench or amplify historical bias and may demonstrate explicit and implicit bias from its designers.[91] Biases exist in all stages of machine learning: model selection, training, evaluation, and interpretation.[92] Data-driven bias includes selection bias (where data selection lacks randomization, such as class imbalance),[93] sampling bias (where certain data instances are oversampled), and reporting bias (where the shared information does not accurately reflect the actual likelihood).[94]

This data source bias can result in an overfitting problem, where the modeling function too closely fits into a limited set of data points.[95] Machine learning inferences typically perform well on the training data but can be non-generalizable for new cases.[96] Different mathematical models trained on the same data have different prediction accuracy and different amounts of bias because of the different cost functions they optimize.[97] This is a Bayesian inference process, which uses Bayes' theorem to update the probability for a hypothesis as more evidence and information becomes available.[98] Bayesian statistical methods are inductive, epistemic, and ontological: probabilities over hypotheses are interpreted as degrees of belief or expressions of epistemic uncertainty.[99] This method adopts inductivism in a cumulative sense and embraces the idea that more data will drive us to more informed probabilistic opinions about a situation or problem.

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90. *See* REVIEW INTO BIAS IN ALGORITHMIC DECISION-MAKING, CTR. FOR DATA ETHICS AND INNOVATION 107 (2020).

91. *See id.* at 6.

92. *See* James Manyika et al., *What Do We Do About the Biases in AI?*, HARV. BUS. REV. (Oct. 25, 2019), https://hbr.org/2019/10/what-do-we-do-about-the-biases-in-ai.

93. *See* Shaun Bevan et al., *Understanding Selection Bias, Time-lags and Measurement Bias in Secondary Data Sources: Putting the Encyclopedia of Associations Database in Broader Context*, 42 SOC. SCI. RSCH. 1750, 1759–61 (2013).

94. *See id.* at 62–63.

95. *See* Douglas M. Hawkins, *The Problem of Overfitting*, 44 J. CHEM. INFO. & COMPT. SCIS. 1, 1 (2004); *see also* Cullen Schaffer, *Overfitting Avoidance as Bias*, 10 MACH. LEARNING 153, 153 (1993).

96. *See* Schaffer, *supra* note 95, at 153 (explaining that performance on training data may not be indicative of "true predictive accuracy").

97. Solon Barocas & Andrew D. Selbst, *Big Data's Disparate Impact*, 104 CAL. L. REV. 671, 688–89 (2016).

98. GEORGE E.P. BOX & GEORGE C. TIAO, BAYESIAN INFERENCE IN STATISTICAL ANALYSIS § 40 (John Wiley & Sons eds., 1992).

99. JAN-WILLEM ROMEIJN, STANFORD ENCYCLOPEDIA OF PHIL., *Philosophy of Statistics* § 4 (Edward N. Zalta & Uri Nodelman eds., 2022).

Simultaneously, the humanistic design of an algorithmic model creates structural bias.[100] Essentially, machine learning is a series of selections by the developer: the model type, regularization, hyperparameters, and loss functions.[101] Among these, hyperparameters play a key role in determining the model's performance. Hyperparameters are preset parameters that control the machine learning process, exemplified by the depth of trees in a random forest model, the number of layers in a neural network, the number of nodes in each layer, the nodes' activation functions, learning rate, data normalization techniques, and regularization techniques.[102] As hyperparameters are adjusted according to the nature of the problem and trade-offs involving computational resources, human interpretation may perpetuate the data issues, causing correlation fallacy (mistaking correlation for causation),[103] overgeneralization (drawing partial conclusions from limited test data),[104] and automation bias (preferring algorithmic decisions over human-generated decisions).[105]

Cross-range estimation reveals that objective functions, definitions of fairness, and the strategies of binding the algorithm inadvertently detract from fairness.[106] An illustration of this is how banks are employing a combination of support-vector machines, which are binary classifiers, and natural-language processing techniques to enhance their ability to detect possible instances of misconduct in customer complaints.[107] The choice of kernel function can significantly impact the performance and generalization capabilities of these models.[108] For capital adequacy requirements, internal ratings of risk involve a bank predicting its likely losses by extrapolating

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100. Barocas & Selbst, *supra* note 97, at 674; REVIEW INTO BIAS IN ALGORITHMIC DECISION-MAKING, *supra* note 90, at 3, 6.9791

101. *See* Li Yang & Abdallah Shami, On Hyperparameter Optimization of Machine Learning Algorithms: Theory and Practice, (Oct. 5, 2022) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/2007.15745 (examining the factors that go into a machine learning model).

102. *See id.* (explaining the role of hyperparameters in a machine learning model).

103. *See* J.M. Tanner, *Fallacy of Per-Weight and Per-Surface Area Standards, and Their Relation to Spurious Correlation*, 2 J. APPLIED PHYSIOLOGY 1, 1 (1949).

104. *See* Shahriar Akter et al., *Algorithmic Bias in Machine Learning-Based Marketing Models*, 144 J. BUS. RSCH. 201, 203 (2022).

105. *See* Virginia Eubanks, *Automating Bias*, 319 SCI. AM. 69, 70 (2018).

106. *See* Jon Kleinberg et al., *Algorithmic Fairness*, 108 AEA PAPERS & PROC. 22, 26 (2018).

107. Sameer Dhanrajani, *Managing Bias in AI: Strategic Risk Management Strategy for Banks*, LINKEDIN (Sept. 23, 2020), https://cn.linkedin.com/pulse/managing-bias-ai-strategic-risk-management-strategy-banks-dhanrajani.

108. *Id.*

from its past loss record. In the prediction of consumer default, the assumption is that the longer the positive history of lending and repayment, the less risk arises for a particular credit transaction.[109] Some deep learning models modify their parameters dynamically to reflect emerging patterns in the data, such as reinforcement learning.[110] If there aren't enough safeguards in place, focusing too much on short-term patterns in the data can potentially damage the long-term performance of the model.[111] The users of these models must determine when it is appropriate to allow dynamic recalibration.[112]

Another result of bias is risk aversion, where an algorithm prefers decisions based on more confident predictions with other factors being equal.[113] This is because probability is not equivalent to causality. If the relationship generalized by deep learning is not a causal relationship, the regulation based on the assumption of risks will impose costly constraints without necessarily contributing to the underlying goal of regulation.[114] As one scholar stated, "the random-forest algorithm tends to favor inputs with more distinct values . . . ."[115] In evaluating the creditworthiness and the interest rate offered to a specific loan applicant, inherent bias can occur if there is information that some large financial institutions have high quality assets and collaterals to repay the debts or provide some guarantees.[116] If a mortgage lending model finds that older people have a higher likelihood of defaulting and reduces lending based on age, both society and legal

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109. Stefania Albanesi & Domonkos F. Vamossy, *Predicting Consumer Default*, NAT'L BUREAU ECON. RSCH. 7 (Jan. 11, 2021), https://www.terry.uga.edu/sites/default/files/inline-files/Albanesi_Domossy_2021.pdf.

110. Bernard Marr, *Artificial Intelligence: What's the Difference Between Deep Learning and Reinforcement Learning?*, FORBES: ENTER. TECH (Oct. 22, 2018, 12:06 AM), https://www.forbes.com/sites/bernardmarr/2018/10/22/artificial-intelligence-whats-the-difference-between-deep-learning-and-reinforcement-learning/?sh=13c52d85271e.

111. Bernhard Babel et al., *Derisking Machine Learning and Artificial Intelligence*, MCKINSEY & CO. (Feb. 19, 2019), https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/derisking-machine-learning-and-artificial-intelligence.

112. *Id.*

113. Bryce Goodman & Seth Flaxman, *European Union Regulations on Algorithmic Decision-making and A "Right to Explanation,"* AI MAGAZINE, Sept. 2017, at 50, 54.

114. Alex Engler, *The EU's Attempt to Regulate Open-Source AI is Counterproductive*, BROOKINGS: TECHTANK (Sept. 1, 2022), https://www.brookings.edu/blog/techtank/2022/08/24/the-eus-attempt-to-regulate-open-source-ai-is-counterproductive/.

115. Dhanrajani, *supra* note 107, at 6.

116. *See* Kristin Johnson et al., *Artificial Intelligence, Machine Learning, and Bias in Finance: Toward Responsible Innovation*, 88 FORDHAM L. REV. 499, 522 (2019).

institutions may consider this age discrimination.

In natural language processing for document analysis, word embeddings map words and phrases on to vectors of real numbers. We label and categorize the world to reduce complex sensory inputs into simplified groups that are easier to work with, trying our best not to lose essential characteristics. Whereas prototypes are assumed to be typical representations of a concept or object, many things in reality are atypical.[117] It has been found that word embedding software trained on news articles exhibits gender stereotypes, which suggests that there is a method for modifying embeddings in a manner that removes gender stereotypes without sacrificing the computational power of these algorithms.[118] We use deep learning to help us reduce disparities caused by human bias, but this bias, in turn, affects the development of an algorithmic model.

The malfunction of algorithmic models tends to be more serious when the task and situation involves complex judgment and selection between different targets, as it is often the case in economic analysis.[119] For example, interpretations of a monetary policy are inherently subjective, and algorithms are bound to make decisions that are "wrong" from some other perspective. Bias, therefore, is a deviation from what the result is supposed to be. Even the discovery of bias entails two conditions: knowledge about the correct result and the gap between the actual and correct results. On the one hand, we need to first establish the correct result for algorithmic models to learn from. On the other, we want to know how the decisions are made, in particular, why deviations from the correct result occur. As we try to understand and explain the rationale of algorithmic decision-making process, we will find this a difficult task.

C. Inexplainability

If machine learning models are to be used for regulation, we need to know how they function and why the result is given so that corrective measures might be taken. In a rule of law context, this corresponds to the transparency principle whereby legislators and regulators have the obligation to share

117. Tolga Bolukbasi et al., *Man Is to Computer Programmer as Woman Is to Homemaker? Debiasing Word Embeddings*, NIPS (2016), https://proceedings.neurips.cc/paper_files/paper/2016/file/a486cd07e4ac3d270571622f4f316ec5-Paper.pdf.

118. *See id.* at 2.

119. *See generally* Arvind Narayanan, *Arthur Miller Lecture on Science and Ethics: How to Recognize AI Snake Oil*, CITP (2019), https://www.cs.princeton.edu/~arvindn/talks/MIT-STS-AI-snakeoil.pdf.

information about their decision-making process so the public can hold these officials accountable for their regulatory conduct and legal decisions.[120] Articles 13(2)(f), 14(2)(g), and 15(1)(h) of the European Union's General Data Privacy Regulation require data controllers to provide data subjects with "the existence of automated decision-making," "meaningful information about the logic involved," and "the significance and the envisaged consequences of such processing for the data subject."[121] Nevertheless, specific definitions of these terms are not given and are difficult to determine.

Most of the training or decision processing of machine learning models has only been partially understood by human beings.[122] As deep learning models use backpropagation algorithms to change their internal parameters in each layer as a representation of some features or values,[123] it is usually unknown to the designers and the public how these relationships are established and these decisions made. It is hard to understand or explain the outputs generated by machine learning models, which cast doubt on the trustworthiness of the algorithmic results. A credit management model may qualify one person for a loan while recommending the rejection of another, without providing sufficient reasons. As this ambiguity brings challenges to the principle of equality and fairness, it also disrupts the flow of funds.[124]

The "explaining" process of a machine learning model is essentially a translation between two languages — from computer language to human language. When translating the law into code, we input natural language into digital codes. But difficulties arise when converting these digital codes back into natural language. The language of algebra is symmetric; given X=Y, X tells us about Y, and Y tells us about X. However, in machine learning models, it is difficult to distinguish cause and effect in such a deterministic relationship. Mathematics has not developed the asymmetric language required to capture our understanding that if X causes Y, that does not mean Y necessarily causes X.[125] This means that while machine learning models

120. Michael Johnston, *Good Governance: Rule of Law, Transparency, and Accountability*, ETICO 1, 3 (2002), https://etico.iiep.unesco.org/en/good-governance-rule-law-transparency-and-accountability.

121. Andrew D. Selbst & Julia Powles, *Meaningful Information and the Right to Explanation*, 7 INT'L DATA PRIV. L. 233, 234 (2017).

122. *See generally* Diogo V. Carvalho et al., *Machine Learning Interpretability: A Survey on Methods and Metrics*, 8 ELEC. 832 (2019).

123. LeCun et al., *Deep Learning*, 521 NATURE 436, 438 (2015).

124. Dmitri Vinogradov, *Destructive Effects of Constructive Ambiguity in Risky Times*, 31 J. INT'L MONEY & FIN. 1459, 1462 (2012).

125. *See generally* Kevin Hartnett, *To Build Truly Intelligent Machines, Teach Them*

can summarize the patterns from a large dataset, it cannot distinguish causal inferences from the general association.[126] Correlation indicates a probability that things will occur in a similar fashion in the future, but it does not reveal why it should be the case.[127]

The nonlinear structure and black-box realities of deep learning models make the explanation more insurmountable than traditional statistical models. This problem becomes more difficult as explanation necessarily involves counterfactual inference. For example, "people do not ask why event P happened, but rather why event P happened *instead* of some event Q."[128] The preference for contrastive explanations is not merely due to the cognitive complexity of non-contrastive explanations, such as the number of links in a causal chain. Instead, the reviewed empirical evidence indicates that humans psychologically prefer contrastive explanations.[129] Counterfactual questions are also at the core of the cognitive advances that made us human and the imaginative abilities that have made science possible.[130]

Data science, or knowledge discovery through data mining and analysis, "is an iterative process of discovering novel, [valid,] useful, and understandable patterns from massive data sources."[131] Explanation, in this sense, raises wider concerns about epistemology, causality, and justification, complicating our attempted overview of the field.[132] Language interpretation

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Cause and Effect, QUANTAMAGAZINE (May 15, 2018), https://www.quantamagazine.org/to-build-truly-intelligent-machines-teach-them-cause-and-effect-20180515/.

126. Bernhard Schölkopf et al., *Towards Causal Representation Learning*, 109 PROC. IEEE 612, 617 (2021).

127. Mireille Hildebrandt, *Defining Profiling: A New Type of Knowledge?*, *reprinted in* PROFILING EUR. CITIZEN: CROSS-DISCIPLINARY PERSPS. 17, 18 (2008).

128. *See* Tim Miller, *Explanation in Artificial Intelligence: Insights from the Social Sciences*, 267 A.I. 1, 3 (2019) (discussing people only needing explanation in a contrastive perspective).

129. *See* Bob Rehder, *A Causal-Model Theory of Conceptual Representation and Categorization*, 29 J. EXPERIMENTAL PSYCH.: LEARNING, MEMORY, & COGNITION 1141, 1153 (2003) (discussing that there is empirical evidence about people's reaction to indirectly connected contrasts); *see also* Bob Rehder, *When Similarity and Causaility Compete in Category-Based Property Generalization*, 34 MEMORY & COGNITION 3, 13 (2006).

130. *See generally* JUDEA PEARL & DANA MACKENZIE, THE BOOK OF WHY: THE NEW SCIENCE OF CAUSE AND EFFECT (1st ed. 2018).

131. Aayush Ostwal, *You Don't Know What You Don't Know*, TOWARDS DATA SCI. (Aug. 25, 2020), https://towardsdatascience.com/you-dont-know-what-you-don-t-know-3e20de7dceb8.

132. *See* Miller, *supra* note 128, at 6.

requires an understanding of a single phenomenon based on the whole knowledge system. Critical realism, as a philosophy of science, is established on a key premise that human knowledge captures only a fragment of the full depth and complexity of social reality.[133] Reality is stratified, or layered, and so cannot be equated with the empirical domain of observable phenomena, nor the beliefs and ideas we form of them. While it is impossible to let everyone know what is happening, we can reach out to the vast majority at a fair level of understandability, regarding the quality, quantity, relation, and representation manner of information.[134]

More importantly, explanation is not only an end in itself but also a means of attaining higher accuracy of the model. Inexplainability is just a phenomenon, behind which is the uninterpretable model whose rationale neither users nor the model designer can understand nor improve accordingly.

IV. DIFFICULTIES IN ESTABLISHING ACCURATE MODELS

The use of machine learning in financial regulation provides an opportunity to reflect on our understanding of the financial system and the methods we use for financial regulation. Machine learning and other computational methods can be seen as part of the empirical approach to law and regulation, which is promoted by the thoughts of legal realism, the availability of empirical data, and the development of our computation techniques. As legal realism encourages paying attention to how judges decide cases according to their personal values, the processes of decision-making through the judges' minds are important. The mind can be regarded as a set of computations that extract representations, like precepts and thoughts.[135] Judges review all arguments and evidence of the case, reach their initial conclusions, and then find legal arguments to justify their decisions.

When this judgment process is applied to financial regulation, the scope of knowledge needed is often uncertain and sometimes prohibitively broad. The complex adaptive nature of the financial system has been widely

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133. *See generally* ANDREW COLLIER, CRITICAL REALISM: AN INTRODUCTION TO ROY BHASKAR'S PHILOSOPHY (1994); MARGARET ARCHER ET AL., CRITICAL REALISM: ESSENTIAL READINGS (Routledge 1998); BERTH DANERMARK ET AL., EXPLAINING SOCIETY: CRITICAL REALISM IN THE SOCIAL SCIENCES (Routledge 2019); Heikki Patomäki & Colin Wight, *After Postpositivism? The Promises of Critical Realism*, 44 INT'L STUD. Q. 213, 233–24 (2000).

134. H.P. GRICE, LOGIC AND CONVERSATION 47 (1975).

135. Michael Rescorla, STANFORD ENCYCLOPEDIA OF PHIL., *The Computational Theory of Mind* § 4 (Edward N. Zalta ed., 2015).

discussed by many law and finance scholars.[136] This complexity and fundamental uncertainty are also in line with the uncertainty principle expressed in physics.[137] Regulatory arbitrage and avoidance in finance are similar to the observer effect that changes the state of an object being observed.[138] These difficulties are manifested in the attempt to both qualify and quantify the risks, and then take regulatory measures accordingly.

A. Establishing Ground Truth

Apart from a lack of training data, it is often difficult to build ground truth in machine learning. Ground truth is the "correct" result that we expect in a specific situation, in the measurement of target variables for training and testing models. In supervised learning, ground truth is the label for classification, or metadata which sets categories and characteristics of other data.[139] Establishing ground truth for a regulation model is not as easy as identifying a dog or cat where the ground truth for image recognition is obvious and uncontested. When we try to interpret a key concept in law, like "bank" and "security," is there an absolutely clear and comprehensive definition that awaits to be understood? While in some cases, the answer is a clear yes, in most situations it is not clear.

First, the meaning and use of natural languages, whether in law documents, contracts, or prospectuses, gives rise to significant controversial ambiguity and subsequently expresses bias. This is not only because of the infinite array of characters and sounds as units of meaning, but also the psychological causality implicit in semanticity delivered by language.[140] Rich meanings in human language give rise to ambiguity and differential meanings in communication and establishing ground truth for algorithmic training. For example, the meaning of a word like "reasonable" may depend

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136. *See generally* Tom Butler & Robert Brooks, *Achieving Operational Resilience in the Financial Industry: Insights from Complex Adaptive Systems Theory and Implications for Risk Management*, J. RISK MGMT. FIN. INSTS., Fall 2021, at 395; Lawrence G. Baxter, *Adaptive Financial Regulation and RegTech: A Concept Article on Realistic Protection for Victims of Bank Failures*, 66 DUKE L.J. 567 (2016); Dirk A. Zetzsche et al., *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 FORDHAM J. CORP. & FIN. L. 31 (2017).

137. *See generally* Howard Percy Robertson, *The Uncertainty Principle*, 34 PHYSICAL REV. 163 (1929).

138. Massimiliano Sassoli de Bianchi, *The Observer Effect*, FOUNDS. SCI. 1, 3 (2012).

139. *See* Jyotsna Sateesh, *Establishing Ground Truth in the Real World*, MACQUARIE ENG'G BLOG (Oct. 13, 2021), https://medium.com/macquarie-engineering-blog/establishing-ground-truth-in-the-real-world-e284ee3c0203.

140. Roger Brown & Deborah Fish, *The Psychological Causality Implicit in Language*, 14 COGNITION 237, 241–42 (1983).

on case-based and contextual-dependent reasoning. Therefore, the meaning of something is largely a social construct which involves subjective or objective interpretation of key concepts and sentence texts.

The legal system is characterized by diversity in judges and the language they use, as well as the influence of common law cases that introduce more variation and specificity to legal rules. Additionally, the legal system is shaped by different legal cultures and social backgrounds, resulting in a heterogeneous system that is slowly becoming more aligned over time. One of the most fundamental concepts in regulation is "risk,"[141] using risk assessment and cost-benefit analysis to impose regulatory standards, which takes the form of a function of harm and probability. The operational and regulatory challenges increase as financial institutions expand their scope of scale across jurisdiction and sectors. Risk management strategies are correspondingly enhanced[142] by using quantitative analysis, financial engineering, and value at risk[143] for major financial institutions.

Additionally, human interpretation depends on the structure of knowledge and level of technical proficiency. Cognitive scientists have previously found that human cognition is the same everywhere; however, according to social science scholars, this may not be the case.[144] The value people assign to their own beliefs — in terms of probability and personal relevance — correspond with the explanatory power of those beliefs.[145] Members of different cultures differ in their metaphysics, or fundamental beliefs about the nature of the world, and the characteristic thought processes of different groups differ greatly. The thought processes individuals engage in are consistent with their beliefs about how the world works.[146] People employ cognitive tools that align with their values and goals.[147] For instance, credit derivatives, insurance, and guarantees may take different names but aim for the same object, which can be misunderstood by the algorithm. In the context of individual legal interpretation, "higher-order cognitive capacities"

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141. Julia Black & Robert Baldwin, *Really Responsive Risk-Based Regulation*, 32 L. & POL'Y 181, 184 (2010).

142. *See generally* PETER CHRISTOFFERSEN, ELEMENTS OF FINANCIAL RISK MANAGEMENT (2011).

143. *See generally* PHILIPPE JORION, VALUE AT RISK: THE NEW BENCHMARK FOR MANAGING FINANCIAL RISK (3d ed. 2007).

144. RICHARD E. NISBETT, THE GEOGRAPHY OF THOUGHT: HOW ASIANS AND WESTERNERS THINK DIFFERENTLY . . . AND WHY xvii (Free Press. 2003).

145. Jesse Preston & Nicholas Epley, *Explanations Versus Applications: The Explanatory Power of Valuable Beliefs*, 16 PSYCH. SCI. 826, 826 (2005).

146. *See* NISBETT, *supra* note 144, at xvii.

147. *See id.*

are essential. These cognitive capacities have evolved in humans over time, allowing humans to better interpret the world through natural language. It is highly unlikely that machine learning approaches will be able to replicate such interpretive abilities.[148]

Different language and interpretation in a natural language model will further impact machine learning results. Since sources of conflict and ambiguity have not been fundamentally addressed by regulators all over the world, artificial intelligence can hardly solve this problem simply by using machine judgment and decisions. Moreover, the complex relationship between different laws, regulations, policies, and guidelines are not easy to label for algorithmic training. At the international level, conflicts of laws are still commonplace and there are ongoing debates as to which are applicable.[149]

Second, legal definitions are dynamic, subject to the objective and purpose of legislation or policymaking, and the specific context of a case. This diversity is also a result of regulatory arbitrage, avoidance, and procyclicality of the financial system.[150] For example, some contracts or transactions are deliberately designed to avoid regulatory standards — so-called regulatory arbitrage or avoidance.[151] For instance, structured finance deals do not easily reveal their transaction structure and underlying assets, as they are a combination of the transfer of debts and similar intangible rights with the structures for raising finance through the issue of debt securities in capital markets. Specifically, information opaqueness may involve pooling the assets owned by the holder, tiered bonds backed by the asset pool, and how far the credit risks of the pooling assets are delinked from the credit risk of the holder of the assets. Financial assets ripe for securitization include residential mortgage loans, commercial mortgage loans, credit cards and other unsecured consumer loans, auto loans, and trade receivables.[152] Setting security interests for underlying assets requires credit analysis of the assets' value.

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148. Simon Deakin & Christopher Markou, *Evolutionary Interpretation: Law and Machine Learning*, J. CROSS-DISCIPLINARY RSCH. COMPUTATIONAL L., July 2022, at 1, 1.

149. *Id.* at 2–3.

150. Emily Lee, The Shadow Banking System — Why It Will Hamper the Effectiveness of Basel III 3 (May 15, 2015) (unpublished manuscript) (on file with SSRN), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587628; Bill Allen et al., *Basel III: Is the Cure Worse Than the Disease?*, 25 INT'L REV. FIN. ANALYSIS 159, 164 (2012).

151. Lee, *supra* note 150, at 1.

152. *Id.* at 9.

B. Statistical Modeling of the Financial World

Machine learning models interpret phenomena based on probability, subject to the metadata design and subsequent adjustment. Statistical reasoning is based on the precept "that, by studying apparently haphazard collections of autonomous individuals, one can" uncover systemic patterns of scientific import at a higher level.[153] Zeger also argues, however, that "[s]tatistical models for data are never true . . . . A more appropriate question is whether we obtain the correct scientific conclusion if we pretend that the process under study behaves according to a particular statistical model."[154] Models assist in organizing information, enhancing logical reasoning, addressing problems, and making predictions about future events. However, in doing so, they necessarily simplify representations by removing specific details, focusing instead on the fundamental features that apply to all entities of that type.

The use of probability assignment over statistical hypotheses suggests closed-mindedness originating from the Bayesian statistics. Closed-mindedness, or a self-referential system, is necessarily incomplete,[155] because self-reference allows for the construction of paradoxes within that theory,[156] exemplified by the statement: "This sentence is not true." Thus, a statistical model by itself is never comprehensive as it is unable to adapt to changes in the environment and new situations. Additionally, Bayesian inferences ignore the determination of the prior probability, and the criteria that might govern it.[157] This is probably because we already have an intuitive judgment on the hypotheses in the model, so we can pin down the prior probability on that basis. Additionally, we might have additional criteria for choosing the prior probability. In financial regulation, credit analysis involves predictions not just about the particular borrower, but also

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153. Scott L. Zeger, *Statistical Reasoning in Epidemiology*, 134 AM. J. EPIDEMIOLOGY 1062, 1064 (1991).

154. *Id.* at 1064.

155. Timothy G. Mccarthy, *Self-reference and Incompleteness in a Non-Monotonic Setting*, 23 J. PHIL. LOGIC 423, 424 (1994); J. Steven Winrich, *Self-Reference and the Incomplete Structure of Neoclassical Economics*, 18 J. ECON. ISSUES 987, 988 (1984); Noson S. Yanofsky, *A Universal Approach to Self-Referential Paradoxes, Incompleteness and Fixed Points*, 9 BULL. SYMBOLIC LOGIC 362, 376 (2003); Panu Raatikainen, *Gödel's Incompleteness Theorems*, STAN. ENCYCLOPEDIA PHIL. 1, 9–10 (2013).

156. Thomas Bolander, *Self-reference and Logic*, 1 PHI. NEWS 1, 1 (2005); Albert Visser, *From Tarski to Gödel—Or How to Derive the Second Incompleteness Theorem from the Undefinability of Truth Without Self-reference*, 29 J. LOGIC & COMPUTATION 595, 596 (2019).

157. Bolander, *supra* note 156, at 2.

economic forecasts and unforeseen crises.[158] Compliance with rules may lead to a false sense of security if the rules alone are followed.

From an economic history perspective, the new statistical method represents a paradigm shift in economics. Traditional financial models, such as the Modigliani-Miller capital structure irrelevance theorem,[159] the efficient market hypothesis, the Black-Scholes option pricing model,[160] portfolio theory,[161] financial equilibrium models,[162] and the concept of money,[163] do not perfectly describe the real-world practice. All mathematical models are limited by their assumptions and conditions. There are several financial models that still require further investigation. These include concepts such as value at risk, which relates to financial risk, as well as the capital asset pricing model, Gaussian copula, random walks, financial derivatives, event studies, forecasting (including the use of big data), volatility, animal spirits, cost of capital, various financial ratios, the concept of insolvency, and neuro-finance. A more comprehensive model of financial markets is necessary to integrate these factors.

The empirical and credibility revolutions[164] of Western economics came into wider application in the past forty years. Since the 1980s, with the development of information technology, increased computation speed, and more accessible data, economic research has turned to a research focus using econometrics and experimental economics for empirical analysis. Observational and experimental data replaced traditional mathematical

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158. Stijn Claessens & Laura Kodres, *The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions* 4 (IMF, Working Paper No. WP/14/46, 2014).

159. Frank Hindriks, *False Models as Explanatory Engines*, 38 PHIL. SOC. SCI. 334, 335 (2008).

160. *See generally* James Weatherall, *The Peculiar Logic of the Black-Scholes Mode*, 85 PHIL. SCIENCE 1152 (2018).

161. *See generally* Harry M. Markowitz, *Foundations of Portfolio Theory*, 46 J. FIN. 469 (1991); Hersh Shefrin & Meir Statman, *Behavioral Portfolio Theory*, J. FIN. & QUANTITATIVE ANALYSIS 127 (2000).

162. *See generally* J. Doyne Farmer & John Geanakoplos, *The Virtues and Vices of Equilibrium and the Future of Financial Economics*, COMPLEXITY, Jan. 2009, at 3, 11; Youngjae Lim & Robert M. Townsend, *General Equilibrium Models of Financial Systems: Theory and Measurement in Village Economies*, 1 REV. ECON. DYNAMICS 59 (1998).

163. *See generally* GEORG SIMMEL, THE PHILOSOPHY OF MONEY (David Frisby ed., Routledge 2004); GEOFFREY INGHAM, THE NATURE OF MONEY (Polity Press 2004).

164. *See* Joshua D. Angrist & Jörn-Steffen Pischke, *The Credibility Revolution in Empirical Economics: How Better Research Design Is Taking the Con out of Econometrics*, 24 J. ECON. PERSPS. 3, 4 (2010) (citing various research over the last forty years in the Western world at-large and domestically).

deduction, especially causal inference, and tested the explanatory power of economic theories or hypothesis. The advance of such an empirical revolution[165] results from mainstream scientific research, using empirical data to verify theories.[166] Such empirical analysis based on data is useful to the extent that causal inference can be proved only with adequate control variables. This control is easy for natural science but difficult and even unrealistic for economists and other social scientists. Thus, economists created several new approaches to causal inferences such as randomized controlled trials,[167] natural experiment,[168] observational method,[169] and structural models,[170] which have been widely used in economics, management, psychology, sociology, and other fields.

This does not mean that economic models themselves are perfect. Rather, it was realized in the 1970s that human beings are not fully rational, nor the market perfectly efficient to reach an equilibrium without friction.[171] Humanistic bias brought by our psychological propensities in consumption, what Keynes lamented as "animal spirits," drove economic sentiments like

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165. *See* Joshua Angrist et al., *Economic Research Evolves: Fields and Styles*, 107 AM. ECON. REV. 293, 297 (2017) (enumerating the increase in empirical research and the frequency by which it is has grown).

166. *See* THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 36 (U. Chi. Press, 2nd ed. 2012).

167. *See generally* Kjell Benson & Arthur J. Hartz, *A Comparison of Observational Studies and Randomized, Controlled Trials*, 342 NEW ENG. J. MED. 1878 (2000) (mentioning the accuracy of randomized control trials in comparison to observational studies).

168. *See generally* Andrew Metrick, *A Natural Experiment in "Jeopardy!,"* 85 AM. ECON. REV. 240 (1995) (using the game show *Jeopardy!* to highlight how causal inferences can be made using game show wagers); E. Jane Costello et al., *Relationships Between Poverty and PsychoPathology: A Natural Experiment*, 290 JAMA 2023 (2003).

169. *See generally* Alexis Diamond & Jasjeet S Sekhon, *Genetic Matching for Estimating Causal Effects: A General Multivariate Matching Method for Achieving Balance in Observational Studies*, 95 REV. ECON. & STAT. 932 (2013) (holding that biases can be reduced if the algorithm is in line with the observed phenomenon).

170. *See generally* Young Ho Eom et al., *Structural Models of Corporate Bond Pricing: An Empirical Analysis*, 17 REV. FIN. STUD. 499, 500 (2004) (highlighting the Merton model and four other models that are used by experts to determine a corporation's risk of credit default); E. K. Berndt et al., *Estimation and Inference in nonlinear Structural Models*, ANNALS ECON. & SOC. MEASUREMENT 653, 653 (1974) (highlighting how one variable has an impact on another variable is not necessarily a perfect correlation).

171. W. Brian Arthur, *Foundations of Complexity Economics*, 3 NATURE REVIEWS PHYSICS 136, 136 (2021).

stock market speculation.[172] Behavioral economics and behavioral finance[173] overthrew established neoclassical economic theory which supposes that human beings make decisions with full rationality and perfect information.[174] Empirical findings suggest that market participants' decision-making is not made in accordance with the optimizing behavior postulated by the perfect information and perfect rationality theory.[175] Human beings have all sorts of bias: overconfidence and illusion of control,[176] self-attribution bias,[177] hindsight bias,[178] confirmation bias,[179] the narrative fallacy,[180] availability bias,[181] representativeness heuristic,[182] anchoring,[183] loss aversion,[184]

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172. GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM AGENDA 117 (2009).

173. *See* Alon Brav et al., *The Rational-behavioral Debate in Financial Economics*, 11 J. ECON. METHODOLOGY 393, 394 (2004); Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, HANDBOOK OF THE ECONOMIC OF FINANCE 1052, 1053 (2003).

174. Gerd Gigerenzer, *Decision Making: Nonrational Theories*, 5 INT'L ENCYCLOPEDIA SOC. & BEHAV. SCIS. 3304, 3305–06 (2001); Matthew Rabin, *An Approach to Incorporating Psychology into Economics*, 103 AM. ECON. REV. 617 (2013).

175. Herbert A. Simon, *Bounded Rationality in Social Science: Today and Tomorrow*, 1 MIND & SOCIETY 25, 27–29 (2000); John Conlisk, *Why Bounded Rationality?*, 34 J. ECON. LITERATURE 669, 672 (1996).

176. Anat Bracha & Donald J. Brown, Affective Decision Making: A Theory of Optimism Bias, 75 GAMES & ECON. BEHAV. 67, 77 (2012); Monika Czerwonka, Anchoring and Overconfidence: The Influence of Culture and Cognitive Abilities, 53 INT'L J. MGMT. & ECON. 48, 49 (2017).

177. Arvid O. I. Hoffmann & Thomas Post, Self-attribution Bias in Consumer Financial Decision-making: How Investment Returns Affect Individuals' Belief in Skill, 52 J. BEHAV. & EXPERIMENTAL ECON. 23, 23 (2014).

178. Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, 28 J. CORP. L. 715, 724 (2003).

179. Saul M. Kassin et al., *The Forensic Confirmation Bias: Problems, Perspectives, and Proposed Solutions*, 2 J. APPLIED RSCH. MEMORY & COGNITION 42, 44 (2013).

180. Doron Menashe & Mutal E. Shamash, *The Narrative Fallacy*, 3 INT'L COMMENT. ON EVIDENCE 1, 15 (2005).

181. Rasoul Sadi et al., Behavioral Finance: The Explanation of Investors' Personality and Perceptual Biases Effects on Financial Decisions, 3 INT'L J. ECON. & FIN. 234, 236 (2011).

182. David M. Grether, Bayes Rule as a Descriptive Model: The Representativeness Heuristic, 95 Q. J. ECON. 537, 538 (1980); David M. Grether, Testing Bayes Rule and the Representativeness Heuristic: Some Experimental Evidence, 17 J. ECON. BEHAV. & ORG. 31, 32 (1992).

183. Adrian Furnham & Hua Chu Boo, *A Literature Review of the Anchoring Effect*, 40 J. SOCIO-ECON. 35, 35 (2011); Jørgen Vitting Andersen, *Detecting Anchoring in Financial Markets*, 11 J. BEHAV. FIN. 1, 1 (2010).

184. Michael S. Haigh & John A. List, Do Professional Traders Exhibit Myopic Loss

herding mentality,[185] etc.

The biological rationale of human bias comes from our brain structure. Prejudice is a fundamental component of human behavior that represents the complex interplay between neural processes and situational factors.[186] Prejudiced responses range from the rapid detection of threats and subjective visceral responses to deliberate evaluations and dehumanization. These processes are supported most directly by the amygdala, orbital frontal cortex, insula, striatum and medial prefrontal cortex.[187] Given the neuroscience of decision making, information cannot be conveyed neutrally.[188] Human decisions are not made by fully rational, deliberative, and reflective thought, but are very often shaped by external influences.[189] This behavioral bias has been proposed as a source of systemic risk in financial markets, the so-called "intellectual hazard," which interferes with accurate thought and analysis within complex organizations.[190] This cognitive risk hampers the process of gathering, evaluating, sharing, and applying information within a company, as well as the transmission of such information between the company and external parties.[191]

These intellectual hazards are exacerbated by the over-recognition of quantitative risk modeling and similar credit ratings.[192] Qualitative assessments entail more judgemental flexibility while relying on the skill, experience, and sometimes, intuition of regulators to make relevant decisions.[193] For instance, the interpretation of "risk-weighted assets" and

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Aversion? An Experimental Analysis, 60 J. FIN. 523, 523 (2005); Mohammed Abdellaoui et al., Loss Aversion Under Prospect Theory: A Parameter-Free Measurement, 53 MGMT. SCI. 1659, 1659 (2007).

185. Andrea Devenow & Ivo Welch, *Rational Herding in Financial Economics*, 40 EUR. ECON. REV. 603, 604 (1996); Christopher Avery & Peter Zemsky, *Multidimensional Uncertainty and Herd Behavior in Financial Markets*, 88 AM. ECON. REV. 724, 724 (1998).

186. *See* David M. Amodio, *The Neuroscience of Prejudice and Stereotyping*, 15 NATURE REV. NEUROSCIENCE 670, 670–71 (2014).

187. *Id.* at 671.

188. *See* Matteo Godi, *Beyond Nudging: Debiasing Consumers Through Mixed Framing*, 128 YALE L. J. 2034, 2037 (2018).

189. Gidon Felsen & Peter B. Reiner, How the Neuroscience of Decision Making Informs Our Conception of Autonomy, 2 AJOB NEUROSCIENCE 3, 3 (2011).

190. Geoffrey P. Miller & Gerald Rosenfeld, Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008, 33 HARV. J. L. & PUB. POL'Y 807, 808 (2010).

191. *Id.*

192. ROSS P. BUCKLEY, FROM CRISIS TO CRISIS: THE GLOBAL FINANCIAL SYSTEM AND REGULATORY FAILURE 121 (Wolters Kluwer Law & Business 2011).

193. Black & Baldwin, supra note 141, at 185.

"countercyclical capital buffer" requires qualitative judgement in defining what is total risk exposure multiplied by an institution-specific risk weighting. Banks also need to satisfy a leverage ratio that measures the bank's degree of debt.

Big data and machine learning can partially alleviate these problems but cannot solve them at a fundamental level. Big data allows for textual regression by using textual data, graphic data, audio data, and unstructured data,[194] as well as interval-valued data,[195] symbolic data,[196] and functional data.[197] These new types of data call for new econometric models and methods by incorporating psychological and emotional factors into the economics. Research on the impact of psychology and sentiments on economics has a long history but has only recently been brought up with more attention. Before the publication of *The Wealth of Nations*, Adam Smith put forward the importance of moral philosophy, such as the sense of propriety, sympathy, pleasure and passion, in economic rationality and optimization in *The Theory of Moral Sentiments*.[198] The notion that psychological factors can influence demand was initially put forth in the marginal utility theory.[199] This idea was later incorporated into Keynesian economics through concepts like marginal propensity to consume,[200]

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194. Paul Losiewicz et al., *Textualyes Data Mining to Support Science and Technology Management*, 15 J. INTELLIGENT INFO. SYS. 99, 99–100 (2000); Ting Sun & Miklos A. Vasarhelyi, *Embracing Textual Data Analytics in Auditing with Deep Learning*, 18 INT'L J. DIGIT. ACCT. RSCH. 49, 55 (2018).

195. *See* L. Billard & E. Diday, *Regression Analysis for Interval-Valued Data*, DATA ANALYSIS, CLASSIFICATION & RELATED METHODS 369, 369 (2000); Lynne Billard, *Dependencies and Variation Components of Symbolic Interval-Valued Data*, SELECTED CONTRIBUTIONS IN DATA ANALYSIS & CLASSIFICATION 11 (2007); Wei Xu, Symbolic Data Analysis: Interval-Valued Data Regression (Aug. 2010) (Ph.D dissertation, Univ. of Ga.).

196. Patrice Bertrand & Françoise Goupil, *Descriptive Statistics for Symbolic Data*, ANALYSIS OF SYMBOLIC DATA 106 (2000).

197. J.O. Ramsay & B.W. Silverman, SPRINGER SERIES IN STATS., FUNCTIONAL DATA ANALYSIS 1–5 (2d ed. 2005).

198. *See generally* Adam Smith, THE THEORY OF MORAL SENTIMENTS (London 1790).

199. *See generally* George Stigler, *The Adoption of the Marginal Utility Theory*, 11 Q.J. BUS. & ECONS. 571 (1972); Emil Kauder, *Genesis of the Marginal Utility Theory: From Aristotle to the End of the Eighteenth Century*, ECON. J., Sept. 1953, at 638; EMIL KAUDER, HISTORY OF MARGINAL UTILITY THEORY 12 (Princeton University Press. 2015).

200. *See* Christopher Carroll et al., *The Distribution of Wealth and the Marginal Propensity to Consume*, 8 QUANTITATIVE ECONS. 977 (2017). *See generally* Tal Gross et al., *The Marginal Propensity to Consume over the Business Cycle*, 12 AM. ECONS. J.: MACROECONOMICS 351, 368 (2020).

liquidity trap,[201] and the Lucas critique proposed by the rational expectations school. Big data expands the scope and scale of economics by incorporating social, psychological, political, legal, and historical variables in the causal inference. These social factors can be analyzed with qualitative and quantitative research such as textual regression to uncover new correlations and causality. These changes are still early in their development and have a long way to maturity.

C. Attaining Fairness in a Complex Adaptive System

The ground truth and statistical truth issues are combined to stimulate reflections on fairness and respect for individual autonomy in financial regulation. Machine learning models used for financial regulation should produce consistent, ethical, and fair outcomes for customers. Critics have stated that the positive approach adopted by machine learning ignores the metaphysical aspects of human life (meanings, beliefs, and experiences) and normative questions (ethical and moral questions about how things should be).[202] Herein lies the core debate between empiricism and rationalism. The world does not merely consist of statistical truth, but also essentialist claims. Essentialism claims that human beings have some properties that are independent of the means describing them.[203] What makes us unique is a totality of human beings' essential properties, in particular the rationality based on reason,[204] and hence the law safeguards our liberty against coercion and arbitrariness. A debate exists about how far social determinism can explain human behavior and the supposed rational nature of our social context.[205] Nonetheless, it is essentially a given that society exerts a subtle influence on individuals that shape our knowledge and awareness. Positivist methodologies concentrate solely on specific types of injuries, aiming to address them through a reductionist lens that overlooks the essence of human

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201. *See* Paul Krugman, *Thinking about the Liquidity Trap*, 14 J. JAPANESE & INT'L ECONS. 221, 233 (2000); *see also* Gauti B. Eggertsson & Michael Woodford, *Policy Options in a Liquidity Trap*, 94 AM. ECON. REV. 76, 76 (2004); Anton Korinek & Alp Simsek, *Liquidity Trap and Excessive Leverage*, 106 AM. ECON. REV. 699, 722 (2016).

202. Deborah Frisch, *Reasons for Framing Effects*, 54 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 399, 422 (1993).

203. Alan McMichael, *The Epistemology of Essentialist Claims*, 11 MIDWEST STUD. PHIL. 33, 33 (1986).

204. *See generally* ARISTOTLE, THE EUDEMIAN ETHICS (Anthony Kenny trans., Oxford Univ. Press. 2011).

205. Ulrike Rangel & Johannes Keller, *Essentialism Goes Social: Belief in Social Determinism as a Component of Psychological Essentialism*, 100 J. PERSONALITY & SOC. PSYCH. 1056, 1056 (2011).

existence and the experience of living in culturally vibrant and diverse societies and environments.[206] A quantitative approach is patently helpful; however, the limitations in understanding human society should be recognized and complemented with other approaches.

To begin, we need to clarify what constitutes "fairness" in financial regulation. In the general legal theory, a just scheme answers to what men are entitled to; it satisfies their legitimate expectations as founded upon social institutions.[207] Correspondingly, modern financial regulation largely adopts a proportionate risk-based approach.[208] The principle of proportionality can be defined as "a set of rules determining the necessary and sufficient conditions for a limitation of a constitutionally protected right to be constitutionally permissible."[209] At the core of proportionality is the balancing of various rights and interests. Since market participants are different in their capital, bargaining power, and information status, one of the legal objectives is to re-empower the weak (consumers and retail investors) by setting unequal rules above social and market realities. Other goals of financial regulation include financial stability, market integrity, sustainable development, and reduced inequality.

Yet it is often difficult to weigh the value and risks of certain behavior by an individual or institution in the whole financial system. The financial market is a complex adaptive system,[210] achieved through feedback and interdependence across time and space. It is complex because of the multifarious participants and stakeholders in the system. It is nonlinear in

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206. Rob Kitchin, *Big Data, New Epistemologies and Paradigm Shifts*, 1 BIG DATA & SOC'Y, Apr.–June 2014, at 1, 7.

207. John Rawls, A THEORY OF JUSTICE 88–89 (1999).

208. HM REVENUE & CUSTOMS, MONEY SERVICE BUSINESS GUIDANCE FOR MONEY LAUNDERING SUPERVISION 12 (2014), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/889077/UTF-8__Guidance-for-Money-Service-Businesses-HM-Treasury-approved.docx_.pdf.

209. Ariel L. Bendor & Tal Sela, *How Proportional Is Proportionality?*, 13 INT'L J. CONST. L. 530, 530 (2015).

210. *See* Michael J. Mauboussin, *Revisiting Market Efficiency: The Stock Market as a Complex Adaptive System*, J. APPLIED CORP. FIN., Jan. 2002, at 47, 47; Wei-Ching Chen, *Nonlinear Dynamics and Chaos in a Fractional-Order Financial System*, 36 CHAOS, SOLITONS & FRACTALS 1305, 1306 (2008); Wang Zhen et al., *Analysis of Nonlinear Dynamics and Chaos in a Fractional Order Financial System with Time Delay*, 62 COMPUT. & MATHEMATICS APPLICATIONS 1531, 1533–37 (2011). *See generally* Andrew Crockett, General Manager of the Bank for International Settlements & Chairman of the Financial Stability Forum, Marrying the Macro- and Micro-prudential Dimensions of Financial Stability, Address at the Eleventh International Conference of Banking Supervisors (Sept. 21, 2000), https://www.bis.org/speeches/sp000921.htm.

that changes are disproportional, unsmooth, and discontinuous. Changes can be sudden, paradoxical, and chaotic: increase capital adequacy requirements a small amount, and liquidity doubles, or falls drastically, or bounces back and forth. This mainly comes from complex transactional relationships and financial innovations, such as credit default swaps, collateralized debt obligations, and other structured credit instruments.[211] Over-the-counter derivatives, like securitization and interbank lending, have given rise to new networks of institutions. Interlinkages are established through direct counterparty exposures, indirect exposures through another counterparty, or immaterial effects linked to confidence, perceptions, and similarities. The system is adaptive because market participants adjust their behavior according to different contexts and expectations.

In a nonlinear complex system, very small differences can have consequences that magnify and amplify into a butterfly effect.[212] This butterfly effect results from emergent complexity,[213] where heterogeneous individual actors take strategic actions. In a system wherein there are simple rules for how large numbers of simple participants interact, the whole system will fashion its own pattern of operation, emerging out of the interaction between members. This contagion has been studied through the lens of network theory,[214] originally developed in physics to visualize how forces bind together structures such as atoms. Research on the diffusion of social networks and internet data reveals how complex webs of people and information are linked.[215] Large networks are complex systems which have emergent properties — the tendency of novel structures, patterns, and properties to manifest themselves in phase transitions that are far from predictable. Because of emergent patterns and network effects, the social processes are not mechanical dynamics that look like those from the past. Outcomes or events are sometimes unpredictable. As Keynes put it, "[t]here

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211. Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, J. ECON. PERSP., Winter 2009, at 77, 79.

212. *See generally* Edward Lorenz, *The Butterfly Effect*, 39 WORLD SCI. SERIES ON NONLINEAR SCI. SERIES A. 91 (2009).

213. *See* Silvio Funtowicz & Jerome R. Ravetz, *Emergent Complex Systems*, 26 FUTURES 568, 569–70 (1994).

214. *See* Stephen P. Borgatti & Daniel S. Halgin, *On Network Theory*, 22 ORG. SCI. 1168, 1170–71 (2011).

215. *See* Yann Bramoullé et al., *Strategic Interaction and Networks*, 104 AM. ECON. REV. 898, 915 (2014); *see also* Yann Bramoullé & Rachel Kranton, *Risk-Sharing Networks*, 64 J. ECON. BEHAV. & ORG. 275, 279–80 (2007); Rachel E. Kranton & Deborah F. Minehart, *Networks Versus Vertical Integration*, 31 RAND J. ECON. 570, 574–75 (2000).

is no scientific basis to form any calculable probability whatever. We simply do not know."[216] This coincides with what economists called as "Knightian uncertainty,"[217] where we cannot know everything that would be needed to calculate the odds.

Simultaneously, the legal system is also a complex adaptive system. Many actors and actions shape this system: judges, legislators, agencies, lawyers, opinions, laws, rules, and claims. Court hierarchies and their interactions influence the validity of a rule. Diverse institutions, instruments, and methods vary over space and time. Additionally, common law precedent adds more variation and specification in legal rules. As we attempt to improve and debias our judgement and decision-making, we must realize that human beings are not infinitely knowing creatures. We have a limited set of sensory and cognitive capabilities with which to interpret events. This limitation manifests itself in the fact that our attention is always limited, our reasoning is often biased, and we are continuously using many assumptions to take shortcuts and rapidly draw conclusions.[218] Being aware of our own way of seeing the world and the process through which we reason is a prerequisite to forming effective cognitive capacities.

Julian Webb suggested three overarching ethical principles concerning legal complexity.[219] First, an appreciation of legal complexity confirms why "the law delivers justice as much by accident as by design," but also "encourages emancipatory movements to embrace the uncertainty this provides."[220] Second, complexity science reveals the interconnectedness of seemingly self-referential closed social systems, meaning that "a failure to achieve normative consistency between systems will generate system conflicts."[221] Third, activating certain ethical values consistent with complex adaptive system behavior, such as altruism, pluralism, and interdependence, will support the maintenance and development of the legal system.[222] In short, the ethical implications of legal complexity call for societal

216. J. M. Keynes, *The General Theory of Employment*, 51 Q.J. ECON. 209, 214 (1937).

217. Kiyohiko G. Nishimura & Hiroyuki Ozaki, *Search and Knightian Uncertainty*, 119 J. ECON. THEORY 299, 300 (2004).

218. Iuliia Kotseruba & John K. Tsotsos, *40 Years of Cognitive Architectures: Core Cognitive Abilities and Practical Applications*, 53 A.I. REV. 17, 36–37 (2020).

219. *See* Julian Webb, *Law, Ethics and Complexity: Complexity Theory and the Normative Reconstruction of Law*, 52 CLEV. ST. L. REV. 227, 228–29 (2005) (giving an overview of the three principles).

220. *Id.* at 239.

221. *Id.*

222. *Id.* at 239–40.

responsibility and participation in the legal system and a deep reexamination of fundamental ethical notions of powers, rights, and rules.

Since law and finance are interwoven and constructed upon each other,[223] the complexity of both systems brings inherent difficulties for mathematical representation and statistical inference. As economists, psychologists, and neuroscientists unravel new rationales of human behavior and decision-making, we might be able to design differential treatment rules in a more scientific and sophisticated way. But for now, crucial decisions made in tough situations are still dependent upon human judgment.[224]

Examining fairness horizontally, a key aspect is equality — whether similar people are treated similarly or, if not, whether differentiation factors are relevant to the situation. Equality in machine learning models means demographic blindness (decisions are made using features that are uncorrelated with certain groups), demographic parity (outcomes are proportionally equal for all protected classes), equal opportunity (true-positive rates are equal for each class), and equal odds (true positive and false-positive rates are equal for each class).[225] Inequalities, either social or economic, are only to be allowed if the worst off in society will be better off than they might be under an equal distribution. If there is such a beneficial inequality, this inequality should not make it harder for those without resources to occupy positions of power.[226] In the financial market, fairness may be defined as the principle that each person has equal access to financial services without discrimination on the basis of race, color, religion, national origin, sex, marital status, or age. In the context of fair lending based on risk assessment, unfair practice means discriminative access to credit, bank

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223. *See generally* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1114–16 (1998) (explaining the connections between law and finance); Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. TRANSITION 325, 326 (2000) (discussing the relevance of law and corporate governance of finance); Ulrike Malmendier, *Law and Finance "at the Origin,"* 47 J. ECON. LITERATURE 1076, 1076–77 (2009) (summarizing the history of law and finance); Katharina Pistor, *A Legal Theory of Finance*, 41 J. COMPAR. ECON. 315, 315 (2013) (explaining how law and finance do not exist in silos).

224. *See* Sebastian Doerr et al., *Big Data and Machine Learning in Central Banking* 14–15 (Bank For Int'l Settlements, Working Paper No. 930, 2021) (discussing where machine learning may not be the solution to every problem).

225. *See generally* Valeria Cortez, *How to Define Fairness to Detect and Prevent Discriminatory Outcomes in Machine Learning*, TOWARDS DATA SCI. (Sept. 23, 2019), https://towardsdatascience.com/how-to-define-fairness-to-detect-and-prevent-discriminatory-outcomes-in-machine-learning-ef23fd408ef2 (explaining the terms demographic parity, equal opportunity, and equal odds).

226. *See* John Rawls, *Justice as Fairness: Political Not Metaphysical*, 9 EQUALITY & LIBERTY 145, 148 (1991).

lending, and setting of insurance premiums.

Statistical discrimination may be more or less morally permissible depending on who and how many people are wrongly judged based on the membership of whatever statistical group they may be part of, compared to the costs involved in improving the accuracy of the generalization.[227] In making a choice of regulation, it is necessary to know what is being allocated, what types of behavior are being predicted, what alternative selection techniques are available, and what advantages and disadvantages inhere in the various techniques. In the use of algorithmic profiling for credit assessment and risk management, discrimination is inevitable because individuals will be placed into established groups deemed more or less creditworthy or risky.[228] A legitimate interest argument may be proposed that such profiling, classification, and limitation are intended for protecting systemic stability and retail investors. The issue turns on the extent of the discrimination based on complex cost-benefit analyses.

A final important aspect of fairness is transparency. The financial system cannot always operate in a black box, where information is controlled by some people or institutions to make profits, while shifting the risks to others. Whether it be a standard crafted by algorithm alone or that has been reviewed by human experts, the public has a right to know the rules in an accessible and understandable way.

One way to solve this problem is for regulators and model designers to explain the algorithm, which has been stipulated in law to protect individual autonomy and liberty.[229] Prescribed explanations will focus on system functionality and specific decisions. System functionality pertains to the reasoning, significance, anticipated outcomes, and overall operation of an automated decision-making system. This encompasses elements such as the "system's requirements specification, decision trees, predefined models, criteria, and classification structures."[230] In contrast, specific decisions encompass the justifications, underlying reasons, and unique factors involved in a particular automated decision. This includes aspects such as

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227. *See Reuben Binns, Fairness in Machine Learning: Lessons from Political Philosophy*, 81 PROC. MACHINE LEARNING RSCH. 1, 4 (2018).

228. *Id.* at 4–5.

229. *See* Richard H Fallon, Jr., *Two Senses of Autonomy*, 46 STAN. L. REV. 875, 875 (1994); *see also* Jonas Wachner et al., *And How Wouls that Make You Feel? How People Expect Nudges to Influence Their Sense of Autonomy*, 11 FRONTIERS PYSCH. 1, 2 (2020).

230. Sandra Wachter et al., *Why a Right to Explanation of Automated Decision-Making Does Not Exist in the General Data Protection Regulation*, 7 INT'L DATA PRIV. L. 76, 78 (2017).

the weighing of features,[231] machine-generated decision rules specific to individual cases, and information pertaining to reference or profile groups.[232] Explanation techniques encompass various approaches to clarify and understand automated decisions. These techniques include visualization using back-propagation[233] and perturbation methods,[234] distillation using local approximation[235] and model translation techniques,[236] as well as intrinsic design through attention mechanisms[237] and joint training. In

231. This "feature" refers to assessing and evaluating specific characteristics or attributes. These features could vary depending on the context of the decision. For example, in a credit scoring system, the features might include an individual's credit history, income level, employment status, and outstanding debts. In image recognition, the features might include color, texture, shape, or specific patters within an image. The choice and significance of features depend on the nature of the decision being made and the specific problem domain.

232. Wachter et al., *supra* note 230, at 78.

233. See Weili Nie et al., A Theoretical Explanation for Perplexing Behaviors of Backpropagation-based Visualizations 80 PROC. OF THE 35TH INT'L CONF. ON MACHINE LEARNING RSCH. (2018); see also Mukund Sundararajan et al., Axiomatic Attribution for Deep Networks, 70 PROC. OF THE 34TH INT'L CONF. ON MACHINE LEARNING RSCH. (2017); Avanti Shrikumar et al., Learning Important Features Through Propogating Activation Differences, 70 PROC. OF THE 34TH INT'L CONF. ON MACHINE LEARNING RSCH. (2017).

234. *See generally* Matthew D. Zeiler & Rob Fergus, *Visualizing and Understanding Convolutional Networks,* EUR. CONF. ON COMPUT. VISION, Sept. 2014, at 818 (2014); Marko Robnik-Šikonja & Igor Kononenko, *Explaining Classifications for Individual Instances*, 20 IEEE TRANSACTIONS ON KNOWLEDGE & DATA ENG'G 1 (2008).

235. *See* Marco Tulio Ribeiro, et al., *Anchors: High-Precision Model-Agnostic Explanations* 32 PROC. OF THE AAAI INT'L CONF. ON A.I. 1527, 1528 (2018); Radhakrishna Achanta et al., *SLIC Superpixels Compared to State-of-the-Art Superpixel Methods*, 34 IEEE TRANSACTIONS ON PATTERN ANALYSIS & MACHINE INTEL. 2274 (2012). *See generally* Marco Tulio Ribeiro et al., *"Why Should I Trust You?" Explaining the Predictions of Any Classifier*, PROC. OF THE 22ND ACM SIGKDD INT'L CONF. ON KNOWLEDGE DISCOVERY & DATA 1135 (2016).

236. Geoffrey Hinton et al., *Distilling the Knowledge in a Neural Network*, (Mar. 9, 2015) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1503.02531; Junho Yim, et al., *A Gift from Knowledge Distillation: Fast Optimization, Network Minimization and Transfer Learning*, CVF 4133, 4133–34 (2017); Bo-Jian Hou & Zhi-Hua Zhou, *Learning with Interpretable Structure from Gated RNN*, 31 IEEE TRANSACTIONS ON KNOWLEDGE & DATA ENG'G (2020).

237. Ashish Vaswani et al., *Attention Is All You Need*, 31st CONF. ON EMPIRICAL METHODS IN NAT. LANGUAGE PROCESSING 2 (2017); Yequan Wang et al., *Attention-Based LSTM for Aspect-Level Sentiment Classification*, PROC. OF THE 2016 CONF. ON EMPIRICAL METHODS IN NAT. LANGUAGE PROCESSING 606, 606 (2016); Gaël Letarte et al., *Importance of Self-Attention for Sentiment Analysis*, PROC. OF THE 2018 EMNLP WORKSHOP BLACKBOX NLP 267, 267 (2018); Jacob Devlin et al., Bert: Pre-Training of Deep Bidirectional Transformers for Language Understanding (Oct. 11, 2018) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1810.04805.

particular, the explanation benefit must outweigh its cost. The societal norm of the need for explanation is threefold: (i) the impact of the decision on persons other than the decision maker; (ii) the possibility of contesting, correcting, or compensating for an error in the decision; and (iii) any reason to believe that an error occurs in the decision-making process.[238]

However, explaining deep learning models is time-consuming and costly, leading to less efficient systems, forced design choices, and bias towards explainable but suboptimal outcomes. These costs may far outweigh the accuracy, correctness, and fidelity benefits of an explanation of the model's decision-making process.[239] Furthermore, machine explanations do not always make sense,[240] especially when the ground truth is unknown. The favorable evaluation metrics may vary significantly depending on the specific evaluation goal and selected user groups. The human-friendly or human-centred criterion suggests that the interpretations should be organized in a way that is easier for human understanding.[241] The more complex the explanations are, the less human-friendly it is. At the same time, it is doubtful whether users need to know so much about the model design and whether such explanation makes any difference to financial consumers.

Otherwise, regulators may use linear and monotonic models, because linear coefficients can help reveal the dependence of a result on the output. There have been systemic demonstrations that gaining interpretability does not correspond to a loss in accuracy, as long as the model is optimized carefully.[242] The accuracy performance of a complex classifier does not necessarily exceed that of a simple model after preprocessing.[243] Such accuracy is built upon certain conditions: structured data with meaningful

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238. Finale Doshi-Velez et al., Accountability of AI Under the Law: The Role of Explanation 7 (unpublished manuscript) (on file with Harvard University), http://nrs.harvard.edu/urn-3:HUL.InstRepos:34372584.

239. Sina Mohseniet et al., A Survey of Evaluation Methods and Measures for Interpretable Machine Learning 2 (Nov. 28, 2018) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1811.11839; Fan Yanget et. al., Evaluating Explanation Without Ground Truth in Interpretable Machine Learning 2 (Jul. 16, 2019) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1907.06831.

240. See Leilani H. Gilpin et al., Explaining Explanations: An Overview of Interpretability of Machine Learning 2 (May 31, 2018) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1806.00069.

241. Menaka Narayanan et al., How Do Humans Understand Explanations from Machine Learning Systems? An Evaluation of the Human-Interpretability of Explanation 2 (Feb. 2, 2018) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1802.00682.

242. Cynthia Rudin, *Stop Explaining Black Box Machine Learning Models for High Stakes Decisions and Use Interpretable Models Instead,* NATURE MACH. INTEL., May 2019, at 206, 206.

243. *Id.*

features and the preprocessing of data. What an interpretable model really calls upon is the understanding of the scientific rationale of a problem so that we can use theories to frame the question in terms that computers can parse, specify target variables and class labels, and create new sub-classes (a set of properties and methods that are common to all objects of one type) under the existing classes to illustrate the inclusion or juxtapose the relationship between variables.

V. REGULATION BEYOND DATA AND STATISTICS

A good algorithmic model is established upon a large amount of data, a comprehensive and accurate designation of metadata, and effective and efficient model design. To achieve these goals, model designers need to understand the rationale of regulation, collect as much data as possible by establishing data infrastructure, promote digital money and smart contracts to trace the detail of transactions, and develop digital identities of natural and legal persons to analyze the risk network. They should also create bias indexes to supervise the model itself and mitigate the deviation, as well as to optimize the model with new data as the market evolves.

A. Theoretical Foundations of Model Design

First and foremost, regulators need to understand the nature of the problem, model objectives, and regulatory tools. This is because algorithmic systems cannot decide the legality of an input.[244] It needs some foundational value to establish what is legal or illegal. This is a preliminary yet crucial process of problem definition as the foundation of further policy judgment. This step involves two major aspects of human efforts: metadata design and hyperparameter selection. Metadata is the data that provides information about and instructions upon other data. It is the underlying structure that constitutes an algorithmic model.[245] Hyperparameters are predesigned model structures that affect the learning result.[246] These two elements are the theoretical foundation of algorithmic models, which reflects the policy judgment and influences prediction accuracy. Metadata design and hyperparameters selection should combine expert knowledge and industry practices to ensure that the parameters are chosen as soundly as possible to make full use of the data.

The model design must comply with applicable laws and rules, including

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244. Deakin & Markou, *supra* note 148, at 2.

245. REVIEW INTO BIAS IN ALGORITHMIC DECISION-MAKING, *supra* note 90, at 24.

246. Yang & Shami, *supra* note 101, at 2.

those relevant to discrimination and public policy. In the United States, models that determine whether to grant credit to applicants are covered by fair-lending laws. As one scholar notes, "the models must be able to produce clear reason[ing] . . . for a refusal."[247] To safeguard the fairness of algorithmic decisions, the target and framework of regulation should not be decided purely by the regulator's risk appetite — the type of risks it intends to tolerate and the level of supervision.[248] In practice, this is often driven by political considerations and policy orientations, involving complex interest structure and economic judgement.

Internal model structures are more technical matters. For instance, money laundering is the process through which criminals disguise the criminal origin of money and assets they earned through criminal activity. It can take many forms of money transmission, such as currency exchange and check cashing. Money transmission can involve placing illegal cash with a money service business or enabling the transfer of value by netting-off transactions in different countries without moving any money. One prevalent method involves dividing transactions into small amounts, depositing cash into another person's bank account, or conducting fund transfers on behalf of another.[249] For suspicious transactions, customer due diligence is required to check the risks. Customer due diligence refers to the process of identifying all customers and beneficial owners, verifying their identities, obtaining information on the purpose and intended nature of the business relationship, conducting ongoing monitoring of the business relationship to ensure transactions are consistent with what the business knows about the customer, retaining records of these checks, and updating them when there are changes.[250] It is crucial to sort out the relationship between the concepts and steps of applying the law so that the algorithm can be trained to apply the law like human judges and regulators.

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247. Sameer Dhanrajani, Managing Bias in AI: Strategic Risk Management Strategy for Banks, LINKEDIN (Sept. 22, 2020), https://cn.linkedin.com/pulse/managing-bias-ai-strategic-risk-management-strategy-banks-dhanrajani?trk=read_related_article-card_title.

248. Black & Baldwin, *supra* note 141, at 201.

249. HM REVENUE & CUSTOMS, MONEY SERVICE BUSINESS GUIDANCE FOR MONEY LAUNDERING SUPERVISION, at 4 (UK), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/889077/UTF-8__Guidance-for-Money-Service-Businesses-HM-Treasury-approved.docx_.pdf.

250. *Id.* at 24.

B. Adequate Data Source

After identifying the types of data needed based on the theoretical foundations of the model, we then try to obtain the data through multiple channels. There are three areas of big data: financial data, payment infrastructure records, and socio-economic indicators.[251] Financial data includes information about credit institutions (balance sheet exposures, investor behavior and expectations), settlement operations (operational risks, market functioning), securities issuance (security-by-security databases), market liquidity (bid-ask spreads), custodian records (securities holding statistics), and tick-by-tick data (real-time analysis of financial patterns), and so on. In order to address privacy, secrecy, and regulatory concerns, certain data should not be published. This includes information related to sensitive matters like constructive ambiguity in the lending of last resort.[252]

After the 2008 financial crisis, "the consolidation of the banking sector and the dramatic growth in nonbank financial intermediaries," such as "security broker-dealers, money market mutual funds, issuers of asset-backed securities," and big technology companies, are "more susceptible than banks to liquidity risks because of a lack of deposit insurance."[253] Related data, such as the leverage of other financial institutions, the institution's risk taking, price of real estate and credit spreads, loss absorption capacity of large financial institutions, and their liquidity, maturity, and balance sheet mismatches, are useful in the assessment of risks and deciding whether the risks are excessive so that central banks should take countercyclical measures.[254]

To trace all possible disruptive financial innovations, training data should include the trading books of a variety of financial institutions. Under Basel III, a revised boundary was drawn between the trading and banking books in an attempt to reduce the risk of regulatory arbitrage for less liquid

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251. *See* Michael van Steen, *Regulatory Big Data: Regulator Goals and Global Initiatives*, MOODY'S ANALYTICS (May 2015), https://www.moodysanalytics.com/risk-perspectives-magazine/risk-data-management/regulatory-spotlight/regulatory-big-data-regulator-goals-and-global-initiatives.

252. *See generally* Xavier Freixas, Optimal Bail Out Policy, Conditionality and Constructive Ambiguity 2–5 (June 23, 1999) (unpublished manuscript) (on file with SSRN), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=199054 (discussing constructive ambiguity in the lending of last resort).

253. Joe Peek & Eric Rosengren, *Credit Supply Diruptions: From Credit Crunches to Financial Crisis*, 8 ANN. REV. FIN. ECON. 81, 81 (2016).

254. *See generally* Simon Gilchrist & John V. Leahy, *Monetary Policy and Asset Prices*, 49 J. MONETARY ECON. 75 (2002).

instruments.[255] Whereas the balance sheet of banks contains loans and other assets that are typically held to maturity and not traded, the trading book contains assets that are easy to trade, highly liquid, and straightforward to value (mark-to-market) at any point in time, such as fixed-income instruments (e.g., bonds) and certain derivatives.[256] The trading book is often identified with market risk whereas the banking book is largely affected by credit risk, and the Basel rules allow banks to use internal value-at-risk models to measure market risks in the trading book, in contrast to the standardized approach carried out by credit rating agencies.[257] This special treatment of trading books was abused in the financial crisis of 2008. Many securitized credit instruments were held in the trading book where they were subject to lower capital requirements.[258]

To supervise the corporate structure of banks and other financial institutions, data reporting should include their parent companies, subsidiaries, the quality and quantity of holding assets of large institutions, off-balance-sheet vehicles, transaction value in a market, counterparties, customers, and accounts.[259] Large exposure values, exceeding ten percent of the bank's eligible capital base to a counterparty or a group of connected counterparties, will entail more strict reporting, although the definition of a "group of connected counterparties" [260] which changes with the acquisition of a significant shareholding stake in the institution itself remains debatable. Regulators also need the records of data on all trades at securities exchanges, which serve as an essential check for unusual transactions before announcing a merger or acquisition.

The above data collection will primarily depend on financial disclosure reporting, revealing profitability, financial stability, and potential vulnerabilities of a company during a specific period. Financial disclosure reporting involves providing specific types of information in various

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255. *See, e.g.*, Caio Ferriera et al., *From Basel I to Basel III: Sequencing Implementation in Developing Economies* 21 (IMF, Working Paper No. 19/127, 2019) (explaining Basel III requirements).

256. *See id.*

257. *See id.*

258. *See id.*

259. *See* BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR EFFECTIVE RISK DATA AGGRESTION AND RISK REPORTING (2013), https://www.bis.org/publ/bcbs239.pdf.

260. Counterparties are "connected" if there is a shareholding control relationship or if there is a degree of economic inter-dependence, such that financial problems suffered by one entity is likely to 'infect' the other, *see* BANK FOR INT'L SETTLEMENTS, SUPERVISORY FRAMEWORK FOR MEASURING AND CONTROLLING LARGE EXPOSURE 4–5 (2014); *see also* BANK FOR INT'L SETTLEMENTS, LARGE EXPOSURE STANDARD — EXECUTIVE SUMMARY (2022), https://www.bis.org/fsi/fsisummaries/lex.htm.

formats.[261] This includes external financial statements such as the income statement, balance sheet, cash flow statement, trading books, and statement of stockholders' equity.[262] It also encompasses details about equity in stockholders or any changes made to it, retained earnings, assets (including current assets, financial assets, investments, fixed assets, and intangible assets) as presented in the balance sheet.[263] Moreover, it covers information related to changes in paid-up capital, liabilities, ongoing operations and results, net sales, total profit or loss, and communication regarding quarterly earnings through press releases and conference calls.[264] Additionally, it involves quarterly and annual reports provided to stockholders, financial information published on a business's website, financial reports submitted to governmental agencies (including quarterly and annual reports to the securities regulatory authority), and documentation pertaining to the issuance of common stock and other securities.[265]

Since machine learning models are fed with structured data (like tabular data in a spreadsheet), financial institutions should provide information in a standardized format. Data reporters should align on definitions, interpretation, and implementation of rules. They can use semantics and triples[266] (a statement in subject-predicate-object form) to map and translate multiple internal and external data ontologies from different domains into a universal format. This may start from standard accounting practices to accurately depict a company's financial status, with items of revenues, expenses, profits, capital, and cash flow. Further progress will rely on a robust governance framework to ensure centralized regulatory reporting utilities do not have an adverse impact. This would require codification of reporting requirements, providing for international realities and funding.[267]

261. *See What is Financial Reporting?*, FRESH BOOKS (Apr. 18, 2023), https://www.freshbooks.com/hub/reports/financial-reporting?fb_dnt=1.

262. *See id.*

263. *See id.*

264. *See id.*

265. *See id.*

266. In the context of data ontologies and semantic mapping, a triple refers to a fundamental building block of semantic data representation. It consists of three components: subject, predicate, and object. These components are used to express relationships between entities in a structured manner. The subject represents the entity or concept being described, the predicate denotes the specific attribute or relationship, and the object represents the value or target entity associated with the subject and predicate. Together, these three components create a statement that captures a semantic relationship between two entities.

267. *See* EMMANUEL SCHIZAS ET AL., THE GLOBAL REGTECH INDUSTRY BENCHMARK REPORT 70 (2019), https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-

Since information is costly, and those who spend resources to obtain it are unwilling to spread it,[268] it is imperative to build a data and information infrastructure to collect and process data. This data infrastructure involves two primary aspects: digital identity and transaction records. A standardized digital identity system should be developed to synthesize information about natural and legal persons to better analyze the risk network. The digital ID system can be linked to socioeconomic indicators such as data generated from internet clicks (Google searches), social networks (confidence and economic sentiment), website scraping (policy communication, expectation analysis), employment history, and other records. This information can be used as an index for financial sentiment in the stock market, money market, and exchange markets. This will provide crucial references to liquidity runs in times of trouble. Since deep learning models can be adopted to improve the performance of sentiment analysis about various financial markets,[269] regulators should take these textual data into account to understand market sentiments. Data sources, in this regard, cover all major social media and platforms, such as StockTwits,[270] SeekingAlpha,[271] AlphaSense,[272] and even Facebook and X (social media platform formerly known as Twitter). This data can be obtained from data submission through Application Programming Interfaces, or web portal data uploads to the central database. More automated data collection techniques can be pre-embedded in the underlying system, which will "reduce the administrative burden for firms, while increasing the quality of data available to the supervisor."[273]

Data from payment infrastructure records should also be collected and used for model training. This includes data generated from large value payment systems and important institutions like correspondent banks, central securities depositories, custodian banks, central counterparties, and core collateral management systems. At a macro level, this involves collecting

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finance/publications/the-global-regtech-industry-benchmark-report/.

268. *See generally* Sanford J. Grossman & Jospeh E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. R. 393 (1980).

269. Sahar Sohangir et al., *Big Data: Deep learning for Financial Sentiment Analysis*, J. BIG DATA, Jan. 2018, at 1, 2 ("It is this media that provides a huge amount of unstructured data (Big Data) that can be integrated into the decision-making process. Such a Big Data can be considered as a great source of real-time estimation because of its high frequency of creation and low-cost acquisition.").

270. STOCKTWITS, https://stocktwits.com/ (last visited, Jan. 20, 2024).

271. SEEKING ALPHA, https://seekingalpha.com/ (last visited Jan. 20, 2024).

272. ALPHASENSE, https://www.alpha-sense.com/ (last visited Jan. 20, 2024).

273. Raphael Auer, *Embedded Supervision: How to Build Regulation into Decentralised Finance* 4 (Bank for Int'l Settlements, Working Paper No. 811, 2022).

and analyzing various types of data related to economic activities. This includes information about foreign trade operations, investment transactions (which are recorded in balance of payments statistics), taxation, loan registers, price levels, inflation rates, housing price indices, and indicators of the financial market. A cohesive data infrastructure needs to be established to collect this payment information. This calls for the promotion of central bank digital currency and smart contracts to trace the detail of transactions and collect relevant data for risk management.

C. Bias Index and Mitigation

To correct algorithmic bias and deviation, human vigilance is needed to eliminate the unfair bias "baked in and scaled by AI systems."[274] The first step is to establish processes and standards to evaluate fairness and potential bias in the model.[275] The measurement result could form a bias index which includes which groups are discriminated against, in what ways, and to what degrees.[276] The bias index offers a feedback mechanism for organizing economic complexities. With negative feedbacks, changes are absorbed quickly and the system gains stability; with positive feedbacks, changes are amplified, leading to instability.[277] The bias index will guide the optimization of model design choices towards more desirable results.

Technicians should debias algorithms by changing the choice of features, revising the definition of the optimization problem, and using large group evaluations.[278] More dynamic solutions to reduce bias can be pre-processing, in-processing, and post-processing. Pre-processing methods learn an alternative representation of the input data that removes information correlated to the sensitive attributes while maintaining the model

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274. Jake Silberg & James Manyika, *Notes from the AI Frontier: Tackling Bias in AI (and in Humans)*, MCKINSEY GLOBAL INST. (June 6, 2019), https://www.mckinsey.com/featured-insights/artificial-intelligence/tackling-bias-in-artificial-intelligence-and-in-humans.

275. *See* Dhanrajani, *supra* note 107.

276. *See* Chris Sweeney & Maryam Najafian, *A Transparent Framework for Evaluating Unintended Demographic Bias in Word Embeddings*, *in* 15th ANN. MEETING OF THE ASS'N FOR COMPUTATIONAL LINGUISTICS 1662, 1662–63, 1665 (2019), https://aclanthology.org/P19-1162/.

277. JOHN H. MILLER & SCOTT E. PAGE, COMPLEX ADAPTIVE SYSTEMS: AN INTRODUCTION TO COMPUTATIONAL MODELS OF SOCIAL LIFE 50 (Princeton Univ. Press 2009).

278. *See* Tolga Bolukbasi et al., *Man is to Computer Programmer as Woman is to Homemaker? Debiasing Word Embeddings*, 30 CONF. ON NEURAL INFO. PROCESSING SYSS. 4356, 4357 (2016), https://dl.acm.org/doi/10.5555/3157382.3157584.

performance as much as possible.[279] The idea is that a decision should remain the same in a counterfactual world in which a sensitive attribute is changed.[280] For example, a probabilistic framework may be used to transform input data to prevent unfairness in the scope of supervised learning.[281] The input transformation is conducted as an optimization problem, aiming to balance discrimination control, individual distortion, and data utility.

In-process methods directly introduce fairness learning constraints to the model to punish unfair decisions during training.[282] Designers might consider adversarial learning[283] and adaptive resampling which use alternative algorithms to benchmark performance.[284] These generative models can discover underlying latent variables in a dataset. We might also mitigate bias by learning latent structure, estimating distributions of these learned latent variables, resampling probabilities of individual data instances to re-weight them in the training, and learning from fair data distribution.

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279. *See* Faisal Kamiran & Toon Calders, *Data Preprocessing Techniques for Classification without Discrimination*, 33 KNOWLEDGE & INFO. SYSS. 1, 2, 28 (2011); Richard Zemel et al., *Learning Fair Representations*, 28 PROC. MACHINE LEARNING RSCH. 325, 332 (2013), https://proceedings.mlr.press/v28/zemel13.html; Paula Gordaliza et al., *Obtaining Fairness using Optimal Transport Theory*, 97 PROC. MACHINE LEARNING RSCH. 2357, 2357 (2019), https://proceedings.mlr.press/v97/gordaliza19a.html.

280. *See* Matt Kusner et al., *Counterfactual Fairness, in* 31ST CONF. ON NEURAL INFO. PROCESSING SYSS, 4069, 4069–71, 4077 (2018), https://dl.acm.org/doi/10.5555/3294996.3295162.

281. *See* Flavio P. Calmon et al., *Optimized Pre-Processing for Discrimination Prevention, in* 31ST CONF. ON NEURAL INFO. PROCESSING SYSS. 1, 1–2 (2017), https://www.researchgate.net/publication/316030535_Optimized_Data_Pre-Processing_for_Discrimination_Prevention.

282. *See* Toshihiro Kamishima et al., *Fairness-aware Learning through Regularization Approach*, 11 IEEE INT'L CONF. ON DATA MINING WORKSHOPS 643, 644, 646 (2011); Michael Kearns et al., *Preventing Fairness Gerrymandering: Auditing and Learning for Subgroup Fairness*, 80 PROC. MACHINE LEARNING RSCH. 2564, 2564, 2566 (2018), https://proceedings.mlr.press/v80/kearns18a.html; Adrián Pérez-Suay et al., *Fair Kernel Learning*, MACH. LEARNING & KNOWLEDGE DISCOVERY DATABASES 339, 341–42, 345, 353 (2017), https://arxiv.org/abs/1710.05578; Mahbod Olfat & Anil Aswani, *Spectral Algorithms for Computing Fair Support Vector Machines*, 84 PROC. MACH. LEARNING RSCH. 1933, 1933, 1935–37 (2018), https://proceedings.mlr.press/v84/olfat18a.html; Aditya Krishna Menon & Robert C. Williamson, *The Cost of Fairness in Binary Classification*, 81 PROC. MACH. LEARNING RSCH. 107, 109, 116 (2018), https://proceedings.mlr.press/v81/menon18a.html.

283. *See* Brian Hu Zhang et al., *Mitigating Unwanted Biases with Adversarial Learning*, ASS'N FOR COMPUT. MACHINERY CONF. ON A.I., ETHICS, & SOC'Y 335, 335 (2018).

284. *See* Dhanrajani, *supra* note 107.

Latent variables can define adjusted probability for sampling a particular datapoint during training. Adaptive adjustment of resampling probability can increase the probability of resampling for situations that have underrepresented features. We could then select batches during the training, so that batches sampled with this model would be more diverse with respect to the learning features.

Post-process methods adjust model predictions after the model is trained. It is an ad-hoc fairness procedure for correcting a trained model. We may construct non-discriminating predictors as a post-processing step to achieve equal odds and opportunities. We can establish a process to create unbiased predictors for two scenarios based on the original model. These scenarios include a binary predictor and a score function. In the score function scenario, the original model produces real score values ranging from 0 to 1.[285] Plus, we can use the technique of "human-in-the-loop" for decision-making. Where algorithms provide recommendations or options, humans will double-check and choose from the available options.[286]

To adapt to the changing environment, models should be updated with new data as markets evolve. The non-ergodic nature of a system highlights the importance of past events in financial processes. However, it is not sufficient to merely extrapolate from the past to predict the future.[287] This notion comes from "ergodic" in statistical mechanics whereby a single trajectory, continued long enough at constant energy, would be representative of an isolated system as a whole.[288] Bias, in this regard, can be understood as the mismatch between social reality and outdated models trained on historical data. To mitigate this bias, the model should keep learning new market situations, financial products, and transaction structures.

Finally, companies and individuals have the right to be informed about the existence of automated decision-making and system functionality.[289] Regulators should provide accessory descriptions of the computation result.

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285. *See* Moritz Hardt et al., Equity of Opportunity in Supervised Learning 5–8 (Oct. 11, 2016) (unpublished manuscript) (on file with arXiv), https://arxiv.org/abs/1610.02413.

286. *See* Dhanrajani, *supra* note 107.

287. *See* Ole Peters, *Optimal Leverage from Non-ergodicity*, 11 QUANTITATIVE FIN. 1593, 1598–1602 (2011).

288. *See* Calvin C. Moore, *Ergodic Theorem, Ergodic Theory, and Statistical Mechanics*, 112 PROC. NAT'L ACAD. SCI. 1907, 1908 (2015).

289. *See* Diana Sancho, *Automated Decision-Making under Article 22 GDPR: Towards a More Substantial Regime for Solely Automated Decision-Making*, *in* ALGORITHMS & L. 136, 150–52 (Martin Ebers & Susana Navas eds., 2020).

This means the disclosure of data source, model construction, sectoral components, training processes, and final decisions with reasons.[290] It starts from releasing the dataset for training the models, and opening source codes for public oversight. Regulators should provide adequate information about what types of data are used and their approach to using customer data. When regulatory decisions are handed down, the model can use counterfactual explanations for its automated decision.[291] Counterfactual explanations take this form: "You were denied a loan because your annual income was £30,000. If your income had been £45,000, you would have been offered a loan."[292] Although it does not directly deliver the computation rationale of the problem, it does help people understand a given decision, offer them grounds to contest it, and guide people to change their behavior to achieve the intended result. In other words, regulators should provide sample judgment and decision standards in a case-by-case situation that demonstrate how things will happen. After the decisions are made, regulators should present a mechanism for customers to inquire and request reviews on the algorithmic decisions and ensure that any related complaint handling and redress mechanisms for algorithm-based products and services are fairly accessible. A special pleading mechanism, as an opportunity to participate actively in the decision process, will enhance the participant's sense of legitimacy and fairness.[293] The pleading result, if eventually found to be justified, can be used as an important ground truth in the dataset to improve the model.

VI. CONCLUSION

This article investigates the accuracy and legitimacy of algorithmic financial regulation. Big data and machine learning are transforming the

290. *See* Brent Mittelstadt et al., *Explaining Explanations in AI*, FAT * 19: PROC. CONF. ON FAIRNESS, ACCOUNTABILITY, & TRANSPARENCY, at 279, 280 (2019); *see also* Bruno Lepri et al., *Fair, Transparent, and Accountable Algorithmic Decision-Making Processes*, 31 PHIL. & TECH. 611, 620 (2018).

291. *See* Sandra Wachter et al., *Counterfactual Explanations Without Opening the Black Box: Automated Decisions and the GDPR*, 31 HARV. J. L. & TECH. 841, 844 (2018).

292. *Id.*

293. *See generally* Jerry L. Mashaw, *The Supreme Court's Due Process Calculus for Administrative Adjudication in* Mathews v. Eldridge*: Three Factors in Search of a Theory of Value*, 44 U. CHI. L. REV. 28 (1976); GEOFFREY C. HAZARD, ETHICS IN THE PRACTICE OF LAW (Seven Springs Center eds., 4th ed. 1978); Frank I. Michelman, *Formal and Associational Aims in Procedural Due Process*, 18 NOMOS 126, 127 (1977); Paul R. Verkuil, *The Emerging Concept of Administrative Procedure*, 78 COLUM. L. REV. 258 (1978).

paradigm of financial regulation.[294] Big data enlarged the scope of our knowledge, whereas machine learning enhanced our knowledge acquisition process which involves cognition and judgment. Methodologically, a machine learning algorithm is a continuation of traditional statistical models for risk evaluation. While it improves the quality and efficiency of risk evaluation and regulatory judgment, it has similar drawbacks to all data analysis techniques that undermine its accuracy. As the famous aphorism suggests, "[a]ll models are wrong, but some are useful."[295]

No machine can predict whether a new initiative will succeed, or even calculate the right probability of various outcomes. In the real world, there are many factors that affect the result. Unfathomable emotional and subconscious drives, beyond the pursuit of wealth, play a crucial role in determining whether someone makes a "leap in the dark."[296] Regulatory gaps, given the limitations of data source, bias, and inexplainability, require new thinking on system-wide or macro-prudential policy interventions.[297]

Fundamental definitions and judgements cannot be produced purely by machine decisions. These models bring in old problems such as limited data sources, inherent human bias, non-robust algorithms, and opaque computation processes. These problems occur for various reasons. Firstly, they arise from the limitations of the algorithmic model itself, which relies on analyzing statistical probabilities based on past situations. Secondly, the problems stem from our own inherent bias and prejudice, which are natural tendencies present in human brains. Thirdly, these problems are influenced by the fundamental uncertainty that exists in the market. This uncertainty arises from the fact that human observation can only shape the prior probability of an event. Additionally, our epistemic knowledge falls short in fully describing the true ontological reality of this world. Overreliance or blind esteem in mathematical models may overlook how the financial market and institutions actually work, leading to severe ignorance of potential risks. This is not to say data, observation, and experiments are useless, but they must be combined with theory, which is a crucial part of both scientific research and policymaking.

The limitation of statistical models revealed some long-existing weaknesses of empirical approaches to financial regulation. The key point is that a reductionist statistical approach cannot interpret the complex

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294. *See* Douglas W. Arner et al., *FinTech, RegTech, and the Reconceptualization of Financial Regulation*, 37 NW. J. INT'L. L. & BUS. 371, 373 (2016).

295. Mittelstadt et al., *supra* note 290.

296. BHIDE, *supra* note 84, at 5.

297. Gensler & Bailey, *supra* note 34, at 4–5.

evolutionary human society. Data cannot always speak for themselves without theory. Big data inevitably falls short of the unpredictable and often paradoxical social relations, molded by political, economic and cultural awareness, and spurious correlations that may hide trivial but influential features. Economists have also acknowledged that mathematical economics "cannot easily cope with Knightian uncertainty."[298] The underlying assumption of the models is that every distinct situation is essentially one among many comparable situations, and the decision-maker's task is simply to ascertain the essential characteristics of that particular group."[299] No models, nor any decision-makers, are universally omniscient, because in a decentralized economy different individuals make different choices depending on how they interpret the world around them and the facts they uniquely observe. More generally, models are not fully neutral. There are inherent politics contained in the datasets analyzed, the algorithm designed, and the interpretations made.[300]

In light of the accuracy challenge of machine learning models, it is better that algorithmic decisions are used as an important reference for legal judgments or regulatory decisions, rather than fully relied upon as the final outcome. Algorithmic models need human intervention for better finishing the regulatory task. First, transacting data should be more readily available for regulators to train and update their models, at a low cost to privacy, trade secrecy, and other public interests and human rights. At a global level, regulators should align their definition of key concepts for capital and portfolio requirements. Accounting sheets and trading books, as well as trading contracts between certain institutions at a particular sum, should be standardized and structured for the convenience of algorithmic decisions. Second, bias mitigation at all stages of the machine learning pipeline is essential. It starts from data collection to build the word corpus (a structured set of words used to train models), word embeddings, and large dataset. This correction is a two-way process that receives feedback from society and improves the model for further deployment. Third, disclosure and explanation are required to prevent irrational market behaviors and corporate misconduct, as well as evaluate unintended demographic bias.[301] The regulator should set a standard for reasonable explanation of the balance between regulatory efficiency and basic human rights.

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298. BHIDE, *supra* note 84, at 105.

299. *Id.* at 102.

300. Gillian Rose, *Situating Knowledges: Positionality, Reflexivities and Other Tactics*, 21 PROGRESS HUM. GEOGRAPHY 305, 312 (1997).

301. Sweeney & Najafian, *supra* note 276, at 1665.

* * *

FISCAL EQUITY: THE NON-PROFIT MODEL OF CORPORATE OWNERSHIP

ERIC A. SAN JUAN*

In an era of excessive executive compensation, the non-profit corporation serves as an exemplary alternative. Voluntarily, some brand-name manufacturers operate under existing law that permits non-profit ownership. Virtually all corporations could become non-profits under a legislative reform potentially more effective than past redistributive measures. Twentieth-century progressive taxation has waned, while initiatives to endow impoverished children with personal accounts have not expanded beyond pilot programs. Instead, economic inequality widens with global industrialization. Traditionally, deprivation led to the call for the abolition of private ownership of the means of production, yet this proved impracticable under revolutionary regimes. A review of the evolution of enterprise from artisanal workshops to nationwide firms leads to the non-profit organization. Currently focused on charity and other mutual benefits, the non-profit is a form of corporation constrained from the distribution of net earnings, operating not only in the traditionally charitable sectors, such as education and healthcare, but also the typically capitalist sectors, such as finance and manufacturing. Non-profit executives receive reasonable compensation for work combined with the satisfaction of a mission accomplished. Meanwhile, state, federal, and foreign legislators have enacted corporate reforms to reduce the tyranny of the profit motive. Even if legislatures cannot extinguish for-profits altogether, they can focus on abuses such as those among for-profit colleges. Reform of stockownership can promote equality, where private property consists of the juridical exclusion of

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economically undesirable persons. Yet the underlying impulse to exclude those who are culturally marked may persist in civil society.

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I. INTRODUCTION

A. Bi-Polar Political Economy

In the second half of the twentieth century, the world was bi-polar.[1] There was either the free world or the Evil Empire.[2] On the other side of the Pacific Ocean, the symmetry would be glossed as neo-colonialism versus the workers' paradise.[3] This binary opposition completed a structural whole that precluded other possibilities.[4] Geopolitically, the possibility that a peasant

1. *See infra* Part II.F.

2. *See* President Ronald Reagan, The Evil Empire, Speech to House of Commons, London (June 8, 1982).

3. *See, e.g.*, AMÍLCAR CABRAL, RESISTANCE AND DECOLONIZATION 3 (Dan Wood trans. 2016); VLADIMIR I. LENIN, THE PROLETARIAN REVOLUTION AND THE RENEGADE KAUTSKY 20 (Univ. Mich. Libr. 1920) (1918) ("Bourgeois democracy . . . under capitalism is . . . a paradise for the rich and a snare and deception for the exploited, for the poor.").

4. *See* CLAUDE LÉVI-STRAUSS, STRUCTURAL ANTHROPOLOGY 152–59 (1963) (discussing binary opposition within a cultural whole).

rebellion could be inspired by independent ideals met bellicose denial between the Superpowers in Southeast Asia.[5] In social science, grand theories settled upon the apparent world-historic order.[6] Attempts to formulate a causal hypothesis gave way to introspective methodologies.[7] In jurisprudence, the Grand Style in which Justice Holmes and successors had interwoven fact and law into common sense yielded to smaller scopes.[8] Taken to their implicit extent, there remained either economic empiricism or a morally ambiguous critique.[9] Intellectually, there was no way out of the ideological loop.[10]

At the dawn of the second millennium, economic inequality was increasing on both sides of the Pacific.[11] Ideological labels became less relevant than rampant industrialization.[12] The modern redistributive effect of taxation had weakened.[13] Initiatives to endow impoverished children or other poor populations with personal capital accounts had not expanded

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5. *See* KARÍN AGUILAR-SAN JUAN & FRANK JOYCE, THE PEOPLE MAKE THE PEACE 3 (2012) ("Viet Nam was among the many Third World nations that, having recently fought off their colonial masters, sought to remain neutral with regard to the Cold War superpowers.").

6. *See* Eric A. San Juan, *Fiscal Sovereignty: Tax Havens and the Demarcation of the Third World,* 54 GEO. WASH. INT'L L. REV. 101, 131 (2022) [hereinafter FS] ("20th-century social science . . . rationalized the clash of civilizations between the East and the West."); Samuel P. Huntington, *The Clash of Civilizations?,* 72 FOREIGN AFF. 22 (1993); Immanuel Wallerstein, *The Rise and Future Demise of the World Capitalist System: Concepts for Comparative Analysis,* 16 COMP. STUD. SOC'Y & HIST. 387, 388 (1974).

7. *See* ROBERTO MANGABEIRA UNGER, SOCIAL THEORY: ITS SITUATION AND ITS TASK 11 (Camb. Univ. P. 1987) ("those who have rebelled against the intimidating example of natural science have often done so by assimilating social theory to the humanities. The result has been to abandon the causal explanation of social facts."). *Compare* MARVIN HARRIS, CULTURAL MATERIALISM: THE STRUGGLE FOR A SCIENCE OF CULTURE (1979) *with* VINCENT CRAPANZANO, HERMES' DILEMMA AND HAMLET'S DESIRE: ON THE EPISTEMOLOGY OF INTERPRETATION (Harv. Univ. P. 1992).

8. *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY 109–43 (Oxf. Univ. P. 1992); Patrick J. Kelley, *Holmes, Langdell and Formalism,* 15 RATIO JURIS 26, 47 (2002).

9. *Compare* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW (3d ed. 1986) *with* ROBERTO MANGABEIRA UNGER, THE CRITICAL LEGAL STUDIES MOVEMENT (Harv. Univ. P. 1986).

10. *Cf.* NO WAY OUT (Orion Pictures 1987) (Hollywood's Cold War thriller).

11. *See infra* Part II.A.

12. *See* Kai Wang, *Whatever-ism with Chinese Characteristics: China's Nascent Recognition of Private Property Rights and Its Political Ramifications,* 6 U. PENN. E. ASIA L. REV. 43, 45 (2011) ("China's economic growth at break-neck speed has brought enormous prosperity, wealth and pride to its people.").

13. *See* THOMAS PIKETTY, CAPITAL AND IDEOLOGY 31 (Harv. Univ. P. 2020) ("progressive taxation was undone in the 1980s").

beyond pilot programs.[14] In nominally communist countries, the formulaic abolition of private property had failed to level the ground.[15] This Article focuses on the latter issue of private property, particularly its potential reform.

B. Overview

This Article contains eight Parts. Beginning with the problem of inequality, Part II discusses the possible solutions. First comes progressive taxation, accompanied by the endowment of personal accounts for the poor. Traditionally, the inadequacy of such technocratic measures led to a call to abolish private ownership of the means of production. Historically, formulaic attempts to abolish private property have been abandoned by revolutionary regimes. Instead, fundamental property reform may have radical potential. To set the stage, Part III reviews the evolution of enterprise from artisanal workshops to nationwide firms. Then Part IV sets forth the current federal income taxation of the corresponding business entities from sole proprietorship to large corporation. As an alternative, Part V poses the model of the non-profit organization. Currently focused on charity and other mutual benefits, the non-profit is a form of corporation constrained from the distribution of net earnings. Nevertheless, non-profits conduct operations across a full range of industrial sectors, as displayed in Part VI. These extend beyond the traditionally charitable sectors of education and healthcare to the typically capitalist sectors of finance and manufacturing. Consequently, Part VII clarifies the proposal to expand the non-profit model beyond charity, potentially supplanting for-profit corporations in virtually every sector of the economy. The proposal would preserve the productivity of private management while avoiding the excess accumulation of wealth by individual shareowner executives. In conclusion, Part VIII argues that the proposal is feasible as long as non-profit executives achieve reasonable compensation for work combined with the inherent satisfaction of a mission accomplished. Due to opposition from entrenched capital interests or other forces, federal and state legislatures may not be able to enact all parts of the proposal. Nevertheless, each component has counterparts in current corporate and tax law that could be implemented part-by-part.

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14. *See infra* Part II.B.
15. *See infra* Part II.A.

II. INEQUALITY AND REFORM

A. Inequality as the Predicament of Political Economy

Inequality continues to flow from world-historic policies, *i.e.*, the formative principles of the global economy. In the world's largest free market, the last major tax reform bore a cost of $1,456 billion in revenue foregone by the U.S. Treasury – more than a fifth of which was tax breaks primarily for transnational business (over the decade following the Trump-era legislation).[16] Close to the world's highest population in the People's Republic of China (PRC), nominal communism has yielded to an economic reality where "nearly 70 percent of all property is now private."[17] In the largest country by landmass a century after the abolition of private property there, "Russia now stood out as the home of the new oligarchs of offshore wealth; that is, wealth held in opaque entities with headquarters in foreign tax havens."[18] Across the globe, "a facially neutral rule of law that preserves property and contract rights effectively facilitates the inequality that otherwise spreads, in a *de facto* state-sanctioned regressive distribution."[19] A combination of regressive tax policy and increasingly privatized property supports stratified regimes.

Everywhere, inequality appears inevitable, like the stuff of anthropological origin myths.[20] Before territorial states appropriated virtually the entire globe, "the original hunter-gatherers lived off the fat of the land."[21] Now, archaeologists emphasize that these technologically simple economies may have supported stratified states that "were notorious for their industry and, in many cases, near-obsession with the accumulation of wealth."[22] Some foragers may have established class hierarchy in these early societies.

Moreover, civilization advanced with technology. That is, "technology supported the progressively complex division of labor, formalization of law, and unifying ideation that constitute contemporary society."[23] Feeding itself,

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16. *See* H.R. Rep. No. 115-466, 115th Cong. 1st Sess. 690 (2017) (Conf. Rep.).

17. PIKETTY, *supra* note 13, at 607.

18. *Id.* at 578.

19. Eric A. San Juan, *The Distributive State and the Function of Tax Expenditures*, 71 TAX L. 673, 675 (2018) [hereinafter DS].

20. DAVID GRAEBER & DAVID WENGROW, THE DAWN OF EVERYTHING: A NEW HISTORY OF HUMANITY 526 (2021).

21. Eric A. San Juan, *Fiscal Anthropology: Production, Consumption, Wealth, and Taxation*, 30 SO. CAL. REV. L. & SOC. JUSTICE 251, 256 (2021) [hereinafter FA].

22. GRAEBER & WENGROW, *supra* note 20, at 173.

23. FA, *supra* note 21, at 254.

"the modern mode of industry became hegemonic throughout the world."[24] In other words, "technology may facilitate the production of wealth that is captured unevenly among the population, which becomes increasingly unequal."[25] While inequality may have been an outcome of many different factors, developments in technology intensified its extent and severity.

At the same time, redistribution occurred. In particular, "the organic precursors to socio-economic entitlements may have been the redistributive mechanisms to maintain the productive taxpayer population."[26] To the extent that inequality is inescapable, redistribution is implicit in modern political economy.[27] Then the question is how progressive or regressive the redistribution may be.

B. *Taxation and Redistribution as the Technocratic Solution*

Redistribution is among the core functions of taxation.[28] In turn, tax "always has been the political-economic artery that fuels social life."[29] In particular, economic historians assert that among "the changes that contributed to reduction of inequality in the twentieth century was the widespread emergence of a system of progressive taxation of both income and inherited wealth."[30] To promote equality, they champion "a steeply progressive wealth tax," along with "a universal capital endowment, and fair power sharing between a firm's employees and shareholders."[31] Among other initiatives, they entertain proposals from "practitioners in the areas of taxation and public administration rather than philosophers or academics."[32] Thus, certain tax proposals may present a technocratic solution to problems like inequality.

Similarly, technocrats have opened private accounts for needy individuals as a redistributive mechanism.[33] At the turn of the century, a U.S. non-profit corporation sponsored a program in more than a dozen participating

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24. *Id.* at 262.

25. DS, *supra* note 19, at 677.

26. Eric A. San Juan, *Fiscal Geography*, 31 UNIV. FLA. J.L. & PUB. POL'Y 377, 394 (2021) [hereinafter FG].

27. *See* DS, *supra* note 19, at 677.

28. *See* DANIEL L. SIMMONS ET AL., FEDERAL INCOME TAXATION 3 (7th ed. 2017) (listing objectives of taxation as: "*Raising revenue . . . Supplementing fiscal policy objectives . . . Affecting income and wealth distribution* . . . .").

29. FA, *supra* note 21, at 254.

30. PIKETTY, *supra* note 13, at 31.

31. *Id.* at 594.

32. *Id.* at 118.

33. *See* ROBERTO M. UNGER & CORNEL WEST, THE FUTURE OF AMERICAN PROGRESSIVISM: AN INITIATIVE FOR POLITICAL AND ECONOMIC REFORM 62 (1998).

communities to promote financial literacy by, among other services, the opening of bank accounts that matched participants' savings for education, homeownership, or small business start-up.[34] In the first decade of this century, the United Kingdom deposited over a hundred pounds (more for low-income households) into an account for each of approximately five million children born during that period to earn interest compounded until the age of majority.[35] The enacting legislation made these accounts tax-free, which increased the benefit to the new accountholders. Meanwhile, the World Council of Credit Unions launched a similar initiative in Mexico.[36] If capital is the basis of economic equity, then these accounts would hold the seed funding, even in the case of participants who do not work, such as children.[37] While it may be too soon to judge, in both the Global South and North, the pilot programs have been so short-lived and small-scaled as to make their potential an incrementalist fantasy.

C. *Private Property as the Embodiment of Inequality*

Critics argue that the focus on inequality limits the solutions to technocracy rather than revolutionary transformation. "Debating inequality allows one to tinker with the numbers" to "readjust tax regimes or social welfare mechanisms . . . without addressing" the fact "that some manage to turn their wealth into power over others."[38] These critics trace the association between wealth and power back "to the power of the male household head in ancient Rome, who could do whatever he liked with his chattels and possessions, including his children and slaves."[39] Anthropologically, exclusive access to property could have originated in the sacred concept of "*tabu*, meaning 'not to be touched.'"[40] Arguably, inequality is an ideology rather than a difference in wealth. For example, in the Indian caste system, rank "has less to do with how many material goods"

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34. *See* JAMIE M. ZIMMERMAN & SHWETA S. BANERJEE, PROMOTING SAVINGS AS A TOOL FOR INTERNATIONAL DEVELOPMENT 3 (2009).

35. *See generally* Child Trust Funds Act 2004, c. 6 (UK), https://www.legislation.gov.uk/ukpga/2004/6/contents; WILLIAM ZICHAWO ET AL., CHILD TRUST FUNDS: RENEWING THE DATABASE FOR LONG-TERM SAVINGS POLICIES 4 (Aspen Inst. 2014), https://www.aspeninstitute.org/publications/child-trust-funds-renewing-debate-long-term-savings-policies/.

36. *See* ZIMMERMAN & BANERJEE, *supra* note 34, at 1.

37. *See* DS, *supra* note 19, at 706.

38. GRAEBER & WENGROW, *supra* note 20, at 18.

39. *Id.* at 77; *see also* ORLANDO PATTERSON, FREEDOM IN THE MAKING OF WESTERN CULTURE 4 (1991) ("The sovereignally free person has the capacity to restrict the freedom of others or to empower others with the capacity to do as they please with others beneath them.").

40. GRAEBER & WENGROW, *supra* note 20, at 166.

one possesses "than with one's relation to certain (polluting) substances – physical dirt and waste, but also bodily matter linked to birth, death and menstruation."[41] If so, inequality may not be fully tamed by policy measures, but may require a reordering of social ideology.

To elucidate, the exclusive logic of property parallels the religious proscription of *tabu*. As jurisprudents have explained, "property is enforced with claim rights excluding others from interference."[42] As a practical matter, "[t]here are churches in which tramps do not sleep on the benches because the vestry-man will call the police."[43] Yet under a sacred prescription, "India's lower castes used to keep in their place because of similarly effective social sanctions, and all the way up the edifice of caste political and economic forces help to maintain the system."[44] Thus, property institutionalized ritual exclusion.

Historically, private property was institutionalized in modern Europe.[45] According to economic historians, the Church sought "to conceptualize and formalize economic and financial laws . . . because the clerical class existed not as a hereditary class but only as an abstract perpetual organization (somewhat like modern foundations, capitalist corporations, and state administrations)."[46] Previously it had been profane, but the "sacralization of property" closed the loop between the Christian Church and ancient religions.[47] The French Revolution of 1789 resulted in a "distinction between . . . the regalian powers (of security, justice, and legitimate violence) . . . monopolized by the centralized state and . . . property rights, which only individuals could claim."[48] Private property became a sacred right.

Conversely, property could become *tabu* again. After the Bolshevik Revolution of 1917, Russia prohibited private ownership.[49] In places such as the Soviet Union, "property ownership would not rank as an aspect of

41. *Id.* at 324.

42. LAWRENCE C. BECKER, PROPERTY RIGHTS: PHILOSOPHIC FOUNDATIONS 21 (1977).

43. MARY DOUGLAS, PURITY AND DANGER: AN ANALYSIS OF THE CONCEPTS OF POLLUTION AND TABOO 140 (1966).

44. *Id.*

45. Erik J. Olsen, *The Early Modern "Creation" of Property and its Enduring Influence*, 21 EUR. J. POL. THEORY 111, 111 (2022).

46. PIKETTY, *supra* note 13, at 97.

47. *Id.* at 123.

48. *Id.* at 100.

49. *See id.* at 580.

human nature or human rights" although "productive activity was an aspect of species-being."[50] Either way, property had ideological consequences.

D. *Property, Purity, and Pollution*

While inequality may be economically quantified, the cultural aspect of rank order is undeniable. Some political scientists trace social hierarchy back to "man's innate aggression."[51] Alternatively, cultural anthropologists observe that "the universe is divided between things and actions which are subject to restriction and others which are not . . . ."[52] By extension, hierarchy comes from ritual untouchability where "certain moral values are upheld and certain social rules defined by beliefs in dangerous contagion, as when the glance or touch of an adulterer is held to bring illness to his neighbours or his children."[53] Inequality is also symbolic.

In turn, cultural symbols feed back into socio-economic schisms. Eventually, "fundamental cleavages in the social world" come "to align with totemic instincts of race, religion, and nationalism."[54] In effect, "ethno-religious and national cleavages often prevent people of different ethnic and national origins from coming together politically, thus strengthening the hand of the rich and contributing to the growth of inequality."[55] Even if the motivation is ideological, the result is economic. To recapitulate, the preservation of purity from that which is, or those who are, polluted depends on the cultural mechanism of exclusion. Juridically, exclusion is the legal mechanism to protect private property.

E. *Total Revolution*

According to critics, the inegalitarian regime of private property could be toppled only by total revolution.[56] In the nineteenth century, the Anglo-German critics of political economy predicted that "the material productive forces of society" would "come into conflict with . . . in legal terms . . . the property relations" leading to "social revolution" or "the transformation of

50. DS, *supra* note 19, at 689.
51. FA, *supra* note 21, at 280.
52. DOUGLAS, *supra* note 43, at 8.
53. *Id.* at 3.
54. FS, *supra* note 6, at 99.
55. PIKETTY, *supra* note 13, at 6.
56. *See* KARL MARX, A CONTRIBUTION TO THE CRITIQUE OF THE POLITICAL ECONOMY 200 (1859).

the whole immense superstructure."[57] If so, the revolution would free wealth from power. Ultimately, political economy became eschatology.[58]

F. *Ideology as a Mirror Image*

Ideological opposition may become a mutually constitutive structural whole. In 1935, anthropologists "coined the term 'schismogenesis' to describe people's tendency to define themselves against one another."[59] Applied to the Cold War, "ideologically opposed states would become mirror images of bureaucratic apparatus on either side of the Pacific Ocean."[60] Under "the bipolar opposition of Soviet Communism and American capitalism [o]ne was either for unlimited state ownership or for full private shareholder ownership."[61] As discussed above, private property was either *tabu* or sacred.[62] Similarly, "the communist movement seemed to many intellectuals and to the international proletariat to be the only political force in favor of organizing the world on an egalitarian social and economic basis, while colonialist ideology continued to prefer an inegalitarian, hierarchic, racialist logic."[63] Both economically and geopolitically, the Sino-Soviet bloc became the only alternative to U.S. imperialism. Schismogenesis supported the totalizing revolutionary ideology.

G. *Radical Reform*

Historically, incidences of social revolution have been partial rather than total. For example, they have neglected segments of the population such as women and various cultural minorities whether stigmatized by race, language, ethnicity, religion, or gender.[64] Despite release from the fetters of the capitalist superstructure, communities such as the Soviet Jewry and Chinese Muslims were the victims of pogroms and systematic repression.[65]

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57. *Id.*

58. *See* Li Zhixiong & Christopher Rowland, *Hope: The Convergence and Divergence of Marxism and Liberation Theology*, 70 THEOLOGY TODAY 181, 181 (2013) ("eschatology, according to both Marxism and liberation theology, is a form of optimism"). *But see* Roland Boer, *Marxism and Eschatology Reconsidered,* 25 MEDIATIONS 39 (2010).

59. GRAEBER & WENGROW, *supra* note 21, at 68.

60. Eric A. San Juan, *Who Pays the Price of Civilization?* 9 COLUM. J. TAX L. 45, 48 (2017).

61. PIKETTY, *supra* note 13, at 513.

62. *See infra* Part II.C.

63. PIKETTY, *supra* note 13, at 589.

64. *See, e.g.*, BRENDAN MCGEEVER, ANTISEMITISM AND THE RUSSIAN REVOLUTION 38 (Camb. Univ. P. 2019).

65. *See id.* at 38 ("[I]n some regions of the former Pale, Bolshevik power was actually constituted *through* anti-Jewish violence."); Raphael Israeli, *The Muslim*

Against the weight of cultural conformity, the turn-of-the-century Jewish-American feminist Emma Goldman embodied the sentiment notoriously captured in the slogan: "If I can't dance I don't want to be *part* of your revolution."[66] Purportedly total socioeconomic revolutions turned out to be culturally partial.

At the same time, communists as well as capitalists sought to wash out perceived moral pollution. By 1967, the Cuban commander-in-chief (*jefe máximo*) identified homosexuality, for instance, as a "deviation" that "clashes with the concept we have of what a militant communist should be . . . ."[67] That same year, the high court of the nearby United States affirmed the deportation of a Canadian man given "homosexual and perverted characteristics" constituting a "psychopathic personality."[68] Then Justice Douglas dissented, observing that the latter term was "a treacherous one like 'communist' or, in an earlier day, 'Bolshevik.' A label of this kind, when freely used, may mean only an unpopular person."[69] Thus, intimate orthodoxy became a reflexive Cold War standard against which capitalist and communist alike could project mirrored patriarchal ideals.[70] Notwithstanding the projected transformation of the superstructure, proscriptive morality persisted under revolutionary as well as reactionary regimes.

Instead, historical change has been incremental. For example, historic cases of wealth taxation have encapsulated "both the continuity and discontinuity between feudal nobility and industrial capitalism."[71] In early twentieth-century Scandinavia, "a profoundly inegalitarian country . . . was able to change its trajectory . . . thanks to unusually effective popular

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Minority in the People's Republic of China, 21 ASIAN SURVEY 901, 910–11 (1981) ("In 1975, . . . the Muslim-Hui minority of Yunnan revolted against the authorities who had intended to impose the raising of pigs . . . . Muslim villages were bombarded and their population harmed.").

66. *See* Alix Kates Shulman, *Women of the PEN: Dances with Feminists*, WOMEN'S REV. BOOKS, Dec. 1991, at 13, 13.

67. Carlos A. Figueroa, *Rice and Beans with a Side of Queer: Socio-Legal Developments in the Cuban LGBTQ+ Community*, 28 WM. & MARY J. RACE, GENDER, & SOC. JUST. 421, 428 (2022) (quoting Fidel Castro in MARVIN LEINER, SEXUAL POLITICS IN CUBA: MACHISMO, HOMOSEXUALITY, AND AIDS 26 (Routledge 2019)).

68. Boutilier v. Immigr. & Naturalization Serv., 387 U.S. 118, 124–25 (1967).

69. *Id.* at 125 (Douglas, J. dissenting).

70. *See* Naoko Shibusawa, *The Lavender Scare and Empire: Rethinking Cold War Antigay Politics*, 36 DIPLOMATIC HIST. 723, 750 (2012) (discussing how the Soviet Union, China, and Cuba "recriminalized homosexuality . . . as a sign of 'bourgeois decadence'" when the U.S. government "also stated that it had no need for men with 'psychological weaknesses'").

71. FA, *supra* note 21, at 260.

mobilization, specific political strategies, and distinctive social and fiscal institutions."[72] Although this example regarding shareowner reform was not a total revolution, it advanced the economic equality of Swedish workers. Likewise, radical reformers contend that "contexts can be remade part by part . . . taking revolutionary reform rather than either inconsequential tinkering or full-scale revolution as the standard topic of programmatic argument."[73] At the same time, this argument challenges the assumption that the functional system of wealth and power is an "indivisible unit."[74] Rather, historic accretions consist of the "recombination" of component parts.[75]

H. Collective Ownership as the Radical Alternative

Millennia of inequality were punctuated by scourges of slavery and imperialism.[76] Upon the advent of industrial capitalism, private property remained a primary impediment to popular progress. In this era, the "self-earned property" of the "petty artisan and of the small peasant" was destroyed by "the bourgeois form . . . of industry."[77] In its place, "stock companies" governed by "capital ownership" grew where "labour is entirely divorced from ownership of means of production and surplus-labour."[78] To remedy this alienation, "co-operative factories of the labourers themselves" would lead a transition "towards the reconversion of capital into the property of producers, although no longer as the private property of the individual producers, but rather as . . . outright social property."[79] This was the ideological foundation of an egalitarian economy.

Paradoxically, the nineteenth-century revolutionary critics concurred in part with the capitalists of the preceding century.[80] Among the latter, the English political philosopher John Locke had pronounced property as the "private right" of the laborer who "added something . . . more than nature,

72. PIKETTY, *supra* note 13, at 185; *see* Margaret Weir & Theda Skocpol, *State Structures and the Possibilities for "Keynesian" Responses to the Great Depression in Sweden, Britain, and the United States*, *in* BRINGING THE STATE BACK IN 107 (Peter B. Evans et al., eds., Camb. Univ. P. 1985).

73. ROBERTO M. UNGER, FALSE NECESSITY: ANTI-NECESSITARIAN SOCIAL THEORY IN THE SERVICE OF RADICAL DEMOCRACY 253 (Camb. Univ. P. 2001).

74. *Id.* at 64.

75. *Id.*

76. *See* DS, *supra* note 19, at 683.

77. KARL MARX & FRIEDRICH ENGELS, THE COMMUNIST MANIFESTO 85–86 (Jeffrey C. Isaac, ed., Samuel Moore, trans., 2012) (1848).

78. KARL MARX, 3 DAS KAPITAL pt. V, ch. 27, III(3) (1867).

79. *Id.*

80. *See* DS, *supra* note 19, at 688.

the common mother of all, had done."[81] Subsequently, those critics echoed that "[l]abour is the source of all wealth" next to "nature, which supplies it with the material that it converts into wealth."[82] On one hand, private property was justified by the work ethic of the early industrialists. On the other hand, capital ownership violated the right of the proletariat to the fruit of their labor. The labor theory of value took on a different meaning when elaborated by the champions of the proletariat.

III. FORMS OF PRODUCTION

A. *Artisanry*

Upon the advent of capitalism, pre-industrial artisanry became the lost ideal. In nineteenth-century England, self-employed tradesmen had propagated "traditions of craftsmanship" connected to "[s]ocial and moral criteria—subsistence, self-respect, pride in certain standards of workmanship," and "customary rewards for different grades of skill . . . ."[83] Consequently, "a journeyman looked forward to becoming independent, with luck to becoming a master himself . . . ."[84] From this expectation, the rapid proliferation of factories was a disappointing development when compared to that ideal.

B. *Cooperative Enterprise*

Historically, the Great Transformation of the European economy prompted workers to organize.[85] In response to "the upheavals that characterized the Industrial Revolution in England during 1750-1850," tradesmen created "cooperative organizations."[86] In an era of "low pay, long hours, [and] unsanitary workplaces," twenty-eight weavers and other skilled workers formed the Rochdale Society of Equitable Pioneers in 1844 that promulgated "business principles to guide their work" based on "shared ownership" and "democratic control," establishing "a shop in which to sell

81. JOHN LOCKE, SECOND TREATISE ON CIVIL GOVERNMENT ch. 5 §§ 28, 34 (1690).

82. Friedrich Engels, *The Part Played by Labour in the Transition from Ape to Man* [1876] *in* ELEANOR BURKE LEACOCK, ED. THE ORIGIN OF THE FAMILY, PRIVATE PROPERTY AND THE STATE 251 (1972).

83. E.P. THOMPSON, THE MAKING OF THE ENGLISH WORKING CLASS 236 (1963).

84. *Id.* at 20.

85. *See* KARL POLANYI, THE GREAT TRANSFORMATION: THE POLITICAL AND ECONOMIC ORIGINS OF OUR TIME 167 (1944).

86. LYNN PITMAN, UNIV. OF WIS. CTR. FOR COOPS., HISTORY OF COOPERATIVES IN THE UNITED STATES 1 (2018).

their goods."[87] This was an early prototype of the industrial cooperative society.

Through the twentieth century, additional cooperatives developed. Today's cooperatives are typically found in groceries or other small enterprises. They are controlled by "member-owners" who "derive . . . improved access to goods or services" but merely proportional "distribution of financial surpluses" rather than "maximize[d] profits."[88] As in the past, each member is productive individually, while the cooperative entity simply passes along the economy of scale rather than generating the benefits.

A contemporary example shows the function of a cooperative in the context of the Spanish tax regime.[89] In Barcelona, a tradesman may become a *socia* (associate or member) of a *cooperativa*.[90] As an individual producer, the tradesman would generate taxable income; yet the ethnographic reality showed where "previously as an *autónomo* [sole proprietor] he would write invoices and declare value-added tax (VAT) at the tax office with his own fiscal number, he now used the Cooperative's fiscal number whenever someone asked him for an invoice."[91] As a result, the "*socia*'s own economic activity was not registered with the state and, according to official statistical metrics, did not produce taxable income."[92] As a practical matter, the concern is "the steep taxes and fees associated with self-employment."[93] Legally, "the official position of the Ministry of Labor is that being a member of these *cooperativas* amounts to fraud . . . ."[94] Although this particular use of the entity was evasive, the *cooperativa* nonetheless collected "commonly pooled resources" in an economy of scale.[95] In a sense, the *cooperativa* became its own "fiscal community."[96] Moreover, "Catalonia is wealthier on

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87. Jennifer Wilhoit, *Cooperatives: A Short History*, CULTURAL SURVIVAL (July 14, 2010), https://www.culturalsurvival.org/publications/cultural-survival-quarterly/cooperatives-short-history.

88. Ill. Inst. for Rural Affairs, *The Cooperative Model of Grocery Store Ownership*, RURAL GROCERY STORE GUIDE, W. Ill. Univ. (Dec. 2014 Supp.).

89. *See generally* Vinzenz Bäumer Escobar, *The Fiscal Commons: Tax Evasion, the State, and Commoning in a Catalonian Cooperative*, SOC. ANALYSIS, June 2020, at 59.

90. *Id.* at 67, 70.

91. *Id.* at 68.

92. *Id.* at 70.

93. Nicolette Makovicky & Robin Smith, *Tax Beyond the Social Contract: An Anthropology of Tax*, SOC. ANALYSIS, June 2020, at 1, 8.

94. Bäumer Escobar, *supra* note 89, at 71.

95. *Id.* at 60.

96. *Id.* at 73.

average than the rest of Spain,"[97] where national taxation (*regimen común de financiación*) would have a redistributive effect to poor provinces elsewhere in the Kingdom.[98] As fiscal anthropologists have observed, "individuals are more willing to contribute to the public purse when they see the tangible results of fiscal revenues put to work in their local environment."[99] Local empowerment loops back into the impulse motivating the cooperative concept.

Similar to the cooperative is the nationally specific concept of the kibbutz. According to international scholars, the kibbutz is a "collective social organization based on public ownership of the means of production and equality . . . ."[100] In 1909, pioneers established the prototype kibbutz as "an independent and collectively owned farm beside the Sea of Galilee in northern Palestine."[101] There they proceeded "[u]nder the influence of Zionism" and "utopian socialism . . . to establish an ideal society owned by all of its members, in which all members could work and live together, and the principle of equality among all members could be realized."[102] Democratically, the members "determine development plans, significant operation decisions, and . . . election and dismissal of leaders" in a weekly meeting each Sabbath.[103] There, the volunteers on the "[m]anagement committee and professional committee are public servants" who "enjoy no privilege or additional remuneration . . . ."[104] Over the twentieth century, kibbutzim developed as industrial enterprises, in part by sending "some people to China to learn experiences."[105] By 1985, kibbutzim had become economically significant, accounting for "42.2% of the total output and 62.6% of export value in the plastic and rubber industry," 14.7 and 30.9 percent in wooden ware, 10.4 and 9.5 in metal and machinery, and 5.1 and 22.4 in food.[106] Consequently, the kibbutz serves as an example of "a successful socialist economic organization based on collective ownership."[107] The kibbutz grounds the egalitarian collective where

97. PIKETTY, *supra* note 13, at 921.

98. *See* Bäumer Escobar, *supra* note 89, at 66; *cf.* FG, *supra* note 26, at 384–85.

99. Makovicky & Smith, *supra* note 93, at 5.

100. Enfu Cheng & Yexia Sun, *Israeli Kibbutz: A Successful Example of Collective Economy*, 6 WORLD REV. POL. ECON. 160, 172 (2015).

101. *Id.* at 164.

102. *Id.* at 163–64.

103. *Id.* at 162.

104. *Id.* at 161.

105. *Id.* at 171.

106. *Id.* at 168–69.

107. *Id.* at 160.

exclusive nationalism has provoked controversy.[108]

Statistically, cooperatives occupy a discrete market segment (quantified as follows as of 2009).[109] Of almost thirty thousand cooperatives in the U.S., only one percent are worker cooperatives as contemplated above.[110] Overall, cooperatives account for more than $3 trillion in assets and almost $515 million in revenue.[111] The vast majority, over twenty-six thousand, are consumer co-ops that offer their members wholesale prices.[112] Others are business-to-business structures.[113] Within this population, the collective of skilled labor is a unique ideal which has not been fully realized on a large scale.

In sum, cooperative entities may revive pre-modern ideals of egalitarian enterprise. By the same token, they may value local contribution to the exclusion of national redistribution or democratic governance to the exclusion of pluralist membership. To the extent that small is beautiful, the beauty of cooperatives is marred only by their limits.

C. Economy of Scale

Technologically, the small enterprises of skilled tradesmen were overtaken by mass production organized in corporate industry. The multi-tiered scale of mass production entailed executives monitoring production managers who in turn "watch over supervisors," who are the only direct link to the "assembly workers" who "are unable to better their lot" vis-à-vis the corporation.[114] Thus, "primitive communalism or . . . the artisan labor of a feudal economy" was displaced by "alienation."[115] If small cooperatives were beautiful, big corporations were ugly.

Even before the advent of capitalist industry, massive projects required an economy of scale.[116] Archaeologically, one of the first incidents of monumental architecture were the pyramids of Egypt dating to 2530

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108. *See* G.A. Res. 3379, Declaration on the Elimination of All Forms of Racial Discrimination (Nov. 10, 1975) ("Zionism is a form of racism"), *rev'd* Resol'n 46/86 (Dec. 16, 1991).

109. *See* STEVEN DELLER ET AL., RESEARCH ON THE ECONOMIC IMPACT OF COOPERATIVES 11 tbl. 2-2 (2009).

110. *See id.*

111. *See id.*

112. *See id.*

113. *See id.* at 12.

114. STEPHEN R. MUNZER, A THEORY OF PROPERTY 175 (Camb. Univ. P. 1990).

115. *Id.* at 168.

116. *See* Claude Meillassoux, *From Reproduction to Production: A Marxist Approach to Economic Anthropology*, 1 ECON. & SOC'Y 93, 93 (1972) (differentiating agricultural from industrial production).

B.C.E.[117] Egyptologists "believe that the colossal marshaling of resources required to build the three pyramids at Giza . . . must have shaped the civilization itself."[118] Initially, builders were "replicating a household mode of production."[119] Later, they enlarged the underlying components "for some economies of scale."[120] Nevertheless, the "builders were skilled well-fed Egyptian workers" rather than slaves.[121] This pre-capitalist material culture raises the question whether complex production is specific to modern technology or whether capitalism has a unique claim to alienation. Even "in more than one 'socialist' country in the world today," the beneficiaries of large industry "are elite managers, who are rewarded for high production with summer homes" and university admission for their children.[122] Consequently, the discussion below will address inherent features of large, integrated enterprise.

D. *The Corporate Form of Public Ownership*

Starting in the West, individual property was succeeded by corporate ownership. By the medieval epoch, the city or municipal charter became a predecessor to the corporate legal personality.[123] Pre-modern European "towns remained 'economic corporations' whose franchises provided protection against control by the King and fracturing by individuals. Commerce was the basic activity of municipal corporations," facilitated by "the protection afforded by the corporate charters."[124] In the subsequent mercantile era, the corporate form developed from the chartering of the British and Dutch East India Companies in 1600 and 1602 in London and Amsterdam, respectively.[125] While both companies were motivated by the prospects of enormous gains from trade with Asia, they also assumed quasi-governmental and paramilitary rights and responsibilities.[126] Municipally or

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117. Jonathan Shaw, *Who Built the Pyramids?*, HARV. MAG., July–Aug. 2003, https://www.harvardmagazine.com/2003/07/who-built-the-pyramids-html.

118. *Id.* (discussing the archaeology of Mark Lehner).

119. *Id.*

120. *Id. See generally* Mark Lehner, *Giza*, *in* ORIENTAL INST. 1995-1996 ANN'L REP'T 54 (William M. Sumner ed., 1996).

121. Brian Handwerk, *Pyramids at Giza*, NAT'L GEOGRAPHIC, https://www.nationalgeographic.com/history/article/giza-pyramids (last visited Sept. 16, 2023).

122. MUNZER, *supra* note 114, at 176.

123. DS, *supra* note 19, at 702.

124. Gerald Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057, 1090 (1980).

125. *See* NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD 128–29 (2008).

126. *See* Giuseppe Dari-Mattiacci et al., *The Emergence of the Corporate Form*, 33

imperially, the original corporations were public projects.

Chronologically, corporations both preceded and succeeded cooperatives. Offering limited liability and tax advantages, corporations proliferated on a world-historic scale.[127]

This corporate proliferation would give rise to a theory and practice of the firm as a form of widespread yet individual ownership.[128] According to economists, shareowners who held stock passively awaited the dividends declared by executive managers acting under fiduciary duty, "for which the common law metaphor may have been the obligation of trustee to beneficiary."[129] Stepping back, economic historians explained that

> the Anglo-Saxon 'trust,' a form of ownership that allows for the beneficial owner of a property to be someone other than its manager (the trustee), thereby offering better protection of assets, originated with modes of ownership developed as early as the thirteenth century by Franciscan monks, who could not or would not be seen as direct owners.[130]

This history harks back to the sacred or *tabu* aspect of property discussed above.[131]

The reasons for split ownership were as follows. Where multiple owners have "communal rights" to property, a free-rider problem arises if any individual maximizer tends "to overhunt and overwork the land because some of the costs of his doing so are borne by others."[132] On the other hand, "if all owners participate in each decision . . . the scale economies . . . will be overcome quickly by high negotiating cost."[133] In theory, corporate executives act as "agents" who can balance the competing claims of the shareowners, who become "principals."[134] Nominally, corporate shareholding was a type of "distributive ownership . . . a device to share in property" that "is actually individual as regards the locus of the sanctioned rights of action."[135] Paradoxically, the corporation was a form of collective

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J.L. ECON. & ORG. 1, 3 (2017).

127. *See* FS, *supra* note 6, at 74–75.

128. *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 305 (1976).

129. DS, *supra* note 19, at 703.

130. PIKETTY, *supra* note 13, at 96–97.

131. *See supra* Part II.C.

132. Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347, 354 (1967).

133. *Id.* at 358.

134. *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 1 (1932).

135. Barry A. Stein, *Collective Ownership, Property Rights, and Control of the Corporation,* 10 J. ECON. ISSUES 298, 304 (1976).

ownership that alienated shareholders from the management of their property.

By their very structure, corporations could often spawn an executive elite.[136] Structurally, "collective ownership and property rights can easily become a source of problems to the extent that those acting on behalf of the collectivity mistake delegated duties for personal rights" and fiduciary office for ownership.[137] By the mid-twentieth century advent of the military-industrial complex, sociologists could identify members of interlocking corporate boards as a self-serving class.[138] After the Cold War, empirical research confirmed that excess executive compensation was not justified by corporate performance.[139] Over the past half century, U.S. corporate chiefs' pay dramatically outpaced not only workers' wages but the actual stock market, as set forth in Table 1 below. Since 1980, for publicly-traded corporations in developed countries, "variations in tax rates explain . . . the variation in executive pay—much more than other factors such as sector of activity, firm size, or performance."[140] In 1993, the U.S. Congress enacted a $1 million tax deductibility limit on executive salaries only to trigger a "huge rise in stock-option pay" that exploited a loophole for incentive compensation.[141] This incentive for executives to become shareowners — if they were not already — merges control into ownership. Thus, corporations transformed property from the fruit of labor into a fiscal phantasm.

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136. *See* DS, *supra* note 19, at 703.

137. Stein, *supra* note 135, at 304.

138. *See* C. WRIGHT MILLS, THE POWER ELITE 1, 4 (Oxford Univ. P. 1956).

139. *See* LUCIEN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 121 (2006); *see also* David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 213 (2006).

140. PIKETTY, *supra* note 13, at 533.

141. Jia Lynn Yang, *Maximizing Shareholder Value: The Goal that Changed Corporate America*, WASH. POST (Aug. 26, 2013, 7:34 PM), https://www.washingtonpost.com/business/economy/maximizing-shareholder-value-the-goal-that-changed-corporate-america/2013/08/26/26e9ca8e-ed74-11e2-9008-61e94a7ea20d_story.html; I.R.C. § 162(m), *amended by* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

Table 1. Compensation Realized by CEOs or Workers in the Private Sector[142]

Year	CEO ($000)	Worker ($000)	S&P 500 (indexed)	Avg. Ratio
1965	995	45.2	664	20.4
2020	25,008	63.8	3,368	365.6
Change (%)	2,413.3	41.2	407.2	1,692.2

E. *Employee Ownership*

Even in the leading capitalist countries, the idea of employee ownership has arisen. If labor owned a share, its interest would better align with that of management.[143] Harking back to the cooperative concept, advocates advanced the Employee Stock Ownership Plan (ESOP) as a mechanism to supply capital to employees for this purpose.[144] The mechanism would be indirect as the employees' capital is in their retirement fund. That is, an ESOP is a tax-exempt retirement plan that owns stock of the employer corporation through an exception to the prudent investor rule that otherwise would require diversification to ensure that retirees would retain their pensions even if the company failed.[145] Across the pond, both "Conservatives in Britain and Republicans in the United States have regularly championed the idea of employee stock ownership . . . ."[146] In contrast, critics argue that the ESOP "forces workers to concentrate all their holdings in the firm" in an imprudently skewed portfolio that "imposes costs borne willingly by no other group of investors in our economy."[147] Disinterested pension scholars counsel that the ESOP is "best understood as a medium of corporate finance, somewhat quixotically entangled with the

142. *See* JOSH BIVENS & JORI KANDRA, ECON. POL'Y INST., CEO PAY HAS SKYROCKETED 1,460% SINCE 1978 8, tbl. 1 (2022) https://files.epi.org/uploads/255893.pdf (reflecting CEO pay in the top 350 U.S. firms).

143. *See* DS, *supra* note 19, at 710 (explaining supporter sentiment around the Employment Retirement Income Security Act of 1974, where employees could invest their pension funds in their company stock).

144. *Id.*; *see* I.R.C. § 409.

145. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1104, Pub. L. No. 93-406 § 404, 88 Stat. 877.

146. PIKETTY, *supra* note 13, at 502.

147. William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 173 (1985); *see also* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1752 (1990).

world of pension plans."[148] Ironically, the ESOP has become an example of employee ownership in the interest of corporate management. While observers acknowledge the persistence of alienation, the proposed solution has been modest, if not inverted.

Generally, capitalists have not afforded sweat equity to labor. To give "workers voting rights without any corresponding participation in the firm's capital" would constitute a "radical conceptual challenge to the very idea of private property . . . ."[149] Nevertheless, 1951, 1952, and 1976 legislation in Germany required coal, steel, and other large corporations to reserve between a third and a half of the voting seats on the board of directors for employee representatives, generally elected from union slates.[150] While profits do not accrue to the workers as such, the legislation qualitatively reformed corporate ownership, promoting equity in that industrial country.

F. Nationalized Enterprise

The ultimate form of collective ownership is nationalization.[151] According to a Soviet textbook, property was either cooperative or national.[152] As discussed above, the cooperative economy consisted of "collective farms, industrial artels, [and] enterprises of the consumer cooperatives."[153] Grassroots democracy was often achieved in the collective farms where, "in accordance with their cooperative nature, their entire business is administered by the highest body of the agricultural artel – the general meeting of the collective farmers, and the management and collective farm chairman elected by them."[154] At the higher level, "State enterprise" consisted of "factories, mills, [and] State farms . . . ."[155] There, the Socialist State directly exercised control over its owned enterprises, managing them through its representatives, namely, the directors of these enterprises, who were designated and dismissed by the relevant State authorities.[156] As foreshadowed above, the Socialist State could not avoid the executive elite, even in the nationalized corporations.

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148. JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 49 (2d ed. 1995).

149. PIKETTY, *supra* note 13, at 502.

150. *Id.* at 495–96.

151. *See supra* Part II.H ("outright social property").

152. ECON. INST. OF THE ACAD. OF SCI. OF THE U.S.S.R., POLITICAL ECONOMY pt. 3.B, ch. XXVIII (Lawrence & Wishart 1957).

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

The PRC's aspirations to collectivize property were similar. After the 1949 revolution, the Chinese Communist Party "aimed to establish the so-called Socialist Public Land Ownership System by nationalizing the urban real property ownership and simultaneously collectivizing rural land ownership."[157] In 1962, the Operational Regulations on Rural People's Communes eliminated private farms while peasants retained homeownership.[158] In 1978, the Household Responsibility System allowed a family unit to "enter into contracts with the collective to obtain the right to farm certain . . . land, in exchange for a certain portion of the produce."[159] As in the case of cooperatives, farmland is "collectively owned by the peasants of the village and is managed and administered either by rural collective economic organization[s] such as the village agricultural producers' collectives (村农业生产合作社) or by villagers' committee[s] (村民委员会)."[160] As a practical matter, "local township and village heads acted as the *de facto* owners and sold the land for industrial or commercial purposes as urbanization invaded the countryside."[161] Eventually, "[a]s many as one out of five homes purchased in Beijing [was] on unauthorized rural land."[162] By 2007, 70 to 80 percent of residential real estate was "privately owned in Shanghai and other coastal cities."[163] By the era of sky-rocketing national growth, China's collective aspiration had become a fragmented economic reality.

G. Summary

Theoretically, the evolution of modes of production forms an overlapping array from simple to complex. Arising over the primary producer, ownership that was cooperative, corporate, or national potentially imposed efficient management while extracting surplus. Preserving the integrity of the proletariat has been the persistent problem.

IV. CURRENT TAXATION

Under current law, the federal taxation of the income of entities that correspond most closely to the forms of enterprise above is discussed below. While the smallest entities are the most numerous, the largest are the richest.

157. Wang, *supra* note 12, at 53.

158. *Id.*

159. *Id.* at 56.

160. *Id.* at 57 (quoting Land Administration Law promulgated by the Standing Comm. Nat'l People's Cong., Jun. 25, 1986, effective Jan. 1, 1987) (China).

161. *Id.* at 89.

162. *Id.*

163. *Id.* at 62.

Table 2 shows the tax returns and receipts for various forms of business entities in the U.S. in 2019.

Table 2. Business Entity Returns and Receipts (Tax Year 2019)[164]

Entity type	Returns (Mn)	Receipts ($Tn)
Proprietor (non-farm sole)	27.8	1.6
Partnership (incl. LLC)	4.0	8.1
Corporation (C & S)	6.5	35.9

A. *Sole Proprietor*

An artisan may be "someone who owns an unincorporated business by himself or herself," *i.e.*, a sole proprietor.[165] If so, the income of the business is that of the artisan, who reports it on the individual return, typically Internal Revenue Service (I.R.S.) Form 1040, *U.S. Individual Income Tax Return*, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*.[166] Even if the artisan forms a limited liability company (LLC) to limit business exposure, generally, "for income tax purposes, a single-member LLC is disregarded as an entity separate from its owner and reports its income and deductions on its owner's federal income tax return."[167] In practice, this means that the artisan pays tax on an individual basis.

B. *Cooperative*

As previously discussed, a cooperative may be a group of individual producers who would not generate income at the level of the entity.[168] For income tax purposes, "money flows through the cooperative" to the productive members (also known as patrons), "leaving no margins to be retained as profit by the cooperative."[169] Accordingly, the Internal Revenue Code states in pertinent part that the taxable income of cooperatives shall not take "into account amounts paid . . . as patronage dividends" essentially

164. *See* I.R.S., *SOI Tax Stats - Nonfarm Sole Proprietorship Statistics*, https://www.irs.gov/statistics/soi-tax-stats-nonfarm-sole-proprietorship-statistics (last updated Sept. 13, 2023); I.R.S. Pub. 5655, Corporate Income Tax Returns (Sept. 2023); I.R.S. Pub. 5338, Partnership Returns (June 2022).

165. *See* I.R.S. Pub. 334 (Jan. 27, 2022) [hereinafter Tax Guide for Small Businesses].

166. *See* I.R.C. § 1.

167. *See* Tax Guide for Small Businesses, *supra* note 165. *See generally* Treas. Reg. § 301.7701-3.

168. *See supra* Part III.B.

169. DONALD A. FREDERICK, RURAL BUS. SERV., INCOME TAX TREATMENT OF COOPERATIVES 8 (2013) (U.S. Dep't of Agric.).

constituting the profit produced by a member (akin to a "deduction" of the cooperative).[170] Effectively, the cooperative enjoys an exemption from tax, explicitly described by the Code in the case of

> farmers', fruit growers', or like associations organized and operated on a cooperative basis
> (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or
> (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.[171]

Thereafter, the tax on the net proceeds "is ultimately paid by the final recipient (the cooperative patron) . . . ."[172] This result is similar to that of the artisan above.

C. Partnership or Small Corporation

Artisans, tradesmen, or other individual producers may band together. As partners or a small corporation, they may experience taxation parallel to the foregoing. That is, the partnership or small corporation may not attract tax at the entity level as the income passes through to the underlying owners. The applicable statute states that a "partnership as such shall not be subject to the income tax . . . ."[173] Similarly, a small "S corporation shall not be subject to the taxes" on income.[174] As a general rule, the S corporation is small in that it can have but a hundred individual shareholders in only one class of stock.[175] Rather, the duty passes through the small entity to the persons "carrying on business as partners [who] shall be liable for income tax . . . in their separate or individual capacities."[176] Thus, the productive individuals bear the tax on their income.

Small businesses may be organized as partnerships or S corporations. Even so, they may retain some of the workmanlike values of the old-fashioned artisan. Nowadays, some partnerships may serve as large vehicles for widespread investors.[177] Current law allows a business entity that acts

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170. I.R.C. § 1382(b).
171. I.R.C. § 521(b)(1).
172. FREDERICK, *supra* note 169, at 8.
173. I.R.C. § 701.
174. I.R.C. § 1363(a).
175. *See* I.R.C.§ 1361(b)(1).
176. I.R.C. § 701.
177. *See generally* I.R.C. § 7704.

either like a pass-through or a corporation to elect that classification.[178]

D. Corporation

As a taxpayer and citizen, a large business organized in corporate form has a distinct legal personality under federal law.[179] Expressly, the Internal Revenue Code imposes the income tax on "every corporation."[180] As distinguished by Subchapter C from the S corporations, large "C" corporations pay tax on their income before passing it to the equity owners.[181] As a stockholder in a large corporation, the individual owner may be a merely passive investor. By contrast, a small business owner may be conceived as a primary producer. In the context of the overall rates, the corporate income tax contributes to progressivity by levying on those individual taxpayers who can afford to invest.[182] To be clear, equity investments received are excluded from gross income to the corporation.[183] The entity-level tax makes sense where the corporation may have economic and even political effects beyond those of the underlying shareowners.

Naturally, capitalism harbors antipathy to the corporate tax. Arguably, corporate receipts fall outside income conceived as consumption plus net saving.[184] Critics may call this "double taxation" in the sense that "dividends taxed upon receipt by the individual stockholder were previously included in the corporation's gross income as profit."[185] In view of these criticisms, along with concern about global competition for corporate income, the Trump-era tax reform reduced the tax rate from 35 to 20 percent (subsequently increased to 21 percent during the Biden Administration).[186] Nonetheless, a corporation is still a taxpayer.

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178. *See* Treas. Reg. § 301.7701-3.

179. *See generally* Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010) (upholding "nonprofit corporate political speech").

180. I.R.C. § 11(a).

181. *See* I.R.C. §§ 301, 385.

182. *See* FS, *supra* note 6, at 76.

183. *See* I.R.C. § 118(a).

184. *See generally* Henry C. Simons, *Federal Tax Reform*, 21 UNIV. CHI. L. REV. 20 (1950).

185. DS, *supra* note 19, at 693.

186. *See* I.R.C. § 11 as amended by Pub. L. No. 115-97 § 12001, 131 Stat. 2094, 2096 (2017); *see also* Pub. L. No. 117-169 § 10101, 136 Stat. 1822 (2022).

E. Government Entity

Nationalized enterprises may be government entities. Generally, these are exempt from federal income tax.[187] As a statutory construction, governments may be neither individuals nor corporations expressly subject to the federal income tax law as discussed above.[188] In a nod to intergovernmental comity, the Code confirms that gross income does not include "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision . . . ."[189] Even where a government entity is separately incorporated or organized, administrative rulings extend tax-exempt status depending on:

> (1) whether it is used for a governmental purpose and performs a governmental function;
> (2) whether performance of its function is on behalf of one or more states or political subdivisions;
> (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner;
> (4) whether control and supervision of the organization is vested in public authority or authorities;
> (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and
> (6) the degree of financial autonomy and the source of its operating expenses.[190]

If a federal or state enterprise is productive, presumably the government captures the profit through its directorate rather than through the tax collector.[191]

Among federally-exempt government entities, Indian tribal governments give an example of the distribution of profit among the citizenry.[192] In 1987, the U.S. Supreme Court effectively deregulated bingo games conducted by a Native American tribe in California, clearing the way for a billion-dollar gaming industry located in Indian Country for mostly Caucasian customers.[193] Since then, tribal revenue resulting in *per capita* distributions

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187. *See* Ellen P. Aprill, *Revisiting Federal Tax Treatment of States, Political Subdivisions, and Their Affiliates,* 23 FLA. TAX REV. 73, 83 (2019).

188. *See* Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803, 803 (1998).

189. I.R.C. § 115(1).

190. Rev. Rul. 57-128, 1957-1 C.B. 311.

191. *See supra* Part III.F.

192. *See* DS, *supra* note 19, at 704.

193. *See* California v. Cabazon Band of Mission Indians, 480 U.S. 202, 222 (1987).

to enrolled members have skyrocketed.[194] The Native American case is an instance of equal distribution of profit from an industry conducted by a government entity.

F. *Summary*

In general, the tax on business income falls to either individuals or corporations. Specifically, the taxpayers are either individual proprietors, corporate entities, or pass-through vehicles that return the income to individual producers. In the case of government agencies, they may be exempt from tax even if they produce income. Whether retained by the proprietor, passed through an entity, captured by a corporation, or exempted by a government, people's labor creates the income.

V. THE NON-PROFIT MODEL

A. *Overview*

Historically, production grew in scale. Successively, this occurred under the formation of the hierarchical state, as in the case of monumental architecture, and the corporate form, as in the case of industrial capitalism.[195] Yet the extremes of state ownership and corporate capitalism often failed to produce equitably throughout history. Two years after the abolition of private property by the Bolshevik Revolution, "some 7 percent of the urban and 4 percent of the rural population was included on so-called *listenzii* lists for engaging in prohibited activities," extinguishing the productivity of a whole stratum of Soviet "carters, food sellers, craftsmen, and tradespeople."[196] Likewise, the plight of the "wage slave" under capitalism has been extensively chronicled by critics.[197] Consequently, the question is whether there is a practical alternative to either state control or private exploitation.

Recently, commentators have mentioned a potential alternative.[198] Between the public and private sectors, "cooperatives and nonprofit organizations such as associations and foundations . . . play a central role in many sectors, including education, health, culture, universities, and

194. *See generally* Stephen Cornell et al., Per Capita Distributions of American Indian Tribal Revenues, Harv. Project on Am. Indian Econ. Dev't No. 2008-02 (2008).

195. *See supra* Parts III.C, D.

196. PIKETTY, *supra* note 13, at 580.

197. *See* David Graeber, *Turning Modes of Production Inside out: Or, why Capitalism is a Transformation of Slavery,* 26 CRITIQUE ANTHRO. 61, 68 (2006).

198. *See* PIKETTY, *supra* note 13, at 510.

media."[199] This Part sets forth the nonprofit model, especially its potential to conduct industry beyond essential government functions or traditional charity. The result is an alternative to both state and corporate ownership of industry.[200]

B. *An Alternative Form*

The core of the non-profit model is private control of publicly dedicated assets. Traditionally, philanthropists could donate funds to a private charity whose legitimate purpose the attorney general could enforce on behalf of the public interest.[201] Federally, the charitable entity would have tax-exempt status to effectively subsidize the public good.[202] While state bureaucracy would not dissipate private productivity, regulators would have oversight of prescribed functions. Additional oversight comes from natural constituencies, such as the customer base in any particular sector.[203] Public oversight expands the notion of collective ownership.

The non-profit moniker deserves clarification. The label means not that the enterprise must be unprofitable but that any net earning must return to the endowment or the entity's treasury.[204] There shall be neither dividends nor shareowners. Although investors may serve in leadership roles, they cannot reap profit in the typical sense, other than the satisfaction of a mission accomplished (a non-pecuniary form of consumption). Thus, the non-profit model eviscerates capital ownership, but not corporate control.

Economically, the non-profit can do virtually anything a for-profit corporation can. In principle, Professor Hansmann observed that, "if the only thing distinguishing nonprofit firms from for-profit firms was the fact that, by virtue of the nondistribution constraint, in the nonprofit firm price never exceeds cost, then there would be no situation in which a for-profit firm would have a competitive advantage over a nonprofit firm."[205] Realistically, "nonprofit firms are at a disadvantage relative to for-profit firms" with respect to "access to capital, efficiency of operation, and speed

199. *Id.*

200. *Cf.* Giacomo Corneo, *Inequality, Public Wealth, and the Federal Shareholder*, Policy Paper No. 115, Forschungsinstitut zur Zukunft der Arbeit (Inst. for the Study of Labor) Bonn (Oct. 2016) (proposing federal stockownership).

201. *See, e.g.*, MASS. GEN. LAWS ch. 68, § 32.

202. *See* I.R.C. § 501(c)(3).

203. *See, e.g.*, Treas. Reg. § 1.170A-9(c)(1) ("a regularly enrolled body of pupils or students in attendance").

204. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

205. *Id.* at 879.

of entry and growth in expanding markets."[206] These impediments are a condition of the capitalist context, the persistence of which would not be an assumption of this Article's proposal.

Traditionally, non-profit missions have been delimited by the common law of charity and related doctrines.[207] Archetypally, charities work in: education, including science and publishing; health care; and the visual or performing arts.[208] At the same time, non-profits have conducted utilities, financial or professional services, real estate, retail sales, and even manufacturing or food production.[209] The range of industry shows that individual profit has not been necessary to a productive business model. For Tax Year 2015, charities alone reported over $3.8 trillion in assets and $2.9 trillion in revenue.[210] With neither the maximizing motive of a private corporation nor the autarky of independent producers, the non-profit model may facilitate the economy of scale in complex industries.

C. *The Non-Profit Corporation*

Generally, state statutes allow the incorporation of a non-profit organization. In 1987, the American Bar Association promulgated a revised version of the 1952 Model Non-profit Corporation Act for this purpose.[211] As a general rule, state non-profit legislation prohibits the payment of dividends.[212] Most states "prohibit the issuance of stock" but permit "the payment of a reasonable compensation to officers and directors."[213] The constraint on distribution does not preclude oversight by members (or non-capital stockholders). A salient example comes from academia where "the board of trustees of some universities is structured so that roughly half is elected by the alumni – which constitutes the bulk of past customers and present donors – while the other half is self-perpetuating."[214] Non-profit incorporation with the secretary of the state registers the organization vis-à-vis consumer protection by the attorney general.[215] Thus, the state statutes

206. *Id.*

207. *Id.* at 882.

208. *See* Treas. Reg. § 1.501(c)(3)-1.

209. *See infra* Parts VI.H–M.

210. *See* I.R.S., *Charities and Other Tax-Exempt Organizations, Tax Year 2015*, Pub. 5331 (Dec. 2018).

211. *See generally* MODEL NONPROFIT CORP. ACT (1987) (Am. Bar Ass'n, amended 2021).

212. MARILYN PHELAN, 1 NONPROFIT ENTERPRISES 34 § 1:12 (Supp. 1997).

213. *Id.*

214. Hansmann, *supra* note 204, at 841.

215. *See, e.g.*, MASS. GEN. LAWS ch. 68 § 32.

govern the corporate form.

In parallel, the federal tax law governs the income. Specifically, Internal Revenue Code § 501(c)(3) describes "[c]orporations . . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual."[216] Recognition by the I.R.S. affords exemption from federal income tax.[217] While charities are a subset of non-profits, the state and federal regimes dovetail in this case.

D. Taxation of Otherwise Exempt Organizations

Aptly categorized, exempt organizations are generally exempt from federal income tax. Like for-profit corporations, exempt entities owe payroll tax for the public pension and health coverage of their employees.[218] As discussed below, income or excise taxes apply in circumstances pertinent to this Article's proposal to expand the non-profit form to corporations in all industries.

Theoretically, the premise of tax exemption was that non-profit organizations served a charitable, public, or mutual purpose.[219] Logically, the exemption should not apply where they exceed that purpose. Instead, the corporate income tax would apply to business conducted by a non-profit organization unrelated to its exempt purpose. For example, general merchandise in the gift shop of a museum, if subsidized by the museum's tax exemption, could constitute "unfair competition" against for-profit retailers.[220] Legally, "unrelated trade or business" means

> any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption . . . .[221]

Assuming current law, the unrelated business income tax (UBIT) could apply to the proposed expansion of the non-profit corporation in industry of

216. I.R.C. § 501(c)(3).

217. *See* I.R.C. § 508.

218. *See* I.R.C. § 3111(a) (imposing tax on "every employer").

219. *See* STAFF OF JOINT COMM. ON TAX'N, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 28 (2005) (explaining that "[e]xemption from tax may be . . . charitable . . . public . . . or attributable to the structure of an organization.").

220. H.R. Rep. No. 2319, 81st Cong. 2d Sess. 36 (1950).

221. Treas. Reg. § 1.513-1(a).

all kinds, not merely limited to exempt functions. In a for-profit economy, the concept of unfair competition implies that non-profit industries are competitive.

Among non-profits are charities, which in turn include private foundations. In the pertinent part of the Tax Reform Act of 1969 (TRA '69), the U.S. Congress imposed an excise regime on private foundations.[222] Essentially, these were grant-making charities supported by one donor or family, typically representing a captain of industry, lacking the inherent oversight of natural constituencies such as patients, a congregation or student body.[223] As a general rule, private foundations (other than those with an operative mission) became subject to a tax, now a couple percent of their net investment income.[224] To counter their traditional connection to business dynasties, another tax limited the extent to which private foundations could control a business.[225] The legislative history memorializes the concern that the directors of a foundation that was in turn a corporate stockholder "may become so interested in making a success of the business, or in meeting competition, that . . . carrying on charitable, educational, etc. activities is neglected."[226] Potentially, a confiscatory excise effectively precluded the donor from continuing to operate his for-profit company through the foundation as the nominal stockholder.[227] In general, the dynasty cannot retain more than a fifth of the voting stock.[228] While there are other private foundation taxes, the relevance of these particular excises to the non-profit proposal will appear below.

In the case of a non-profit that is an exempt charity, federal tax law requires perpetual dedication of the assets to the public interest.[229] The non-profit charter must stipulate that on dissolution of the corporation, its assets shall "be distributed for one or more exempt purposes, or to the Federal

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222. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended at I.R.C. §§ 4940–4948).

223. *See* S. Comm. on Fin., Tax Reform Act of 1969, S. Rep. No. 91-552, at 25 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2052 ("In part, the problem is that if foundations have a permanent tax-exempt life, their economic power may increase to such an extent that they have an undue influence both on the private economy and on governmental decisions."); *see also* H.R. Rep. No. 2319, 81st Cong. 2nd Sess. 42, 1950-2 C.B. 412, 413-14 ("Frequently families owning or controlling large businesses set up private trusts or foundations to keep control of the business in the family after death.").

224. *See* I.R.C. § 4940.

225. *See* I.R.C. § 4943.

226. S. Rep. No. 91-552, *reprinted in* 1969 U.S.C.C.A.N., at 2067.

227. *See* I.R.C. § 4943.

228. *See* I.R.C. § 4943(c)(2)(A).

229. *See* Treas. Reg. § 1.501(c)(3)-1(b)(4).

government, or to a State or local government, for a public purpose."[230] For the subset of charities that are private foundations, a termination tax may result in the confiscation of any assets not left to charity.[231] These rules extinguish any role for shareholders.

E. Equity or Debt Financing

Under current law, a taxpayer enjoys a deduction for a donation to charity.[232] On receipt, the charity excludes the donation from gross income as a gift.[233] If the corporation were for-profit, it would exclude an investment as a contribution to capital by a shareowner.[234] Under the proposal to replace for-profit corporations with non-profits, donations would supplant the capital market.[235] Nowadays, phenomena such as the crowdfunding site GoFundMe show that people are happy to contribute to personally sympathetic, but not necessarily charitable, causes, including business start-ups, without an equity stake.[236] Still, the deduction could be justified to the extent that the expanded non-profit scope continues to represent the public good. Commentators have anticipated that

> the tax system can be changed to encourage more democratic and participatory outcomes by allowing each citizen to give the same amount to nonprofit ventures of his or her choosing, possibly including gifts to sectors not previously exempt from taxation (such as the media or ventures in sustainable development).[237]

The industrial sectors not previously exempt from taxation are discussed below.

Under current federal law, charities, as well as state and local governments, may issue tax-exempt bonds.[238] The interest is excluded from the gross income of the bondholders.[239] Under the proposal to expand the scope of non-profits, this exclusion could expand inasmuch as the bond issuance continues to represent the public good. At the same time, the supplanting of for-profit corporations would largely reduce competition

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230. *Id.*

231. *See* I.R.C. § 507(b)(1).

232. *See* I.R.C. § 170(a)(1).

233. *See* I.R.C. § 102.

234. *See* I.R.C. § 118.

235. *See* Mónika Kuti & Gábor Madarász, *Crowdfunding*, 3 PUB. FIN. Q. 355 (2014).

236. *See id.* (crowd funders "voluntarily decide to finance . . . even when they are not promised anything in return.").

237. PIKETTY, *supra* note 13, at 512.

238. *See* I.R.C. § 145; *see also* I.R.S., Tax-Exempt Bonds for 501(c)(3) Charitable Organizations, Pub. 4077 (Sept. 2019).

239. *See* I.R.C. § 103.

from commercial borrowers. In effect, the tax exclusion would subsidize a larger pool of exempt borrowers as the for-profit sector recedes.

G. *Executive Compensation*

Non-profit managers, like other corporate executives, currently receive compensation subject to the supply and demand in the job market. The applicable federal tax law confirms that in the case of charity leaders, reasonable compensation means what it does for private sector employees, who may or may not receive an incentive bonus.[240] Reasonableness depends on "the aggregate benefits . . . and the rate at which any deferred compensation accrues" including any overall cap.[241] To enforce the reasonableness standard, the 1996 legislation imposed an excise (up to 200 percent in extreme cases) on excess compensation or benefits beyond consideration by an executive or other interested party in a charity.[242] In view of the empirical concern over excess corporate pay, this legislation should extend to the proposal to expand the non-profit sector.

Quantitatively, non-profit executive compensation is as follows. In 2018, "the average annual CEO pay in most nonprofit industries was between $100,000 and $200,000 . . . ."[243] Nonetheless, "university CEOs . . . were paid an average of $350,000, and hospital CEOs . . . $600,000."[244] These two large industries within the non-profit sector are discussed below. While non-profit leaders' pay can be substantial, it is at least an order of magnitude lower than that of for-profits as set forth above.[245]

After the 2017 tax reform, non-profits fell under a new compensation excise.[246] Generally, the legislation imposed a tax (at the corporate rate) on an exempt organization that paid an executive in excess of a million dollars.[247] For the prior two decades, for-profit executive compensation at that level already had been subject to the cap on deductibility.[248] The new enactment confirmed that, at the highest echelons, non-profits were parallel to their commercial counterparts.

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240. *See* I.R.C. § 4958.

241. Treas. Reg. § 1.4958-4(b)(1)(ii)(A).

242. *See* Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311, 110 Stat. 1452 (1996).

243. Vikas Saini et al., *Nonprofit Hospital CEO Compensation: How Much Is Enough?* HEALTH AFF. FOREFRONT (Feb. 10, 2022), https://thepressfree.com/nonprofit-hospital-ceo-compensation-how-much-is-enough/.

244. *Id.*

245. *See supra* Table 1.

246. *See* Pub. L. No. 115-97, § 13602, 131 Stat. 2054, 2157 (2017).

247. *See* I.R.C. § 4960(a).

248. *See supra* Part III.D.

H. Mission-Oriented Corporate Control

Under the proposed model, the non-profit may serve as an alternative form of industrial ownership that collectivizes public goods. To do so, a capital-oriented executive elite cannot continue to capture control of the corporation. At the enactment of TRA '69, legislators worried that a rentier class would perpetuate control of both for-profit and non-profit organizations especially through private foundations, leading Congress to impose the restrictive excise regime discussed above.[249] The prototypical examples were the closely-held companies and associated family foundations of twentieth-century American business dynasties.[250]

For example, the Ford Motor Company was established by the automotive titan Henry Ford.[251] In 1936, his son Edsel "established the Ford Foundation with an initial gift of $25,000."[252] In turn, Edsel's eldest son Henry Ford II assumed leadership of the foundation, while "he and the board of trustees commissioned a blue-ribbon panel . . . to explore how the foundation could best put its greatly increased resources to use."[253] The resulting recommendations were "that the Ford Foundation become an international philanthropy dedicated to the advancement of human welfare through reducing poverty and promoting democratic values, peace, and educational opportunity."[254] Today, an openly gay African-American, Darren Walker, "is president of the Ford Foundation, a $16 billion international social justice philanthropy . . . ."[255] Previously, Mr. Walker was leader of "Harlem's largest community development organization," having been educated "exclusively in public schools" as "a member of the first Head Start class in 1965 . . . ."[256] Thus, the presidency of a private non-profit transitioned from Anglo-Saxon patrilineal primogeniture to a post-modern profile.[257] While any individual can effectuate only so much change, this executive evolution

249. S. Rep. No. 91-552, *reprinted in* 1969 U.S.C.C.A.N., at 2052.

250. *See Tax Reform Act of 1969: Hearing on H.R. 18270 Before the Sen. Comm. on Fin.*, 91st Cong. 6–7 (1969) (statement of John D. Rockefeller III) (acknowledging that the "Committee was disturbed about reports that many wealthy people were paying no taxes.").

251. *See Our Origins*, FORD FOUND., https://www.fordfoundation.org/about/about-ford/our-origins/ (last visited Nov. 2, 2023).

252. *Id.*

253. *Id.*

254. *Id.*

255. *Darren Walker*, FORD FOUND., https://www.fordfoundation.org/about/people/darren-walker/ (last visited Nov. 2, 2023).

256. *Id.*

257. *See generally* FRANKLIN A. THOMAS, AN UNPLANNED LIFE: A MEMOIR (2022) (discussing the career of the first Black president of the Ford Foundation).

is an indicator of the decaying grip of capital after a century of rigorous proscriptions on private inurement and related self-aggrandizement. If policymakers suspect that corporations will be creatures of the rich, they can enact rules to protect the public interest.

I. The Low-Profit Company

Over the past decade, an alternative to both for-profit and non-profit corporations arose.[258] In Vermont and several other states, legislation allowed the chartering of the so-called low-profit limited liability company (L3C).[259] Generally, the legislation defined an L3C as a limited liability company formed to accomplish in significant part a charitable (or educational) purpose without significant income (or capital) production or any political (or legislative) purpose.[260] Prior to the L3C enactment, the applicable corporate law had stated that a "limited liability company may be organized under this chapter for any lawful purpose, subject to any provision of laws of this state governing or regulating business."[261] Under the statute, the term "business" included "every trade, occupation, profession and other lawful purpose, whether or not carried on for profit."[262] On its face, the corporate statute did not preclude operating a business at cost, allowing for reasonable compensation of both managers and workers. Nor did it foreclose the myriad judgments required to optimize outcomes. Nevertheless, the L3C legislation reflected the obtuse belief that in for-profit corporations, "shareholder interest must be the top priority because managers are legally obligated to run the business in a manner that maximizes shareholder value."[263] Legally nuanced or not, the belief reflected the neo-classically unquestionable dogma that the only "social responsibility of business is to increase its profits."[264] According to advocates, the "advent of L3Cs" gave a new generation of entrepreneurs the states' imprimatur "to sustainably

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258. *See* Cody Vitello, *Introducing the Low-Profit Limited Liability Company (L3C): The New Kid on the Block*, 23 LOY. CONSUMER L. REV. 565, 565 (2011).

259. *See* J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 273 (2010).

260. *See* VT. STAT. ANN. tit. 11, § 3001(27) (2009) (repealed 2014) succeeded by § 4162 (2015).

261. *Id.* at § 3012(a).

262. *Id.* at § 3001(3).

263. Vitello, *supra* note 258, at 567.

264. Milton Friedman, *A Friedman Doctrine - The Social Responsibility of Business Is to Increase its Profits*, N.Y. TIMES (Sept. 13, 1970) https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html. *But see* GEOFFREY JONES, DEEPLY RESPONSIBLE BUSINESS: A GLOBAL HISTORY OF VALUES-DRIVEN LEADERSHIP 7 (2023).

further a social purpose" or to do good while doing moderately well.[265] In any case, the legislation codified popular desire for an alternative to the for-profit corporation.

The tax consequences were another matter. Under the Internal Revenue Code, "L3Cs are technically for-profit ventures and will have to pay property, state, and federal income taxes."[266] Unfortunately, "the existence of the L3C form gives rise to the delusion that the form actually does something, and ill-advised people may use it believing that the form enables PRI treatment."[267] Rather than entice profit-seeking shareowners, L3Cs hoped to receive program-related investment (PRI) from a private foundation, but that is a tax-exempt charity subject to the restrictions on business ownership discussed above.[268] While L3Cs turned out to be ineffective for federal tax purposes, their creation showed the popular desire for an alternative to both for-profit and non-profit corporations as traditionally conceived. Moreover, the legislation illustrated legislators' readiness for reform through an organic amendment to state corporation law.

J. Summary

In sum, the non-profit may be the mirror image of the for-profit corporation. Both entities can extend ownership to the public. Whereas the for-profit has a mass of individual shareowners, the non-profit constrains distribution while acting in the public interest. In the former, stockowners may desire, but not necessarily reap, profit. In the latter, no individual executive or employee shall benefit beyond reasonable compensation. Nonetheless, the non-profit retains private control. The mission of the non-profit justifies its existence. If the non-profit form is to extend past traditional charity, it needs to operate in a full range of industries without a profit motive. The next Part addresses the feasibility of the non-profit model.

VI. CURRENT NON-PROFIT INDUSTRIES

A. Overview

Under current law, non-profits conduct business operations across the full range of industries without appropriating surplus for shareowners. In traditionally charitable segments, such as education and healthcare, non-profits dominate for-profits that maintain a small market share. In ordinarily

265. Vitello, *supra* note 258, at 578.
266. *Id.* at 573.
267. Callison & Vestal, *supra* note 259, at 291.
268. *See supra* Part V.D.

capitalist segments, such as finance and manufacturing, non-profits are competitive against commercial firms. These examples show the feasibility of private corporations operating on a mission-oriented basis. Table 3 below lays out different categories of tax-exempt organizations, the corresponding sections of the Internal Revenue Code, and the number of entities in each category.

Table 3. Selected Tax-Exempt Organizations (Fiscal Year 2021)[269]

IRC § 501(c)	Type of organization	Population
(3)	Charities	1,431,266
(9)	Voluntary employees' beneficiary associations (VEBAs)	5,890
(12)	Mutual utilities and benevolent life insurance associations	5,774
(14)	State-chartered credit unions	2,152
(15)	Mutual insurance companies	760
(17)	Supplemental unemployment compensation trusts	87

B. *Basic Science And The Non-Profit Motive*

Under capitalism, the premise has been that the profit motive generates efficient production.[270] Operating under that premise, the for-profit corporation proliferated.[271] Conversely, activities that are not immediately profitable would be neglected. First among these was basic science, the foundation of technology that in turn could lead to profit.[272] To remedy the lack of business investment in science, in 1981, Congress enacted a tax credit to incentivize expenses for research.[273] This legislation underscored the policy imperative to support activities such as scientific research that failed to attract immediate monetary investment.

Where a for-profit corporation conducted basic science, it was an

269. *See* I.R.S. DATA BOOK, Publ'n 55-B, 30 (2021) [hereinafter I.R.S. DATA BOOK].

270. *See* POSNER, *supra* note 9, at 395.

271. *See supra* Part III.D (explaining the history and implications of corporate public ownership).

272. *See* Iulia Georgescu, *Bringing Back the Golden Days of Bell Labs,* 4 NATURE REVS. PHYSICS 76, 77 (2022) ("basic research is the foundation on which all technologic advances rest." (quoting John R. Pierce, *Marvin Joe Kelly*, *in* 46 BIOGRAPHICAL MEMOIRS 191, 202 (1975)).

273. *See* I.R.C. § 41 (1981).

exception that proved the rule. In the exemplary case of Bell Labs, many observers "have wondered how an industrial lab could have had such a tremendous impact on both fundamental and applied science."[274] Business historians recall that before the landmark break-up of "Ma Bell" by antitrust regulators, the American Telephone & Telegraph Company (AT&T) "benefited from a government-guaranteed telephone monopoly."[275] In that case, there was an indirect subsidy.[276] One way or another, necessary but unprofitable work needs support. By implication, the non-profit corporation may be the natural form for advancement in science and other fundamental arts.

Rather than profit motivated, science appears mission oriented. Scientists strive not for net earnings but peer review, honorary awards, and academic titles.[277] While they cannot eat prestige, it feeds their need for recognition, assuming that reasonable compensation covers their subsistence.[278]

C. *Colleges*

At common law, education was a charitable purpose.[279] In 1601, this was codified in the Statute of Charitable Uses as the "maintenance of schools of learning, free schools, and scholars in universities."[280] In Anglo-American jurisdictions, education developed largely as a non-profit or governmental endeavor.[281] In 1828, Yale College issued a report defending the "classical curriculum" as the source of the discipline of the mental faculties needed by

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274. Georgescu, *supra* note 272, at 76.

275. Rob Goodman, *Why Bell Labs Was so Important to Innovation in the 20th Century*, FORBES (Jul. 19, 2017, 11:55 AM), https://www.forbes.com/sites/quora/2017/07/19/why-bell-labs-was-so-important-to-innovation-in-the-20th-century/?sh=3cacfeeb7015.

276. *See* Paul W. MacAvoy & Kenneth Robinson, *Winning by Losing: The AT&T Settlement and its Impact on Telecommunications*, 1 YALE J. ON REG. 1, 1 (1983).

277. *See* Bruno S. Frey, *Giving and Receiving Awards*, 1 PERSPS. ON PSYCH. SCI. 377, 377, 378 (2006) ("people value status independently of the monetary consequence;" "awards are one of the most important producers of status," "[a]cademia has an elaborate and extensive system of awards."); *see also* PIERRE BOURDIEU, DISTINCTION: A SOCIAL CRITIQUE OF THE JUDGEMENT OF TASTE 23 (Harv. Univ. P. 1984) (considering the "effect of the educational system, the one it produces by imposing 'titles,' a particular case of the attribution by status").

278. *See* Joseph Henrich & Francisco J. Gil-White, *The Evolution of Prestige: Freely Conferred Deference as a Mechanism for Enhancing the Benefits of Cultural Transmission*, 22 EVOLUTION & HUM. BEHAV. 165, 173 (2001).

279. *See* Rupert Sargent Holland, *The Modern Law of Charities as Derived from the Statute of Charitable Uses*, 52 AM. L. REG. 202, 203–04 (1904).

280. *See* List of Proceedings for Commissioners for Charitable Uses, 1601, ch. 4, 43 Eliz. (Eng.).

281. *See* DS, *supra* note 19, at 679.

future leaders.[282] This type of education took place in the proverbial ivory tower.

However, the Anglo-American system of education was not the only one in practice. Across the Asian continent, the ancient Confucian scholarly tradition spread mainly on the model of "family schools" (*chia-shu*) that retained tutors in the "wealthy homes" of "private individuals" institutionally succeeded by "private academies" (*shu-yuan*).[283] With an element of private consumption, education is a public good.

Now in the United States, tertiary education demonstrates the division of an industry between public and private entities. Between state and private four-year colleges, tuition at the latter can be three times that for the former.[284] Among private colleges, non-profit tuition paradoxically can be double that of for-profit colleges.[285]

Consider U.S. enrollment at the beginning of this century. State or other public colleges accounted for three quarters of that enrollment, of which more than half was in four-year programs.[286] In turn, private colleges comprised non- and for-profits. Of the national student body, almost one fifth enrolled in private non-profit colleges, where virtually all students were in four-year programs.[287] The non-profits constituted fewer than a third of all colleges but almost two thirds of four-year colleges.[288] Like all schools, non-profit colleges are classified as public charities for purposes of federal tax exemption.[289]

282. *See generally* Jurgen Herbst, *The Yale Report of 1828*, 11 INT'L J. CLASSICAL TRADITION 213 (2004).

283. C.T. Hu, *The Historical Background: Examinations and Control in Pre-modern China*, 20 COMPAR. EDUC. 7, 8–9 (1984).

284. *See* DS, *supra* note 19, at 697.

285. *See* Matthew R. Hodgman, *Understanding For-Profit Higher Education in the United States Through History, Criticism, and Public Policy: A Brief Sector Landscape Synopsis*, J. EDUC. ISSUES, Dec. 2018, at 1, 4 (2018).

286. *See infra* Table 4.

287. *See infra* Table 4.

288. *See infra* Table 4.

289. *See* I.R.C. § 170(b)(1)(A)(ii).

Table 4. U.S. College Enrollment (2001)[290]

	Public	Private Non-profit	For-profit	Total
Colleges	**2,099**	**1,941**	**2,418**	**6,458**
4-year	629	1,567	324	2,520
2-year	1,165	269	779	2,213
< 2-year	305	105	1,315	1,725
Enrollment	**12,370,079**	**3,198,354**	**765,701**	**16,334,134**
4-year	6,236,486	3,120,472	321,468	9,678,426
2-year	6,047,445	63,207	241,617	6,352,269
< 2-year	86,148	14,675	202,616	303,439

Unlike private foundations, public charities are not required to expend any annual amount on exempt functions.[291] In the case of colleges, the imperatives of hiring professors, supplying laboratories, and otherwise fulfilling the needs of students perhaps naturally prompts that spending. At the same time, "the gap between the resources available to the best universities and those available to less well-endowed public universities and community colleges has grown to abyssal proportions in recent decades."[292] As listed in Table 5 below, the endowments grew in the last half decade to more than $10 billion for seven universities, comprising six Ivy League or other private non-profits and one public university in a petro-state.[293] Among smaller colleges, there were 707 endowments between $50 and $10 million, and 516 less than $10 million.[294] The similarity between the university endowments and non-operating charities classified as foundations did not escape the scrutiny of the U.S. Congress. In particular, the Tax Cuts & Jobs Act of 2017 appended to the private foundation chapter a 1.4 percent excise on the net investment income of a private non-profit college that has assets of at least half a million dollars per student, given at least five hundred tuition-paying students, more than half of whom are in the U.S.[295] Originally, the Elizabethan ideal of scholarship may have justified a public

290. Peter D. Eckel & Jacqueline E. King, *United States*, INTERNATIONAL HANDBOOK OF HIGHER EDUCATION 1035, tbl. 1 (2007).

291. *See* I.R.C. § 4942 (imposing an excise tax on private foundations' failure to distribute funds).

292. PIKETTY, *supra* note 13, at 537.

293. *See* Peter Hinrichs, *College Endowments*, ECON. COMMENTARY (May 17, 2018), https://www.clevelandfed.org/en/publications/economic-commentary/2018/ec-201804-college-endowments.

294. *See id.*

295. *See* I.R.C. § 4968.

charity classification, then accompanied by high deduction ceilings favorable to donors.[296] To the extent that non-profit universities have become corporate shells for patrimonial funds, now policymakers have taxed them.

Table 5. Endowments (2018)[297]

University	$ Bn
Harvard	35.7
Yale	25.4
Univ. of Tex.	23.9
Stanford	22.4
Princeton	21.7
Mass. Inst. of Tech.	13.2
Univ. of Penn.	10.7

For-profit colleges have small enrollments, but are numerous. The for-profits, which were overwhelmingly junior colleges, enrolled fewer than five percent of students across more than a third of all colleges.[298] In short, non-profits focus on baccalaureate degrees, while for-profits offer a lower level of college generally associated with vocational training.[299]

Across the U.S., for-profit colleges disproportionately enroll historically under-represented students, including women, African- and Latin Americans, and adult learners.[300] One decade ago, women made up 76 percent of for-profit enrollment but only 57 percent of public or non-profit students; Blacks, 27 and 16 percent, respectively.[301] Researchers relate the disparity to this population's need for "[p]ractical business education."[302]

Over time, trade and other proprietary schools proved to be a low-cost alternative for students who needed to increase their employability. In 1994, the University of Phoenix became the first among the for-profit schools to be offered to investors by a publicly-traded corporation.[303] While education

296. *See* I.R.C. § 170(b)(1)(A)(ii). *See generally* Herbst, *supra* note 282.

297. *See* Hinrichs, *supra* note 293.

298. *See supra* Table 4.

299. *See* Hodgman, *supra* note 285, at 9 (characterizing for-profits as "primarily business schools that taught a career-oriented curriculum that deviated distinctly from the liberal classical curriculum of traditional colleges and universities.").

300. *See id.*

301. *See id.* § 2.1.

302. *See id.* (contrasting from the historical defense of classical curriculum, which prioritized mental discipline in education).

303. *See id.* § 2.3.

may take either for-profit or non-profit form, the difference was between the trade school and the ivory tower.

For-profit colleges can convert to non-profit status. In this situation, the educational mission would persist, whereas individual shareowners would not. Under current law, for-profits convert not only to avoid tax but to make students and laboratories eligible for state and federal loans and grants.[304] During conversion, the owners may seek to capture excess profit. Over the previous decade, the Government Accountability Office (GAO) found, conversions generally entailed the sale of the college (or all its tangible and intangible assets) to a non-profit.[305] In about one third of cases, GAO concluded that the sellers "were insiders to the conversion . . . ."[306] Not only were they owners of the for-profit, but they were founders of the non-profit purchaser. According to the Comptroller General, "insider involvement in a conversion poses a risk that insiders may improperly benefit—for example, by influencing the tax-exempt purchaser to pay more for the college than it is worth."[307] Consequently, a proposed policy to convert for-profits would have to include safeguards against excess profit-seeking by the exiting owners. Meanwhile, the voluntary conversions confirm the viability of the non-profit model.

Ironically, the for-profit sub-sector tends to target needier students.[308] In particular, for-profit colleges have been subject to criticism for "employing deceptive recruiting and marketing techniques, saddling students with large debt burdens, leaving students with high student loan default rates, creating job placement issues, and producing low graduation rates."[309] In modern economies, the educated elite have formed a new Brahmin class benefitting largely from non-profit colleges and universities.[310] Hopefully, the proposed elimination of for-profit colleges would reconfigure an industry that exploited those who need access to higher education.

D. Publishing

Alongside education, publishing is an industry that combines public good with private consumption. Publishing companies may be non- or for-profit.

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304. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-21-89, HIGHER EDUCATION: IRS AND EDUCATION COULD BETTER ADDRESS RISKS ASSOCIATED WITH SOME FOR-PROFIT COLLEGE CONVERSIONS 2–3 (2020).

305. *See id.*

306. *Id.*

307. *Id.*

308. *See* Hodgman, *supra* note 285, § 2.4.

309. *Id.* § 3 (citations omitted).

310. *See* PIKETTY, *supra* note 13, at 755.

Among the former, profitable titles need not undermine their educational mission. In one case, a religious publisher "experienced a considerable increase in economic activity as a result of the sudden and unexpected popularity of books written by . . . a . . . [t]heological faculty member."[311] The court confirmed the company's exempt status, which did not conflict with the expansion of readership. Thus, the non-profit form is no hindrance to successful publishing.

E. Hospitals

Traditionally, care of the poor constituted a charitable purpose.[312] When national health insurance took over the coverage of the poor and aged, private hospitals that charged for medical services wondered whether they could retain their charitable tax-exemption.[313] In 1969, the U.S. Treasury administratively confirmed that the "promotion of health" for a broad class was a charitable community benefit, effectively reversing a prior revenue ruling that had required free or below-cost patient care.[314] With guaranteed tax relief, the non-profit corporate form continued to be "more typical of the organizations that provide medical services to patients."[315] As a profession, medical doctors "have historically distinguished themselves from business and trade by claiming to be above the market and pure commercialism."[316] Theoretically, non-profit hospitals offer healthcare without pecuniary consideration.

The following healthcare industry research confirms that non-profit hospitals retain charitable priorities. As may be expected, "nonprofit hospitals tend to provide more unprofitable services and charity care than for-profits . . . ."[317] For example, non-profits are more likely than for-profit hospitals "to offer the unprofitable service of psychiatric emergency care."[318]

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311. Presbyterian & Reformed Pub. Co. v. Comm'r, 743 F.2d 148, 151 (3d Cir. 1984).

312. *See* Rev. Rul. 56-185, 1956-1 C.B. 202 (ruling that a tax-exempt hospital "must not, however, refuse to accept patients in need of hospital care who cannot pay for such services.").

313. *See* S. Rep. No. 91-552, *reprinted in* 1969 U.S.C.C.A.N., at 2090 ("The committee decided to reexamine this matter in connection with pending legislation on Medicare and Medicaid.").

314. Rev. Rul. 69-545, 1969-2 C.B. 117.

315. Bradford H. Gray, *An Introduction to the New Health Care for Profit*, *in* THE NEW HEALTH CARE FOR PROFIT: DOCTORS AND HOSPITALS IN A COMPETITIVE ENVIRONMENT 1 (Bradford H. Gray ed., 1983).

316. PAUL STARR, THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE 23 (1982).

317. Karen Mulligan et al., *What Do Nonprofit Hospitals Reward? An Examination of CEO Compensation in Nonprofit Hospitals*, PLOS ONE, Mar. 2022, at 3.

318. Jill R. Horwitz, *Does Nonprofit Ownership Matter?* 24 YALE J. ON REG. 139, 173 (2007).

Nonetheless, non-profit hospitals "still balance financial objectives with social ones."[319] In the compensation of their executives, non-profit data show a positive association not with uncompensated care but with financial performance.[320] Researchers acknowledge that "[t]here is no consensus in the research literature about whether tax-exempt hospitals are more altruistic than nonexempt hospitals."[321] In 2010, healthcare reform legislation ("ObamaCare") did not impose any quantum of charity care but codified the public reporting of community benefit of whatever kind.[322] Thus, the tax law continues to require the exempt hospitals to promote community health.[323]

Conversely, for-profit hospitals may prioritize profit over patients. Scholars observe "[w]here the physicians own a proprietary interest in the investor-owned hospital, the reason behind their decision to admit only paying patients there is rather obvious."[324] Among health-care services, for instance, "corporate ownership plays . . . a strikingly large role . . . in the decision to offer cardiac care" which is "typically well-reimbursed by insurers."[325] In their medical offerings, for-profit and non-profit "hospital types differ according to their interest in pursuing profits" or not.[326] Under current law, hospitals can choose which classification they utilize.

To recapitulate, non-profit hospitals spend more on charity care than for-profits.[327] Like colleges, hospitals may be organized as government entities, typically at the county level, as well as private taxable or exempt

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319. Mulligan et al., *supra* note 317, at 3.

320. *See id.* at 9.

321. Sara Rosenbaum et al., *The Value of the Nonprofit Hospital Tax Exemption Was $24.6 Billion in 2011*, HEALTH AFFS., July 2015, at 1225, 1231.

322. *See* STAFF OF JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010,"AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 78 – 79, JCX-18-10 (citing Rev. Rul. 69-545 for the proposition that "community benefit can include . . . an emergency room . . . an independent board of trustees composed of representatives of the community . . . an open medical staff policy . . . charity care; and utilizing surplus funds to improve the quality of patient care, expand facilities, and advance medical training, education and research").

323. *See* Hossein Zare et al., *Comparing the Value of Community Benefit and Tax-Exemption in Non-Profit Hospitals*, 57 HEALTH SERV. RESEARCH 270, 282 (2022); *see also* Michael D. Rozier, *Nonprofit Hospital Community Benefit in the U.S.: A Scoping Review From 2010 to 2019*, FRONTIERS PUB. HEALTH, Mar. 2020, at 1, 8.

324. Gray, *supra* note 315, at 25; *see also* BRADFORD H. GRAY, THE PROFIT MOTIVE AND PATIENT CARE: THE CHANGING ACCOUNTABILITY OF DOCTORS AND HOSPITALS (Harv. Univ. P. 1993).

325. Horwitz, *supra* note 318, at 165, 171.

326. *Id.* at 173.

327. *See infra* Table 6.

organizations.[328] In terms of free care, the government hospitals are the most charitable.[329] These characteristics are quantified in Table 6 below.

Meanwhile, many hospitals of world renown are non-profits.[330] In turn, they may be affiliated with cutting edge tax-exempt medical colleges.[331] In the healthcare industry, critics have opposed proposals to increase government involvement.[332] Yet the proposal to transition to non-profit from for-profit form poses no reason to believe that patient care would suffer.

Table 6. Levels of Charity Care by Hospital Types (Fiscal Year 2012)[333]

Element ($000)	For-profit	Tax-Exempt	Government
Cost of charity care	1,539,232	12,861,600	10,144,615
Total operating expenses	109,955,939	574,568,780	138,960,813
Share of operating expenses (%)	1.40	2.24	7.30

F. *Pharmacy and Health Services*

Similarly, allied health services can operate in non-profit as well as for-profit form. Historically, the "manufacture and marketing of pharmaceuticals and medical equipment have . . . been predominantly organized on a for-profit basis."[334] Nevertheless, courts have confirmed that a pharmacy can function as a non-profit. In one case, "pharmacy sales to private patients of the doctors [were] substantially related to the provision of hospital service [by an exempt organization] and therefore not taxable under section 511 of the Code . . . ."[335] In other words, retail pharmacy need not be an unrelated business in a non-profit context. For the purposes of the instant proposal, the transition to non-profit from for-profit business need not diminish the accessibility of medical supplies.

Likewise, health insurance may be offered on a non-profit as well as for-

328. *See* I.R.S. Report to Congress on Private Tax-Exempt, Taxable and Government-Owned Hospitals, Tax Analysts Doc. No. 2017-534 (June 2016) [hereinafter I.R.S. Report].

329. *See infra* Table 6.

330. *See U.S. News Best Hospitals*, U.S. NEWS, https://health.usnews.com/best-hospitals (last visited Nov. 10, 2023).

331. *See id.*

332. *See* DS, *supra* note 19, at 696.

333. *See* I.R.S. Report, *supra* note 328, at 4, tbl. 1.

334. Gray, *supra* note 315, at 1.

335. Hi-Plains Hosp. v. United States, 670 F.2d 528, 533 (5th Cir. 1982).

profit basis.[336] In America, one of the biggest health insurers has been the historically non-profit Blue Cross Blue Shield company, to which federal legislation grants special deductions.[337] Moreover, the Internal Revenue Code affords an exemption from income tax for health and welfare plans, formally known as voluntary employees' beneficiary associations (VEBAs) that underwrite life, sickness, accident, or other member payments, but only if no part of the net earnings of the VEBA inures to the benefit of any private shareholder or individual (other than through the insurance payments).[338] Additionally, non-commercial insurance incidental to a health maintenance organization may be tax-exempt.[339] The proposed conversion from a for-profit economy need not undermine the availability of health coverage.

G. Visual And Performing Arts

Traditionally, charity encompassed the visual and performing arts.[340] While artists may perform for art's sake, their work can become profitable. Even then, the courts have sustained the exempt status of galleries and theaters that maintain an artistic rather than profit motive.[341] In one non-profit gallery, the Tax Court found it "significant that the works are chosen not for their salability but for their representation of modern trends."[342] In a case involving a non-profit theater troupe, the court upheld the tax exemption even though one production had private investors who were not officers or directors of the troupe itself.[343] These cases exemplify the operation of non-profits in an industry that may, but need not, be profitable.

H. Utilities

Utilities are another industry that may be organized either publicly or privately. Water, power, and the like may run under the supervision of the government, a for-profit, or a non-profit company. Federal tax exemptions exist for mutual or cooperative irrigation, telephone, or electric companies if 85 percent or more of their income is collected from members solely for losses and expenses.[344] In a non-profit economy, public works would not be captured by private interests.

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336. *See* Gray, *supra* note 315, at 1.
337. *See* I.R.C. § 833(c).
338. *See* I.R.C. § 501(c)(9).
339. *See* I.R.C. § 501(m)(3)(B).
340. *See* Treas. Reg. § 1.501(c)(3)-1.
341. *See generally* Goldsboro Art League, Inc. v. Comm'r, 75 T.C. 337 (1980).
342. *Id.* at 344.
343. *See generally* Plumstead Theatre Soc'y v. Comm'r, 675 F.2d 244 (9th Cir. 1982).
344. *See* I.R.C. § 501(c)(12).

I. Financial Services

Although Wall Street is emblematic of capitalism, non-profits render significant financial services. The behemoth institutional investors comprise tax-exempt retirement trusts that may be qualified plans, individual retirement accounts, or various non-profit funds.[345] In 2020, almost 747,000 ERISA plans held $11.909 trillion in assets for more than 142,000 pensioners, employees, or other participants.[346] Tax-exempt entities, therefore, weigh heavily on the financial market.

Additionally, various types of tax-exempt funds relate to employment and insurance. Publicly-funded local teachers' retirement associations may be tax-exempt where no part of their net earnings inures to the benefit of any private shareholder or individual (other than through the retirement payments).[347] Also exempt is a trust for the payment of supplemental unemployment compensation benefits.[348] Similarly, tax exemption applies to non-commercial insurance carriers that offer retirement and welfare benefits, or property and casualty insurance, to a church or other house of worship, or below-cost insurance to charitable beneficiaries.[349] Locally, benevolent life insurance associations may be tax-exempt where virtually all of their income is collected from members to meet losses and expenses.[350] Likewise, small or mutual property and casualty insurers are tax-exempt below statutory ceilings on gross receipts, a prescribed percentage of which consists of premiums.[351] While these entities tend to be smaller than the institutional investors, they may be woven into the social fabric of local employers and civil society.

Beyond insurance, a full range of banking services may be offered by federal or state-chartered credit unions. In general, these are "without capital stock organized and operated for mutual purposes and without profit."[352] As the courts have confirmed, credit unions are "cooperative financial institutions formed by their members for their members."[353] Exemplifying a non-profit ethos, the credit union "and its capital are owned by the members;

345. *See* I.R.C. §§ 401, 408.

346. *See* EMP. BENEFITS SEC. ADMIN., PRIVATE PENSION PLAN BULLETIN: ABSTRACT OF 2020 FORM 5500 ANNUAL REPORTS 3, tbl. A1 (2022).

347. *See* I.R.C. § 501(c)(11).

348. *See* I.R.C. § 501(c)(17).

349. *See* I.R.C. § 501(c)(17).

350. *See* I.R.C. § 501(c)(12).

351. *See* I.R.C. § 501(c)(15).

352. I.R.C. § 501(c)(14)(A).

353. Bellco Credit Union v. United States, 735 F. Supp. 2d 1286, 1288 (D. Colo. 2010).

it has no shareholders. This means that any profits . . . are used to benefit the members. The profits are used, for example, to pay higher rates to depositors, to offer lower rates to borrowers, or to offer additional member services."[354] The credit union "is not permitted to pay interest on its deposit accounts unless it has profits."[355] In the case of certain financial products offered by credit unions, the applicability of UBIT confirms that the non-profit model is competitive with commercial banks.[356] This is true even in finance, the lifeblood of the for-profit economy.

J. Professional Services

Along with financial services, non-profits may also render professional services. Currently, law firms advocating for the public interest may be tax-exempt. They may even charge attorney fees to indigent clients, as long as the "fees are based upon the indigents' limited abilities to pay rather than the type of service rendered."[357] However,

> attorneys' fees will be paid to the organization, rather than to individual staff attorneys. All staff attorneys and other employees will be compensated on a straight salary basis, not exceeding reasonable salary levels and not established by reference to any fees received in connection with the cases they have handled.[358]

No lawyer would draw a partner's share as in a for-profit firm. Theoretically, this avoids the distortionary effect of the profit motive on the priorities of professionals.[359] Under the non-profit proposal, any excess over reasonable compensation and other costs, resulting from settlement or otherwise, would remain at the entity level where it redounds to the productivity of the firm. For purposes of the proposed transition from for-profit organization, the public-interest firm may serve as a model.

K. Real Estate

Typically, real estate is a commercial enterprise in the market economy. Nevertheless, there are non-profit aspects. Historically, planned

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354. *Id.*

355. *Id.*

356. *See id.* at 1298; *cf.* Morgan Ricks et al., *Central Banking for All: A Public Option for Bank Accounts*, Gr. Democracy Initiative, Roosevelt Inst. (June 2018) (proposing a federal alternative to commercial banks).

357. Rev. Rul. 78-428, 1978-2 C.B. 177, 1978 IRB LEXIS 173, at *2.

358. Rev. Proc. 92-59 § 4.07, 1992-2 C.B. 411, 1992 IRB LEXIS 346, at **8–9.

359. *See generally* Kathryn A. Sabbeth, *What's Money Got to Do with It?: Public Interest Lawyering and Profit*, 91 DENV. UNIV. L. REV. 441 (2014) (discussing motives of public interest lawyering).

communities operated on a non-profit basis.[360] Since 1976, homeowner associations have been tax-exempt, even if they are not charitable.[361] With exempt status, charities may offer low-income housing "for resale at cost."[362] They may offer mortgage loans to needy borrowers to underwrite homeownership in communities that otherwise would face deterioration.[363] Non-profit realty programs like these would accommodate low- and moderate-income homeowners, serving those who otherwise might face homelessness. This illustrates how the non-profit proposal could advance economic equality. By its nature, the for-profit enterprise caters to the high-income customers, who can afford the biggest margins, while neglecting the needy.

L. Retail Sales

Typically, retail shops are owned by sole proprietors as well as mid-size or large corporations. Nominally for-profit, small mom-and-pop shops may operate at cost, allowing for the proprietor's salary.[364] As discussed above, some stores are run on a cooperative or non-profit basis. In one case, a

> corporation was organized, without capital stock, to conduct a general book and supply store, dealing in books, magazines, stationery, student supplies, emblems, and sporting goods, and to operate a cafeteria and restaurant on the campus of a State university for the convenience of its student body and the members of its faculty.[365]

The store (including the food service here) was distinguished by affiliation with a non-profit institution. Nevertheless, it shows that there is nothing inherent in retail operation that requires the for-profit form.

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360. *See, e.g.*, Columbia Park & Recreation Ass'n v. Comm'r, 838 F.2d 465, 465 (4th Cir. 1988) ("Since 1970, the Association [a nonstock, not-for-profit corporation] has been recognized by the Internal Revenue Service as a tax exempt 'social welfare' organization pursuant to § 501(c)(4) of the Internal Revenue Code.").

361. *See* I.R.C. § 528.

362. Rev. Rul. 67-138, 1967-1 C.B. 129, 1967 IRB LEXIS 363, at *1.

363. Rev. Rul. 68-655, 1968-2 C.B. 213, 1968 IRB LEXIS 182, **2–3.

364. *See* Vijay Govindarajan et al., *The Gap Between Large and Small Companies Is Growing*, HARV. BUS. REV. (Aug. 16, 2019), https://hbr.org/2019/08/the-gap-between-large-and-small-companies-is-growing-why (explaining that "the median profit margin of the small companies turned *negative* during 2015-2017"); John Haltiwanger, Commentary, *What Do Small Businesses Do?*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2011, at 73, 119 (explaining that "small business owners often suggest that their motive for being a sole proprietor is to 'be one's own boss' rather than a profit motive per se.").

365. Rev. Rul. 58-194, 1958-1 C.B. 240, 1958 IRB LEXIS 398, at *1.

M. Manufacturing and Food Production

Typically, manufacturing and food production, not generally exempt functions, are for-profit.[366] Nevertheless, non-profits have operated within these essential industries. For a period after the Second World War, a staple food brand was owned by a corporation that merged into a public charity.[367] The federal appeals court felt it was obvious that the non-profit remained charitable.[368] Consequently, the court upheld the tax exemption of the New York University law school although it had taken over the Mueller macaroni business — apparently, the commercial kitchen did not overwhelm the educational operation.[369] This case was later superseded by the enactment of UBIT, as discussed above.[370] Following the enactment of that legislation, a charity that directly conducted manufacturing or the like would incur tax on the resulting unrelated business income in any case.[371] Meanwhile, the historical event confirms that manufacturing could continue when the profits were directed to the public interest.

Recently, Congress expanded the ability of a charity to own and operate a factory. For the past half century, a federal excise tax has effectively precluded foundations from owning businesses.[372] As discussed above, the legislative concern was that the profit motive might overshadow the non-profit mission.[373] In 2018, Congress carved an exception out of the rule.[374] This applies where the foundation owns all the stock of the business, which donates all the profits to the foundation, while the foundation and the business have different directors on their respective boards.[375] Where the business is incorporated for manufacturing or similar purposes, it will be a corporation taxable for federal purposes even if it donates all net income to the foundation.[376] Generally, a corporation may deduct up to 10 percent of

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366. "[T]he manufacture and sale of commercial items as an end in itself does not constitute a charitable purpose," Rev. Rul. 73-128, 1973-1 C.B. 222, 1973 IRB LEXIS 522, at *4.

367. *See* C.F. Mueller Co. v. Comm'r, 190 F.2d 120, 120–21 (3d Cir. 1951).

368. *Id.* at 122 (stating: "It is clear that we are not here dealing with a corporation the purpose of which is to benefit, directly or indirectly, private interest").

369. *See id.* at 123.

370. *See supra* Part V.D.

371. *See* I.R.C. § 511.

372. *See* I.R.C. § 4943.

373. *See supra* Part V.D.

374. *See* Bipartisan Budget Act of 2018, Pub. L. No. 115-123, § 41110, 132 Stat. 159 (2018).

375. *See* I.R.C. § 4943(g) (allowing an exception for an independently-operated philanthropic business).

376. *See* Rev. Rul. 73-128, 1973-1 C.B. 222, 1973 IRB LEXIS 522.

adjusted gross income as a charitable contribution.[377] On receipt of the donation, the foundation is tax-exempt, and in any case, gifts are excluded from gross income.[378] If the foundation receives dividends, these are excluded from UBIT as passive income.[379] This philanthropic legislation establishes a new model for non-profit business.

Reportedly, the primary beneficiary of the legislation was a celebrity.[380] The late movie star Paul Newman had established an eponymous sauce bottling company whose products were labeled "all profits to charity."[381] Similarly, other companies have converted. Particularly, the non-voting stock of the sportswear manufacturer Patagonia is now owned by an environmental non-profit.[382] Freed from the dogma of shareowner maximization, the company pursues "employee wellbeing" and prioritizes "sustainability over profits."[383] Business analysts observe that "despite claims that firms will flounder without human owners and 'market discipline,' foundation-owned firms have similar (and in some cases superior) financial performance compared with their investor-owned counterparts."[384] The for-profit corporation remains a taxable business whose managers are dedicated to manufacturing.

Now, charities can own manufacturing operations or other for-profit businesses. Subject to certain excise taxes, private foundations must stay within prescribed limits that public charities need not.[385] Where the business pays income tax at the corporate level, the charity may receive dividends exempt from UBIT.[386] To be clear, the unrelated trade or business must

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377. *See* I.R.C. § 170(b)(2)(A).

378. *See* I.R.C. § 102(a).

379. *See* I.R.C. § 512(b)(1).

380. Rob Meiksins, *The Newman's Own Philanthropic Exception Is Now Law—What Will the Consequences Be?* NPQ (Mar. 30, 2018), https://nonprofitquarterly.org/newmans-philanthropic-exception-now-law-will-consequences/.

381. *Id.*

382. *See* Arthur Gautier & Joel Bothello, *Corporate Governance: What Happens When a Company (Like Patagonia) Transfers Ownership to a Nonprofit?*, HARV. BUS. REV. (Oct. 10, 2022), https://hbr.org/2022/10/what-happens-when-a-company-like-patagonia-becomes-a-nonprofit#:~:text=In%20some%20cases%2C%20a%20foundation,the%20equity%20and%20philanthropic%20activities.

383. Grace Dean, *Patagonia's Founder just Gave Patagonia Away*, BUS. INSIDER (Sept. 22, 2022), https://www.businessinsider.nl/patagonias-founder-just-gave-the-company-away-the-latest-unusual-step-in-a-history-of-corporate-innovations-from-being-an-early-adopter-of-paid-parental-leave-to-donating-145-million-to-the/.

384. Gautier & Bothello, *supra* note 382.

385. *See* I.R.C. § 4943.

386. *See* I.R.C. § 512(b)(1).

remain less than a substantial portion of the exempt organization's activity.[387] Recently legislated, the exception from the foundation tax on excess business holding works toward to the proposal presented here.

Under pre-existing law, when brand-name manufacturers effectively choose a non-profit structure, the concerns from TRA '69 may return.[388] Historically, business dynasties had held stock positions inside foundations to perpetuate corporate control while shedding excess wealth.[389] Today, commentators confirm the undesirability of a loophole that would permit wealthy individuals to avoid tax on the growth of their equity while retaining effective oversight.[390] By contrast, the 2018 legislation requires the foundation to own all the stock of the corporation, in which the dynasty cannot retain a profit share.[391] Under the instant proposal, all corporations would become non-profits.

Conceptually, the key is the separation of the equity owners from the managers. Theoretically, the business corporation was premised on the separation of ownership from control.[392] Factually, the major shareowners interlocked with the chief executives of the for-profit corporations.[393] Practically, the facts need to be reconciled with the theory. Consequently, this Article proposes that the factory managers would be compensated for their work, but not for any ownership. Under the proposal, the profit could be donated to charity but otherwise would remain in the corporate treasury for allocation to productive costs.

N. Summary

Currently, non-profits produce quality goods and services. These extend beyond traditionally charitable industries such as the arts and sciences. As non-profits already conduct some commerce, sales, and marketing, their role can expand. The proposed expansion of the non-profit model should be welcomed by productive people who want to be freed from the dogma of the profit motive.

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387. *See* Rev. Rul. 66-221, 1966-2 C.B. 220 (allowing merely "incidental" unrelated business).

388. *See supra* Part V.D.

389. *See id.* (explaining legislative concern for foundations more interested in competition and business success than in charitable activities).

390. Aaron Dorfman, *Is Donating Your Company to a Foundation or Nonprofit a Desirable Trend?*, NAT'L COMM. RESPONSIVE PHILANTHROPY (Feb. 6, 2023), https://www.ncrp.org/2023/02/company-donation-trend-questioned.html.

391. *See* I.R.C. § 4943(g)(2)(A).

392. *See supra* Part III.D.

393. *See id.*

VII. THE PROPOSAL

A. *Overview*

To support an egalitarian economy, this Part proposes a fundamental reform of private property. Historically, communist countries nationalized corporations in an attempt to abolish private property.[394] Some of these bureaucratic attempts proved unproductive while others were abandoned.[395] In post-modern economies, corporate stock along with realty persists as the major form of wealth.[396] By expanding the non-profit model into industries now dominated by the stock market, the proposal would perpetuate the productivity of private enterprise while avoiding the accumulation of personal wealth. This is an alternative form of corporate ownership.

The proposal would recycle profit. Productive companies could continue to operate, but not distribute dividends to private stockowners. Net earnings would remain in the corporate treasury for the expenses of the enterprise. As under current law, the corporation could donate a portion or all the profit to charity.[397] Workers and managers alike would receive compensation commensurate with their work. Ownership of the corporation would not be the goal.

The non-profit proposal would retain private management. This would not guarantee employee control, which has not generally been able to attain a great economy of scale.[398] Worker control was a goal of cooperatives formed as a reaction against corporate capitalism.[399] Since then, cooperatives have persisted on the margins of capitalist and communist economies.[400] By design, cooperatives have remained relatively small, out of the commercial mainstream.[401] As proposed here, there need be no reduction in cooperatives. The proposal attempts to retain the corporate scale economy.

As proposed, the non-profit would be under the influence of stakeholders. These would include customers, members, regulators, or other constituents

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394. *See supra* Part III.F.

395. *See supra* Parts II.A, V.A.

396. *See* FA, *supra* note 21, at 319.

397. *See* I.R.C. § 170(b)(1)(B).

398. *See supra* Part III.C.

399. *See supra* Part III.B.

400. *See supra* Part III.B (describing the market segment of cooperatives today).

401. *See* ROSA LUXEMBURG, SOCIAL REFORM OR REVOLUTION § II, ch. VII (1900) ("[W]orkers forming a co-operative . . . are obliged to take toward themselves the role of capitalist entrepreneur—a contradiction that accounts for the usual failure of production co-operatives which either become pure capitalist enterprises or, if the workers' interests continue to predominate, end by dissolving.").

including, but not limited to, labor. A requirement of labor representation on corporate boards as exemplified in Northern Europe would complement the proposal.[402] Where state legislatures authorize the issuance of stock by non-profit corporations, this could persist as long as the stockholders are not entitled to net earnings.[403] For example, private stockholders could vote on corporate resolutions to clarify the collective interest. Thus, the proposal would differentiate mission control from pecuniary ownership. The various stakeholders would influence managerial efficiency.

This proposal does not directly address real property. To the extent that commercial realty may be held in corporate form, the proposal would apply. On the other hand, residences may be individually owned.[404] The thrust of the proposal is at capital, not homes. A home is one of the most common forms of wealth among the populace.[405] Traditionally, homes remained private even in communist countries.[406] Among the rich, a home may be an investment as well as a shelter. Yet riches will be largely addressed outside the home.

Commercially, realty may be held by various other forms as well. These include individual landlords, management partnerships, investment trusts, or pass-through entities.[407] To the extent that the entity assumes a corporate function or serves as a vehicle for passive investment, it should fall under the proposed reform of for-profits. If the landlord is an individual or active partner, a reform of private property could take another form. In particular, excess accumulation of wealth in land can be addressed through property taxes, commonly assessed at the local level, or the county in the U.S.[408] Generally, local property taxes support public elementary and high schools, a common good.[409] Property tax reform would complement the proposal for non-profit corporate ownership.

B. *Taxation of Earnings and Investments*

Under the proposal, virtually all corporations would become non-profits. Under current law, non-profits enjoy tax exemption, essentially subsidizing their charitable works or other common goods.[410] If businesses convert to

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402. *See supra* Parts II.G, III.D.
403. *See supra* Part V.C.
404. *See* FA, *supra* note 21, at 316.
405. *See id.*
406. *See supra* Part III.F.
407. *See, e.g.*, I.R.C. § 856.
408. *See* FA, *supra* note 21, at 316.
409. *See* DS, *supra* note 19, at 697.
410. *See supra* Part V.D.

non-profit form, there are three options for their tax status, namely retaining taxability, expanding exemption, or taxing investment income, as discussed in the three paragraphs below.

On one hand, private enterprise does not deserve tax exemption. Even if legislation created a new exemption, the concept of UBIT could apply to non-charitable activity.[411] As long as corporations continue to play the role of private actors in the marketplace and even civil society, they should also be taxpayers.[412]

On the other hand, the corporate income tax arguably exceeds the measure of taxpayers' ability to pay.[413] By some reckoning, corporate tax comprises double taxation of the shareowners' capital income.[414] Historically, the corporate tax made income taxation more progressive overall.[415] Since the proposal would drastically reduce capital income to shareowners, the corporate tax may no longer be necessary. To reiterate, the redistributive effect of the corporate tax may no longer be necessary if the source of private wealth recedes. Moreover, exempt status would be an incentive to convert to non-profit form.

On balance, there are arguments for and against continued taxation of corporate net earnings from activity that is not charitable or traditionally exempt. Meanwhile, the proposal assumes that profit will accumulate in the corporate treasury, where it would produce investment income. As under current law, interest-bearing accounts would persist. In that case, the argument for tax exemption is less sympathetic. Under current law, even private foundations and university endowments pay tax on investment income.[416] Under the proposal, businesses that convert to non-profit form should continue to pay tax at least on investment income.

C. *Enforcement Against Private Inurement*

Fundamentally, the proposal would supplant private ownership of corporate enterprise. Nonetheless, certain aspects could be implemented more gradually than others. In the first place, industries already dominated by non-profits, such as education and healthcare, should readily transition from private ownership to the extent that it persists.[417] Likewise, industries

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411. *See* I.R.C. § 511.

412. *See supra* Part IV.D.

413. *See id.*

414. *See id.*

415. *See* FS, *supra* note 6, at 75–76.

416. *See supra* Parts V.D, VI.C (discussing I.R.C. sections 4940 and 4968, respectively).

417. *See supra* Parts VI.C, VI.E.

inherently tied to public goods or public works such as utilities should naturally convert to the non-profit model.[418] For industries dominated by business dynasties, additional transition may be in order. In particular, an enactment of significant taxes on capital, reversing current preferences, could reduce entrenched interests while advancing economic equality.[419] As suggested above, the taxation of wealth would complement the proposal for non-profit ownership of corporations. The reduction of riches can be more or less gradual.

The proposal can be adopted through the democratic process. In itself, the proposal consists of legislative policy to be enacted in corporate and tax law. Potentially, opponents would resist even if duly enacted. As recently shown, armed insurrection is possible even in advanced democracies.[420] At the same time, the grinding poverty, overt and covert oppression suffered by the masses under the proprietarian economy constitutes the violence of the status quo.[421] Although the proposal is self-contained, its implementation would disrupt private property and the status quo.

Because the proposal consists of discrete propositions applicable to different industries, some parts may be implemented even while others are not.[422] While the proposal is for fundamental change, the component parts have analogies to current law. Thus, the proposal is a radical reform.

If the proposal were adopted, it would require enforcement. Under current law, charities and other non-profits should not award net earnings to private individuals or shareowners.[423] Federal revenue agents and state attorneys general strive to detect and prosecute transgressions. In Fiscal Year 2021, more than fifteen hundred I.R.S. employees comprised a division that examined fewer than ten thousand returns of a couple million exempt organizations, retirement plans, government entities, tax-exempt bond issuers, and related filers.[424] In that same year, the I.R.S. examined 0.92

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418. *See supra* Part VI.H.

419. *See* FA, *supra* note 21, at 324.

420. *See, e.g.*, SELECT COMM. TO INVESTIGATE THE JAN. 6TH ATTACK ON THE U.S. CAPITOL, FINAL REPORT, H. Rep. No. 117-000 (2022).

421. *See* Barbara Deming, *On Revolution and Equilibrium*, LIBERATION, Feb. 1968 ("what Russell Johnson calls accurately 'The violence of the status quo . . . .'"); William Eckhardt, *Symbiosis Between Peace Research and Peace Action*, 8 J. PEACE RSCH. 67, 68 (1971); David Levine, *The Violence of the Status Quo*, 41 J. BRIT. STUD. 511, 517–19 (2002).

422. *See supra* Part II.G (explaining that social revolution has been partial and incremental historically).

423. *See supra* Part V.B.

424. *See* Message from the Tax-Exempt and Government Entities (TE/GE) Commissioners 2, Pub. 5329 (2021); *see also* I.R.S. DATA BOOK, *supra* note 269, at 53, tbl. 21.

percent of corporation returns filed for Tax Years 2011 through 2019.[425] If focused on the most egregious offenses, limited but exemplary enforcement can have an effect.

The proposal would dramatically expand the regulated sector. Consequently, the government would need an increased enforcement capability, especially if corporations did not willingly convert to non-profit form. At the same time, the agencies currently devoted to securities regulation and the like presumably would change direction after the effective abolition of stock issuance. Under the Securities and Exchange Act of 1934, the Securities and Exchange Commission deploys a staff of forty-five hundred to enforce order in the stock market and related financial arena.[426] Ideally, voluntary compliance would become the norm if executives receive tangible and intangible satisfaction from their productive work.

D. *Economy of Prestige*

Among others, the proposal seeks to solve the following problem. In pertinent part, excess accumulation occurs where shareowners use the corporate economy of scale to extract wealth disproportionate to their actual work as executives or otherwise.[427] Technically, the proposal would eliminate equity ownership. Consequently, the component of executive compensation attributable to stock (or options thereon) would dissipate.[428] Meanwhile, the limitations on executive pay effectuated in large part through taxation could persist.[429] The question is who needs to be paid beyond reasonable compensation.

Where compensation exceeds necessity, it appears to be feeding needs beyond the economic, such as the emotional.[430] While there may be no cap on the desire for prestige, that could be satisfied by intangible rather than pecuniary measures.[431]

In economic anthropology, the oddity would be as follows. Despite the diversification in the modern economy, "the money medium flattens all achievements into a potentially infinite quantity."[432] Ironically, anthropologists have observed that accumulation for its own sake occurs in

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425. *See* I.R.S. DATA BOOK, *supra* note 269, at 33.

426. *See* I.R.C.§ 78d; SEC, FY 2022 Agency Financial Report 7 (stating "the SEC employed 4,547 full-time equivalents").

427. *See supra* Part III.D.

428. *See supra* Part III.D.

429. *See supra* Part III.D.

430. *See* FG, *supra* note 26, at 416.

431. *See supra* Part VI.B.

432. FA, *supra* note 21, at 313.

rich nations, leaving the populace "generally poor," whereas "in poor nations the people are comfortable."[433] By the same token, poverty "is not a certain small amount of goods, nor is it just a relation between means and ends; above all it is a relation between people."[434] As discussed above, private property consists of the legal exclusion of economically undesirable persons parallel to the ritual exclusion of culturally undesirable persons.[435] Particularly in a pecuniary economy, private property distorts personal priorities.

Traditionally, leaders had achieved prestige by giving rather than receiving. To surmount rivals, a tribal chieftain who gained access to surplus could distribute items "so as to transform into persons having an obligation" those rivals who previously had turned him into a debtor.[436] Under the non-profit proposal, management and labor would achieve satisfaction by producing quality goods with craftsmanship, harking back to artisanal values.

VIII. CONCLUSION

To help create an egalitarian economy, this Article proposes to expand the scope of the non-profit corporation. In itself, the proposal can be enacted by legislative amendment to corporate and tax law. Recently, state and federal legislators enacted corporate reform in the case of the L3C and of the exception to the excise on excess business holding.[437] Although the effects of these acts were modest, they add to the earlier precedents from Northern Europe that effectuated significant reform of corporate ownership.[438] To the extent that legislatures may not accept all aspects of the proposal, they nonetheless can implement parts.[439] For instance, legislators could focus on eliminating for-profit abuses among institutions such as colleges and hospitals.[440] Gradually, the egalitarian benefits of the non-profit model could proliferate by radically reducing wealth accumulation through mere stockownership rather than work.

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433. MARSHALL SAHLINS, STONE AGE ECONOMICS 2 (1972).

434. *Id.* at 37.

435. *See supra* Part II.C.

436. MARCEL MAUSS, THE GIFT: THE FORM AND REASON FOR EXCHANGE IN ARCHAIC SOCIETIES 47 (transl. W.D. Halls 1990) (1950); *see also* Paolo Silvestri, *Anthropology of Freedom and Tax Justice: Between Exchange and Gift. Thoughts for an Interdisciplinary Research Agenda*, 2 TEORIA E CRITICA REG. SOC. 115 (2015) (applying reciprocal theory to fiscal policy).

437. *See supra* Parts V.H, VI.M.

438. *See supra* Parts II.G, III.D.

439. *See supra* Part II.G.

440. *See supra* Parts VI.C, E.

Perpetuating private management, the proposal would not accomplish worker control of the means of production. Historically, the division of labor orchestrated by dedicated managers achieved the economy of scale memorialized by the monuments of civilization.[441] To the extent that autonomous production is efficient, it has been institutionalized by cooperatives in limited markets.[442] In any case, the proposal contains no change to the law of cooperatives.

Finally, the proposal leaves several questions open. Rather than a teleologically inevitable total revolution, the proposal assumes incremental historical change.[443] Theoretically, any state could enact legislation to delimit for-profits as non-stock corporations, diminishing the capital markets. Presumably, private investment would be superseded by public funds. Current shareowners could receive compensation through a variety of legislative or contractual measures, such as a transition rule that preserves pre-existing positions subject to potential wealth taxation, conversion of equity into debt obligations (*i.e.*, corporate bonds), or stock buy-back in some cases. The institutional investment held by private pension trusts, already tax-exempt, potentially would recede in favor of public pensions.[444] Meanwhile, an expanded class of non-profit industries would continue to pay tax on employment (*i.e.*, social insurance) and at least capital income.[445] Given the necessarily partial nature of socioeconomic transformation, the proposal for non-profit production is not prescriptive.

Fundamentally, the proposal would curtail aspects of private property by extinguishing the shareownership of corporate wealth. Like any call for the appropriation of entrenched interests, the proposal may engender resistance. At the high end, consumption satiation may afford support from generous elites who have already entered philanthropy as an intangible means of personal expansion.[446] Yet the proposal would not address the underlying impulse for privatization that stems from the popular, if oxymoronic, desire for exclusive belonging.[447] In capitalist and communist regimes alike, what has transcended economic ideologies is the people's instinctive allegiance to

441. *See supra* Part III.C.

442. *See generally* RICHARD D. WOLFF, DEMOCRACY AT WORK: A CURE FOR CAPITALISM (2012).

443. *See supra* Part II.G.

444. *See supra* Part VI.I.

445. *See supra* Parts V.D, VII.B.

446. *See* FG, *supra* note 26, at 415 (discussing "consumption satiation"); *cf. Open Letter from Millionaires and Billionaires Calls for Wealth Taxes*, PHILANTHROPY NEWS DIGEST (Jan. 21, 2022), https://philanthropynewsdigest.org/news/open-letter-from-millionaires-and-billionaires-calls-for-wealth-taxes.

447. *See supra* Part II.D.

totemic identities that exclude others who are culturally marked.[448] Hopefully, the circumscription of the legal mechanism for widespread individual ownership would prevent the exclusive impulse from transmuting into excess wealth and utter poverty.

448. *See* FS, *supra* note 6, at 99; *see also* JONATHAN HAIDT, THE RIGHTEOUS MIND 219–55 (2012); *e.g.*, Joseph Menn, *Attacks on U.S. Jews and Gays Accelerate as Hate Speech Grows on Twitter*, WASH. POST (Jan. 24, 2023, 7:00 AM), https://www.washingtonpost.com/technology/2023/01/18/hate-speech-antisemitism-antigay-twitter/.

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THE SECRET'S OUT: THE ROLE OF RESTRICTIVE COVENANTS IN TRADE SECRET LAW

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I. INTRODUCTION

Trade secrets derive economic value from their classified nature, which leads companies to implement legal measures to prevent the spread of their

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confidential company information to the public.[1] Restrictive covenants within employment agreements are a common form of these legal measures.[2] However, because of employers' restrictive terms, states are placing regulations on the scope of these agreements.[3] With limited ability to contract their employees away from sharing their confidential information with direct competitors, companies utilize alternate methods to protect their trade secrets.[4]

Trade secret law is most commonly codified in state law with the language of the Uniform Trade Secrets Act (UTSA).[5] To succeed on a trade secret misappropriation claim, the plaintiff must establish the existence of a trade secret under the definition set forth by the UTSA.[6] One element of this definition requires the plaintiff to prove that it made reasonable efforts to maintain the secrecy of the alleged trade secret.[7] Documentation such as restrictive covenants serves as one form of evidence in establishing the plaintiff's reasonable efforts.[8] Statutory regulation of these agreements may require courts to alter their interpretation of this UTSA element because fewer legal measures are available to the plaintiff in the protection of its trade secrets.[9]

Part II of this Comment will provide an overview of trade secret law and restrictive covenants. Part III of this Comment will compare courts' analyses of a plaintiff's reasonable efforts and the evidence it offered in support of

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1. *See* William M. Corrigan, Jr. & Jeffrey L. Schultz, *Trade Secret Litigation — An Updated Overview*, 71 J. MO. B. 18, 23 (2015).

2. *See* Tom Spiggle, *President Biden's Recent Executive Order Takes Aim at Non-Competes*, FORBES (Jul. 16, 2021, 10:53 AM), https://www.forbes.com/sites/tomspiggle/2021/07/16/president-bidens-recent-executive-order-takes-aim-at-non-competes/?sh=187d76942cc4.

3. *See, e.g.*, *id*; *see also* Chris Marr, *Employee Noncompete Clause Limits Adopted by Three More States*, BLOOMBERG L. (June 29, 2021, 5:30 AM), https://news.bloomberglaw.com/daily-labor-report/employee-noncompete-clause-limits-adopted-by-three-more-states (discussing the adoption of noncompete limits in Oregon, Nebraska, and Illinois).

4. *See* 1 ROGER M. MILGRIM & ERIC E. BENSEN, MILGRIM ON TRADE SECRETS § 1.04 (2021) (discussing limitations against sharing trade secrets under common law tort claims).

5. *But see* 141 AM. JUR. 3D *Proof of Facts* § 2, Westlaw (database updated August 2022) (comparing UTSA variations amongst states).

6. *See* UNIF. TRADE SECRETS ACT § 1(4) (UNIF. L. COMM'N 1985); RUSSELL BECK, TRADE SECRETS LAW FOR THE MASSACHUSETTS PRACTITIONER (MCLE) § 2.2.1 (2019).

7. *See* UNIF. TRADE SECRETS ACT § 1(4)(ii).

8. 152 AM. JUR. 3D *Proof of Facts* § 4, Westlaw (database updated August 2022).

9. *See* InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020).

this assertion. Finally, Part IV of this Comment will recommend specific business procedures to protect company trade secrets under current regulations. Part IV of this Comment will also consider the effect of a federal ban on restrictive covenants and outline a legislative mechanism to protect the interests of the employer-employee relationship while maintaining the existence of restrictive covenants.

II. THE UNIFORM TRADE SECRETS ACT & RESTRICTIVE COVENANTS

A. *Trade Secrets & the Uniform Trade Secrets Act*

Trade secrets are a form of intellectual property, "a property right in discovered knowledge."[10] Trade secret laws protect information that may not qualify for patent protection but still holds economic value in being kept secret.[11] Legally acknowledging the existence of trade secrets promotes commercial ethics and supports invention by prohibiting the misappropriation of confidential company information and protecting the creator's invested time, money, and labor.[12] State trade secret statutes are commonly a variation of the UTSA language or common law, as reflected in the Restatement of Torts.[13]

The Uniform Trade Secrets Act was first issued in 1979 by the National Conference of Commissions on Uniform Laws.[14] Amended in 1985 to its current form, the UTSA streamlined and expanded the definition of a "trade secret," originally outlined in the Restatement (First) of Torts.[15] Most states and the District of Columbia have adopted some form of the UTSA, and many of these states have modified the language to protect only business information.[16]

10. Microbiological Rsch. Corp. v. Muna, 625 P.2d 690, 696 (Utah 1981) (citing Jewett-Gorrie Ins. Agency, Inc. v. Visser, 531 P.2d 817, 822 (1975)) (stating that a trade secret is a property right so it cannot be appropriated or used without its owner's permission); Corrigan & Schultz, *supra* note 1, at 18.

11. *See* Corrigan & Schultz, *supra* note 1, at 18.

12. Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 481–82 (1974); *see also* AvidAir Helicopter Supply, Inc. v. Rolls-Royce Corp., 663 F.3d 966, 973 (8th Cir. 2011) (explaining that the value in a trade secret is found in keeping the information confidential).

13. *See* BECK, *supra* note 6, at § 2.1.

14. *Id.* § 2.1.2.

15. *Id.*

16. *See id.* (noting that New York is the only state that has not adopted any form of the UTSA).

The UTSA provides:

> (4) "Trade secret" means information, 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.[17]

As noted in the statute's language, the plaintiff must have taken reasonable efforts to maintain the secrecy of the alleged trade secret to succeed on its claim.[18] To determine this element, courts consider the number and types of methods used by the plaintiff to protect the proprietary information.[19] For example, in *QSRSoft, Inc. v. Restaurant Technology, Inc.*,[20] the plaintiff password-protected its alleged trade secrets, restricted public access to its system, and required potential customers to consent to a licensing agreement before providing them with the access codes and passwords.[21] Similarly, in *Rockwell Graphic Systems, Inc. v. DEV Industries, Inc.*,[22] the plaintiff kept its alleged trade secrets in a vault, limited access to the vault and building to authorized employees with identification, and required the authorized employees to sign confidentiality agreements.[23]

Courts use the reasonableness standard to determine whether this element is satisfied, which is usually interpreted in one of two ways: the plaintiff went beyond its everyday efforts to protect the alleged trade secret or made efforts specific to the alleged trade secret.[24] Generally, the fewer efforts the plaintiff has made to protect the information, the less likely the court will rule in the plaintiff's favor.[25] However, the plaintiff is not required to create

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17. UNIF. TRADE SECRETS ACT § 1(4) (UNIF. L. COMM'N 1985).

18. *Id.* § 1(4)(ii); 139 AM. JUR. *Proof of Facts* § 241 (3d ed. 2014).

19. 139 AM. JUR. *Proof of Facts* § 3 (3d ed. 2014).

20. No. 06 C 2734, 2006 WL 2990432 (N.D. Ill. Oct. 19, 2006).

21. *Id.* at *6 ("The evidence shows that QSRSoft is likely to succeed in establishing the existence of valid trade secrets.").

22. 925 F.2d 174, 178 (7th Cir. 1991) (holding that determining whether a plaintiff took reasonable precautions to protect their trade secret requires a balancing of benefits and costs).

23. *Id.* at 177.

24. *See, e.g.*, Titan Int'l, Inc. v. Bridgestone Firestone N. Am. Tire, LLC, 752 F. Supp. 2d 1032, 1042–43 (S.D. Iowa 2010) (interpreting reasonable efforts to extend beyond "general corporate security measures").

25. *See* 139 AM. JUR. *Proof of Facts* § 6 (3d ed. 2014).

an "impenetrable fortress" to prevent competitors from stealing its trade secrets because such a standard would place an unnecessary burden on the plaintiff.[26]

Written agreements are one method utilized by plaintiffs to protect the secrecy of their alleged trade secrets.[27] Courts consider agreements, or the absence of them, more than any other measure during their analysis of the plaintiff's reasonable efforts.[28] The existence of an explicit agreement alone may not satisfy the element, but without one, other efforts are often not enough.[29] Restrictive covenants in conjunction with other security measures are often deemed reasonable efforts by the courts.[30]

B. Restrictive Covenants

Employment agreements outline the rights and expectations of the employer and employee at the outset of their relationship.[31] These agreements commonly place restrictions on the employee's work after their tenure with their current employer has ended.[32] The three major types of employment restrictive covenants are non-compete agreements, non-solicitation agreements, and non-disclosure agreements.[33] These covenants can exist as their own document or a provision of a larger contract.[34]

A non-compete agreement (NCA) places restrictions on an individual's future employment in order to protect company trade secrets and other confidential information.[35] Some employers use NCAs to aggressively limit their employees, ultimately affecting workforce competition.[36] Courts often interpret NCAs in favor of the employee to encourage competition and

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26. E.I. duPont deNemours & Co. v. Christopher, 431 F.2d 1012, 1017 (5th Cir. 1970) ("Reasonable precautions against predatory eyes we may require, but an impenetrable fortress is an unreasonable requirement, and we are not disposed to burden industrial inventors with such a duty in order to protect the fruits of their efforts.").

27. 152 AM. JUR. 3D *Proof of Facts* § 4, Westlaw (database updated August 2022).

28. Pollack, *supra* note 5, § 14

29. 152 AM. JUR. 3D *Proof of Facts* § 4, Westlaw (database updated August 2022).

30. *Id.*

31. GAVRIELA M. BOGIN-FARBER ET AL., MASSACHUSETTS EMPLOYMENT LAW § 2.1 (5th ed. 2020).

32. *See* Jean Murray, *What Is a Restrictive Covenant?*, BALANCE SMALL BUS. (Oct. 27, 2020), https://www.thebalancesmb.com/what-is-a-restrictive-covenant-in-business-law-398201.

33. *Id.*

34. Spiggle, *supra* note 2.

35. *Id.*

36. *Id.* (noting that this practice dissuades employees from changing jobs and leads to wage stagnation).

preclude employers from including provisions unnecessary to the interest of the business.[37]

A non-solicitation agreement (NSA) prohibits an employee from pursuing company employees or clients.[38] The terms in an NSA can overlap with an NCA, impeding the employee's future work.[39] However, unlike an NCA, an NSA does not restrict when and with whom the employee can accept a new position.[40]

A non-disclosure agreement (NDA), also referred to as a confidentiality agreement, is a contract that inflicts liability for the disclosure of confidential information.[41] Companies use NDAs to protect their trade secrets, requiring the presence of a written covenant before disclosing company information to new employees or third parties.[42] Such an agreement serves as notice and often provides the signee with guidance on maintaining the secrets.[43] Courts are more likely to uphold NDAs, as compared to NCAs or NSAs, because they are only an attempt to protect confidential information and do not place any limitations on the employee's future career.[44]

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37. Mark N. Mallery, Member, Kiesewetter Wise Kaplan Prather, PLC, & R. Bradley Mokros, Legal Rsch. Specialist, Kiesewetter Wise Kaplan Prather, PLC, Agreements Not to Compete and Trade Secrets Minimizing the Risks When Hiring Prospective Employees, Address at Georgetown University Law Center Continuing Legal Education 25th Annual Employment Law and Litigation Institute (April 12, 2007), *transcribed in* 2007 WL 5269558, at *2.

38. Mary L. Mikva, *Drafting Confidentiality, Non-Compete and Non-Solicitation Agreements: The Employee's Wish List*, PRAC. LAW., June 2004, at 11, 13 (2004).

39. *See id.*

40. Aaron H. Stanton & John J. Kobus Jr., *Non-Compete vs. Non-Solicitation – Every Business Person Should Know the Difference*, BURKE, WARREN, MACKAY & SERRITELLA, P.C. (Aug. 2, 2010), https://www.burkelaw.com/pressroom-news-Non-compete-vs-Non-solicitation-Every-Business-Person-Should-Know-the-Difference.html.

41. Jeremy H. Coffman, *Protecting Your Startup Client's Intellectual Property and Customer Relationships: The Intersection of Trade Secrets, Confidentiality Agreements, and Covenants Not to Compete*, INTELL. PROP. L. WORKSHOP: IP ISSUES WITH TECH. STARTUPS 5 (Feb. 22, 2017).

42. *Id.*

43. *Id.* at 6 (stating that if an employee is misappropriating a trade secret, a signed NDA can combat any argument that the employee was unaware of the confidentiality of the information).

44. *See* Mikva, *supra* note 38, at 12–13.

C. *Regulation of Restrictive Covenants*

Employment agreements are subject to the laws of contracts, including the requirement of an offer, acceptance, and consideration.[45] However, the enforceability of employment agreements is generally regulated by state law.[46] In recent years, states have implemented legislation placing restraints on the terms of these agreements to combat an imbalance of power between contracting parties.[47]

NCAs must generally include consideration from the employee and be "reasonable."[48] States often evaluate the reasonableness of an agreement in terms of geography, duration, and effect on employer, employee, and public interests.[49] Some states have taken legislative action to limit the scope of NCAs, and three have implemented an overarching ban with few exceptions.[50] Several other states recognize NCAs but limit the type of employee for which they can be required.[51] The Blue Pencil Rule, implemented by states such as North Carolina and Georgia, gives the court discretion to rewrite or wholly strike any overly restrictive provisions and keep the remaining agreement intact.[52]

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45. BOGIN-FARBER ET AL., *supra* note 31, § 2.3.1.

46. Nicholas J. Pappas, *Choice-of-Law Provisions in Restrictive Covenant Agreements*, WEIL, GOTSHAL & MANGES (Oct. 7, 2020), https://www.weil.com/-/media/mailings/2020/q3/employer_update_october_2020.pdf.

47. *See id.* ("During the last 20 months, Maine, New Hampshire, Maryland, Oregon, Washington, and Rhode Island each enacted laws restricting an employer's ability to enforce non-compete agreements."); *see also* Spiggle, *supra* note 2.

48. Mallery & Mokros, *supra* note 37, at *3.

49. *See, e.g.*, Omniplex World Servs. Corp. v. U.S. Investigations Servs., Inc., 618 S.E.2d 340, 342 (Va. 2005) (holding that a NCA is reasonable "if the contract is narrowly drawn to protect the employer's legitimate business interest, is not unduly burdensome on the employee's ability to earn a living, and is not against public policy"); Vantage Tech., LLC v. Cross, 17 S.W.3d 637, 644 (Tenn. Ct. App. 1999) (holding that factors to consider whether a NCA is "reasonable include 'the consideration supporting the agreements; the threatened danger to the employer in the absence of such an agreement; the economic hardship imposed on the employee by such a covenant; and whether or not such a covenant should be inimical to public interest'" (quoting Allright Auto Parks, Inc. v. Berry, 219 Tenn. 280, 409 S.W.2d 361, 363 (1966))).

50. Spiggle, *supra* note 2 (identifying California, Oklahoma, and North Dakota as the three states that have implemented a ban on NCAs); Ian T. Clarke-Fisher et al., *The Ever-Changing Landscape of Non-Compete Agreements – Recent Developments,* ROBINSON+COLE (Sept. 27, 2021), https://www.rc.com/upload/BT-Legal-Update-9-27-21.pdf (noting that D.C. also passed a similar prohibition in January 2021).

51. Spiggle, *supra* note 34 (recognizing that some of these states restrict non-compete agreements from applying to hourly workers or employees that do not meet an income threshold).

52. *E.g.*, Wells Fargo Ins. USA v. Link, 827 S.E.2d 458, 469 (N.C. 2019) ("Under

In July 2021, President Biden issued an executive order calling on the Federal Trade Commission (FTC) to use its statutory authority to "curtail the unfair use of non-compete clauses . . . ."[53] The FTC has since proposed a new rule to generally ban NCAs.[54] This Executive Order is an attempt to boost the U.S. economy by addressing potential inhibitions on competition in the market.[55] Congress also introduced legislation concerning NCAs, most recently with the Workforce Mobility Act and the Freedom to Compete Act.[56]

Few states have adopted legislation explicitly addressing the enforceability of NSAs, but courts typically treat NSAs like NCAs.[57] Some applied the statutory requirements for NCAs, while others employ the common law reasonableness standard.[58] If a jurisdiction is likely to enforce

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the 'blue pencil doctrine,' North Carolina courts may specifically enforce divisible or separable sections of restrictive covenants while striking portions that are unenforceable."); GA. CODE ANN. § 13-8-54(b) (2022) ("[A] court may modify the restraint provision and grant only the relief reasonably necessary to protect such interest or interests and to achieve the original intent of the contracting parties to the extent possible."); *see also* Cassie Holt et al., *Trade Secrets, Non-Competes, and More!*, JD SUPRA (Jan. 14, 2022), https://www.jdsupra.com/legalnews/trade-secrets-non-competes-and-more-6348048/; Roberto Bazzani, *United States: Restricting Restrictive Covenants – What Executive Order 14036 Means for Georgia Employers*, MONDAQ (Jan. 7, 2022), https://www.mondaq.com/unitedstates/employee-benefits-compensation/1148194/restricting-restrictive-covenants-what-executive-order-14036-means-for-georgia-employers.

53. Exec. Order No. 14036, 86 Fed. Reg. 36,987 (Jul. 14, 2021).

54. *See* Press Release, Fed. Trade Comm'n, FTC Proposes Rule to Ban Noncompete Clauses, Which Hurt Workers and Harm Competition (Jan. 5, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/01/ftc-proposes-rule-ban-noncompete-clauses-which-hurt-workers-harm-competition' ("Specifically, the FTC's new rule would make it illegal for an employer to: enter into or attempt to enter into a noncompete with a worker; maintain a noncompete with a worker; or represent to a worker, under certain circumstances, that the worker is subject to a noncompete.").

55. *See* Spiggle, *supra* note 2 (describing the Executive Order's "multi-pronged approach" addressing non-competes as well as "various economic concerns, including unfair data collection, right-to-repair laws, antitrust enforcement and occupational license restrictions.").

56. Workforce Mobility Act of 2021, H.R. 1367, 117th Cong. (2021) (narrowing the applicability of NCAs to extraordinary circumstances); Freedom to Compete Act, S. 2375, 117th Cong. (2021) (amending the Fair Labor Standards Act of 1938 to protect low-wage workers from the use of NCAs).

57. *See* Erin Brendel Mathews, Note, *Forbidden Friending: A Framework for Assessing the Reasonableness of Nonsolicitation Agreements and Determining What Constitutes a Breach on Social Media*, 87 FORDHAM L. REV. 1217, 1236–37 (2018).

58. *Id.* (describing how Texas and Connecticut have applied the reasonableness standard in the absence of statutory guidance).

NCAs, it is likely to enforce NSAs.[59] When determining the enforceability of an NSA, courts also interpret "solicitation" narrowly and against the drafter, so the defendant is less likely to have violated the covenant.[60]

Over the last few years, states have implemented regulations that prevent employers from requiring NDAs as a condition of employment in an attempt to conceal illegal company activity.[61] Legislatures specifically intend for these laws to protect employees against discrimination and retaliation.[62] The enforceability of an NDA is jurisdictional, but courts generally take one of three approaches: (1) reading the NDA as an NCA; (2) evaluating the NDA against the NCA standard with a less-exact approach; or (3) assessing the NDA independent from any standard set for NCAs.[63] Under the first approach, courts impose a reasonableness standard, considering factors such as duration, geography, and scope of the agreement.[64] The second approach also utilizes a reasonableness standard, but courts do not base their analysis on a set of specific factors.[65] Finally, courts that distinguish NDAs and NCAs utilize the third approach and analyze NDAs on their purpose alone.[66] Overall, NDAs are rarely subject to the reasonableness standard because

59. David L. Johnson, *The Parameters of "Solicitation" in an Era of Non-Solicitation Covenants*, 28 A.B.A. J. LAB. & EMP. L. 99, 100 (2012) ("It is relatively common for employment agreements to include such a 'non-acceptance of business' covenant in lieu of a non-compete covenant.").

60. *Id.* at 104, 127 (describing how courts used a strict dictionary definition of "solicitation").

61. *See* Jason Sockin, Aaron Sojourner & Evan Starr, *What Happens When States Limit Nondisclosure Agreements? Employees Start to Dish*, WASH. POST (Oct. 4, 2021, 6:00 AM), https://www.washingtonpost.com/outlook/2021/10/04/non-disclosure-employee-reviews-study/ (reviewing regulations in California, New Jersey, and Illinois).

62. *See id.* (noting that some statutes only ban the enforceability of NDAs in the case of sexual harassment or discrimination).

63. Richard E. Kaye, *Cause of Action for Breach of Confidentiality or Nondisclosure Agreement in Employment Contract*, 47 CAUSES OF ACTION 2D 115, § 4 (2011) (last updated May 2022).

64. *See, e.g.*, Henderson v. U.S. Bank, N.A., 615 F. Supp. 2d 804, 810–13 (E.D. Wis. 2009) ("To determine whether a restraint is reasonable . . . , Wisconsin courts usually examine five factors: (1) whether the agreement is necessary to protect the legitimate business interests of the employer; (2) whether it is reasonable as to duration; (3) whether it is reasonable as to geography; (4) whether it is reasonable as to the employee; and (5) whether it is reasonable as to the general public.").

65. *See, e.g.*, First Health Grp. v. Nat'l Prescription Adm'rs, Inc., 155 F. Supp. 2d 194, 228–30 (M.D. Pa. 2001) (balancing the public interest with the rights of the employee to determine reasonableness).

66. *See, e.g.*, Harvey Barnett, Inc. v. Shidler, 338 F.3d 1125, 1134 (10th Cir. 2003) (distinguishing non-disclosure agreements from non-compete agreements and holding that each agreement must be solely evaluated on its purpose).

most courts do not see them as restraints on trade like an NCA.[67]

A new wave of jurisprudence has introduced the criminalization of restrictive covenants in employment agreements.[68] In Colorado, restrictive covenants are generally void under the state's non-compete law;[69] however, recent legislation subjects the employer and any involved acting managers to criminal liability for the use of intimidation to prevent a person from participating in lawful employment.[70] The statute also generally prohibits NCAs, with few exceptions.[71] This misconduct will constitute a Class 2 misdemeanor with potential penalties including a $75 fine or 120 days of imprisonment.[72]

In order to rectify these discrepancies, the Uniform Law Commission drafted the Uniform Restrictive Employment Agreement Act.[73] The model Act focuses on various forms of restrictive covenants and their impact on workers, including both employees and independent contractors.[74] Confidentiality provisions are invalid unless they cover information that is not general knowledge.[75] Additionally, NSAs are only enforceable if the scope is limited to clients with whom the employee had a working relationship and the duration of the agreement is less than six months.[76] These shifts in the legal landscape may require businesses to adjust their

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67. *See* Coffman, *supra* note 41 (citing Zep Mfg. Co. v. Harthcock, 824 S.W.2d 654, 663 (Tex. Ct. App. 1992)).

68. *See, e.g.*, Steve Baumann & Tom Carroll, *Colorado Criminalizes Certain Restrictive Covenants in Employment Agreements*, SHRM (Jan. 19, 2022), https://www.shrm.org/resourcesandtools/legal-and-compliance/state-and-local-updates/pages/colorado-criminalizes-certain-restrictive-covenants.aspx (describing a Colorado bill criminalizing violations of the state's restrictive covenants statute).

69. *See* COLO. REV. STAT. § 8-2-113 (2021).

70. S.B. 21-271, 73rd Gen. Assemb., 2d Reg. Sess. (Colo. 2021) (codified at COLO. REV. STAT. § 8-2-113(1.5)(b) (2021)).

71. § 8-2-113(2).

72. §§ 8-2-113(1.5)(b), 18-1.3-501; *see also* Dawn Mertineit, *Colorado Criminalizes Attempts to Curb Competition*, LEXOLOGY (Jan. 21, 2022), https://www.lexology.com/library/detail.aspx?g=440258e5-a48a-477f-809b-5c34bfb11c91.

73. UNIF. RESTRICTIVE EMPLOYMENT AGREEMENT ACT (UNIF. L. COMM'N 2021); *see also* Alan Levine, *Uniform Restrictive Employment Agreement Act: What You Need to Know*, LINKEDIN (Oct. 22, 2021), https://www.linkedin.com/pulse/uniform-restrictive-employment-agreement-act-what-you-alan-levine/?trk=articles_directory.

74. *See* UNIF. RESTRICTIVE EMPLOYMENT AGREEMENT ACT § 3 (UNIF. L. COMM'N 2021).

75. *Id.* § 9.

76. *Id.* § 11.

practices in order to avoid future civil and criminal penalties.[77]

III. A PLAINTIFF'S REASONABLE EFFORTS: THE COURT'S INTERPRETATION

A. *Reasonable Efforts with a Restrictive Covenant*

While restrictive covenants are not necessary to establish reasonable efforts in a trade secret claim, they are viewed as evidence of the plaintiff safeguarding the trade secret and imposing an explicit duty of confidentiality on an employee or third-party.[78] The information's secrecy, another element required under the UTSA, may be lost due to the actions of a third party that breached this duty; however, the plaintiff can still claim relief if it proves it made adequate efforts to keep the information confidential.[79]

The presence of a restrictive covenant in any company document can support the plaintiff's trade secret claim.[80] In *Handel's Enterprise, Inc. v. Schulenburg*,[81] the defendant met with Handel's, a chain of ice-cream parlors, to discuss the purchase of a franchise.[82] Handel's provided the defendant with a franchise agreement containing two non-compete clauses, one clause for the duration of the term of the agreement and another clause for after the term expired.[83] Additionally, the plaintiff shared confidential information about Handel's operations during the initial training and within a confidential operations manual.[84] The defendant eventually opened an independent ice-cream parlor, and Handel's claimed misappropriation of its operations and procedures as trade secrets.[85]

Handel's made reasonable efforts to maintain the secrecy of its alleged trade secrets because it required the defendant to sign a franchise agreement with restrictive covenants expressly stating the confidentiality of the disclosed information.[86] The company also required all of its employees to

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77. *See* Mertineit, *supra* note 72.

78. MILGRIM & BENSEN, *supra* note 4, at § 4.01.

79. *See* AvidAir Helicopter Supply, Inc. v. Rolls-Royce Corp., 663 F.3d 966, 974 (8th Cir. 2011) (interpreting the USTA as adopted by Illinois and Missouri).

80. *See* Handel's Enters., Inc. v. Schulenburg, 765 F. App'x 117, 122–23 (6th Cir. 2019) (recognizing the implementation of a franchise agreement as evidence of the existence of a trade secret).

81. 765 F. App'x 117 (6th Cir. 2019).

82. *Id.* at 118–19.

83. *Id.*

84. *Id.* at 119.

85. *Id.* at 120, 123.

86. *See id.* at 123 ("[T]he Franchise Agreement described the confidential

sign NDAs before issuing the confidential operations manual.[87] One required agreement for employees and one required agreement for third-parties was sufficient to establish the plaintiff made reasonable efforts and, ultimately, the existence of a trade secret under the UTSA.[88]

The Ninth Circuit came to a similar conclusion in *OTR Wheel Engineering, Inc. v. West Worldwide Services, Inc.*[89] The plaintiff required all entities involved in its tire production to sign confidentiality agreements.[90] This action alone sufficiently demonstrated the reasonable efforts element in a motion for a preliminary injunction.[91]

B. *Reasonable Efforts Without a Restrictive Covenant*

When a plaintiff fails to impose an express duty of confidentiality upon its employees and duly informed third parties, courts often surmise that the company did not consider its information to hold any value.[92] However, courts consider all security efforts in the context of the circumstances and look to other measures when this express remedy is neglected.[93]

Courts may refuse to acknowledge vague agreements absent a restrictive covenant.[94] In *MAI Systems Corp. v. Peak Computer, Inc.*,[95] MAI claimed its software and operating system to be trade secrets and provided licensing agreements as evidence of its reasonable efforts.[96] MAI failed to meet its burden because the alleged trade secrets were not outlined in the agreements, and the other evidence presented did not provide any further specificity.[97]

The Ninth Circuit refused to acknowledge an agreement that did not

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information given to Defendants as the 'total knowledge of [Handel's] System, and construction, operation, and promotion' . . . ." (Handel's Enters. V. Schulenburg, 4:18UV508, 2018 U.S. Dist. LEXIS 104851, at *9 (N.D. Ohio June 22, 2018))).

87. *Id.*

88. *See id.*

89. *See* 602 F. App'x 669, 672 (9th Cir. 2015).

90. *Id.*

91. *Id.*

92. *See* Tax Track Sys. Corp. v. New Inv. World, Inc., 478 F.3d 783, 787 (7th Cir. 2007) (quoting Curtis 1000, Inc. v. Suess, 24 F.3d 941, 947 (7th Cir. 1994)) ("If the party seeking to protect its information 'did not think enough of it to expend resources on trying to prevent lawful appropriation of it, this is evidence that it is not an especially valuable interest.'"); *see also* MILGRIM & BENSEN, *supra* note 4, at § 4.02.

93. *See* MILGRIM & BENSON, *supra* note 4, at §§ 1.04, 4.01.

94. *See, e.g.*, MAI Sys. Corp. v. Peak Comput., Inc., 991 F.2d 511, 522 (9th Cir. 1993).

95. 991 F.2d 511 (9th Cir. 1993).

96. *Id.* at 522.

97. *Id.*

explicitly limit the use of company information.[98] The absence of specific language makes it difficult for the court to surmise whether misappropriation has occurred, because the plaintiff and defendant may not have an aligned understanding of the information considered confidential.[99]

Plaintiffs also have difficulty succeeding on their trade secret claims without any form of a written agreement.[100] In *IVS Hydro, Inc. v. Robinson*,[101] IVS brought legal action against a competitor and former employee for the misappropriation of its pricing information.[102] IVS took steps to maintain the secrecy of its alleged trade secret, including labeling some job proposals confidential; however, these measures were insufficient to prove the element.[103] All IVS employees had access to the company computer network which included the pricing information, and IVS did not prohibit its customers from sharing their pricing information with competitors.[104] IVS did not require its employees to sign any form of confidentiality agreement, nor did it impose any expectation of confidentiality on its customers.[105] Considering the absence of employee contracts, the court found the plaintiff's efforts inadequate to establish a trade secret, despite other procedures in place.[106] The United States District Court for the Southern District of West Virginia referenced this analysis in *CSS, Inc. v. Herrington*.[107] Similarly, the plaintiff company refrained from implementing a written agreement to maintain employee or third-party confidentiality until nearly twenty-five years into the defendant's employment; the court did not consider this attempt sufficient to establish

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98. *See id.*

99. *See id.*; *see also* Robert S. Schwarts & Michael D. Weil, *United States Law on Restrictive Covenants and Trade Secrets*, CURRENT DEVELOPMENTS IN EMPLOYMENT LAW: THE OBAMA YEARS AT MID-TERM 2291, 2322 (2011).

100. *See, e.g.*, IVS Hydro, Inc. v. Robinson, 93 F. App'x 521, 527 (4th Cir. 2004) (showing there was no written evidence of any agreements regarding trade secrets); CSS, Inc. v. Herrington, No. 2:16-CV-01762, 2017 WL 3381444, at *16 (S.D. W. Va. Aug. 4, 2017) (showing similar evidence that lack of written agreement makes it difficult to discern whether there is a trade secret).

101. 93 F. App'x 521 (4th Cir. 2004).

102. *Id.* at 523.

103. *See id.* at 527 (arguing that the marking was not successful in keeping the information confidential).

104. *See id.* (finding that the two companies were non-exclusive thereby allowing customers to share learned information).

105. *Id.*

106. *See id.* at 528.

107. *See* 2017 WL 3381444, at *16 (S.D. W. Va. Aug. 4, 2017) (citing *IVS Hydro, Inc.*, 93 F. App'x at 527).

reasonable efforts.[108]

Other security measures are often inadequate if not accompanied by a restrictive covenant.[109] Three employees in *Farmers Edge Inc. v. Farmobile, LLC*[110] left their employer, Crop Ventures, to found Farmobile, a direct competitor.[111] The plaintiff claimed trade secret misappropriation over proprietary information that the defendants gained while at Crop Ventures.[112] Crop Ventures did not make reasonable efforts to protect their alleged trade secrets, because it had previously shared the information with a third-party contractor without the protection of a confidentiality agreement and lacked additional measures.[113]

Likewise, the Eleventh Circuit concluded in *Warehouse Solutions, Inc. v. Integrated Logistics, LLC*[114] that the absence of a written NDA, while not dispositive, was relevant in concluding that the plaintiff did not make reasonable efforts to maintain secrecy.[115] The plaintiff presented several security measures as evidence of its protection of the alleged trade secret, including password protection and data encryption.[116] The court refused to accept general security measures in the absence of an agreement.[117] If the plaintiff had implemented a restrictive covenant, the court would likely have viewed these other security measures as supporting evidence for the element of reasonable efforts.[118] However, without any form of contract acknowledging the existence and confidential nature of its alleged trade secrets, the plaintiff's evidence was insufficient.[119]

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108. *Id.* (holding that there was not a trade secret because the defendant was not required to sign a confidentiality agreement until much later in his employment).

109. *See* Farmers Edge Inc. v. Farmobile, LLC, 970 F.3d 1027, 1029–33 (8th Cir. 2020).

110. 970 F.3d 1027 (8th Cir. 2020).

111. *Id.* at 1029.

112. *Id.* at 1030.

113. *Id.* at 1033.

114. 610 F. App'x. 881 (11th Cir. 2015).

115. *See id.* at 885.

116. *Id.*

117. *See id.* (distinguishing general security measures used "to restrict access to customer data—which WSI does not claim as trade secrets" from "the functionality of the program itself.").

118. *See id.*

119. *See id.*

C. *Reasonable Efforts with a Statutory Ban on Restrictive Covenants*

In states that recognize restrictive covenants, these contracts contribute to courts' analyses of the plaintiff's efforts.[120] However, the consideration of this type of measure is limited in states that have implemented a general prohibition on NCAs.[121] This ban is reflected in the outcome of the states' trade secret claims.[122]

For example, in *InteliClear, LLC v. ETC Global Holdings Inc.*,[123] a software company developed an electronic financial system known as the InteliClear System.[124] ETC, the defendant, obtained a license for the system and signed a software license agreement.[125] After the termination of this agreement, ETC developed its own software with similarities to the InteliClear System.[126] The software license agreement included express language requiring ETC to maintain the system's confidentiality.[127] This agreement was the only evidence in support of the plaintiff's reasonable efforts; however, it was sufficient to survive the defendant's motion for summary judgment.[128]

Following the court's reasoning in *InteliClear,* the court in *Woodall v. Walt Disney Co.*[129] ruled that the plaintiff provided sufficient evidence to establish reasonable efforts, because it required the necessary persons to execute confidentiality agreements.[130] Oral and written signs of confidentiality qualify as reasonable efforts in a trade secret claim.[131]

Similarly, the plaintiff's use of NDAs in addition to limited facility and technology access proved to be adequate to establish reasonable efforts in

120. *See, e.g.*, Handel's Enters. v. Schulenburg, 765 F. App'x 117, 123 (6th Cir. 2019) (weighing a confidentiality agreement as evidence for the existence of a trade secret).

121. *See, e.g.*, InteliClear, LLC v. ETC Glob. Holdings Inc., 978 F.3d 653, 660–61 (9th Cir. 2020) (considering the existence of a confidentiality agreement as sufficient evidence of reasonable measures to overcome a motion for summary judgment).

122. *See id.*

123. 978 F.3d 653 (9th Cir. 2020).

124. *Id.* at 655.

125. *Id.* at 656.

126. *Id.*

127. *Id.* at 660–61 ("Confidentiality provisions constitute reasonable steps to maintain secrecy.").

128. *See id.*

129. No. CV 20-3772-CBM-(Ex), 2021 WL 4442410, at *5 (C.D. Cal. 2021) (citing *InteliClear, LLC*, 978 F.3d at 661).

130. *Id.*

131. *Id.*

California International Chemical Co. v. Sister H. Corp.[132] Because the alleged trade secret was unknown within the industry, the court referenced the NDA as sufficient evidence to establish reasonable efforts.[133]

This agreement most likely did not contain a restrictive covenant or language regarding the protection of the alleged trade secret.[134] Even with a general prohibition on NCAs, the Ninth Circuit did not extend its analysis to other documentation because the plaintiff's NDA served as concrete evidence of documentation, and it was adequate to establish the plaintiff's reasonable efforts in tandem with limited facility and technology access.[135]

In *Carr v. AutoNation, Inc.*,[136] the plaintiff did not make reasonable efforts, because he did not label his business plan as confidential, inform the defendant of its confidentiality, nor require any form of confidentiality agreement.[137] Furthermore, the contents of the alleged trade secret did not constitute something evidently confidential; the language amounted to general statements.[138] Statutory regulation of NCAs did not prevent the Ninth Circuit from concluding that the plaintiff did not expend enough effort because its claim lacked a restrictive covenant.[139]

D. Conclusions from the Case Comparison

Courts place substantial weight on restrictive covenants when analyzing the reasonable efforts element of the UTSA, and the absence of such an agreement generally does not force them to extend their analysis.[140]

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132. Nos. 97-15233, 97-16858, 97-16997, 1999 U.S. App. Lexis 868, at *13 (9th Cir. Jan. 19, 1999).

133. *See id.*

134. *See id.* at *14 ("A few licensees stated that CICC informed them verbally only that certain components of the CICC system were trade secrets. Yet almost all of these licensees signed non-disclosure agreements broadly prohibiting them from revealing the CICC system . . . .").

135. *See id.* (citing MAI Sys. Corp. v. Peak Comput. Inc., 991 F.2d 511, 521 (9th Cir. 1993)) (emphasizing that the Ninth Circuit previously found NDAs and facilities restrictions as sufficient reasonable efforts).

136. 798 F. App'x 129 (9th Cir. 2020).

137. *Id.* at 130.

138. *Id.* ("[I]t appears to be a fairly standard business proposal that offers vague, general concepts and merely aspirational language.").

139. *See id.* ("Trade secret law is a two-way street: It protects ideas, but it also requires giving notice that the information is in fact a secret so that others do not fall into a 'trap' of using information that they think is non-confidential.").

140. *See* 152 AM. JUR. 3D *Proof of Facts* § 4, Westlaw (database updated August 2022) (pointing out that "the lack of confidentiality agreements with some individuals may not defeat the reasonable efforts test altogether.").

Restrictive covenants serve as straightforward, tangible evidence of the plaintiff's efforts to protect its alleged trade secrets.[141]

Courts must consider the circumstances of each case individually to determine whether the plaintiff made reasonable efforts or both parties had an established confidential relationship.[142] Any form of restrictive covenant is a clear indicator to courts that the plaintiff believes it is in possession of a trade secret and intends to protect it.[143] In cases where the plaintiff failed to implement a restrictive covenant, the case law illustrates that the court is less likely to find that the plaintiff met the reasonable efforts element.[144] Unlike other security measures, these agreements can serve as sufficient *prima facie* evidence; they do not require any additional investigation into the plaintiff's intentions.[145] Courts can also require that the agreement clearly state the information that the employer wishes to keep confidential.[146] Without a restrictive covenant, the court must look for this evidence elsewhere.[147]

With other measures, such as a password-protected database or physical security on company premises, courts likely have difficulty discerning the overlap between the plaintiff's claims and the defendant's expectations.[148]

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141. *See* MILGRIM & BENSEN, *supra* note 4 (discussing how "written agreements can . . . express and clarify").

142. *See, e.g.*, Direct Techs., LLC v. Elec. Arts, Inc., 836 F.3d 1059, 1070–71 (9th Cir. 2016) (discussing how "a relationship of confidence may be implied" given the particular facts of the case).

143. *See* MILGRIM & BENSEN, *supra* note 4; *see also Carr*, 798 F. App'x 129, 130 (9th Cir. 2020) ("Whether Carr took reasonable efforts speaks to whether he had a trade secret.").

144. *See, e.g.*, Farmers Edge Inc. v. Farmobile, LLC, 970 F.3d 1027, 1033 (8th Cir. 2020) ("Crop Ventures shared the information with a third-party contractor without a confidentiality agreement and without other policies or practices for safeguarding secrets. The district court concluded this information was therefore not protected under the NTSA or DTSA . . . [W]e agree with the district court that Crop Ventures did not take reasonable steps to safeguard its trade secrets."); Warehouse Sols., Inc. v. Integrated Logistics, LLC, 610 F. App'x. 881, 885 (11th Cir. 2015) (stating that the plaintiff did not implement any written agreement to maintain confidentiality of its alleged trade secret and resultingly failed to provide sufficient evidence to survive a motion for summary judgment).

145. *See e.g.*, InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020); MILGRIM & BENSEN, *supra* note 4 ("[A]t least at the preliminary stage of a litigation, a trade secret owner's reliance on an adequate confidentiality agreement may by itself establish that the owner is likely to succeed in satisfying the reasonable efforts requirement.").

146. *See InteliClear, LLC*, 978 F.3d at 660–61.

147. *See, e.g.*, *Warehouse Sols., Inc.*, 610 F. App'x at 885 (directing reasonable efforts analysis to "numerous confidentiality measures" absent a formal written agreement).

148. *Cf.* MILGRIM & BENSEN, *supra* note 4 ("A written agreement can make express and clarify, in an otherwise ambiguous situation, the fact that information is being

The presence of a restrictive covenant in combination with at least one additional form of security often satisfies the element, because the agreement outlines the employer's intentions, and the additional measure serves as reinforcement of that objective.[149] However, other measures alone, including other forms of written agreements, are generally insufficient.[150]

Courts may even disregard other processes the plaintiff put in place to protect the trade secret if a restrictive covenant did not exist.[151] The Ninth Circuit refused to accept a license agreement as evidence of the plaintiff's reasonable efforts because it did not provide specific protection to the company's confidential information.[152] Any plaintiff can frame company procedures in a security context to support its claim.[153] Because of this ambiguity, if a plaintiff provides a restrictive covenant as evidence of reasonable efforts, courts are likely to accept any other security measure as supporting evidence of trade secret protection.[154] This rationale ultimately indicates that these agreements are the determining factor in proving the reasonable efforts element under the UTSA.[155]

The outcome in *RECO Equipment, Inc. v. Wilson*[156] presents the minority approach in which a court finds reasonable efforts without a restrictive covenant.[157] The plaintiff claimed misappropriation of documents that outlined company procedures, and only provided password protection and

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disclosed, used or developed in the context of a confidential relationship.").

149. *See* 152 AM. JUR. 3D *Proof of Facts* § 4, Westlaw (database updated August 2022).

150. *See, e.g.*, MAI Sys. Corp. v. Peak Comput., Inc., 991 F.2d 511, 522 (9th Cir. 1993) (holding that a licensing agreement that did not reference specific trade secrets was insufficient evidence of the existence of a trade secret).

151. *See, e.g.*, IVS Hydro, Inc. v. Robinson, 93 F. App'x 521, 527 (4th Cir. 2004) (noting that while the plaintiff took some steps to maintain the confidentiality of its pricing information, "[n]ot a single employee whose departure was at issue had a written confidentiality or non-compete agreement with IVS.").

152. *See MAI Sys. Corp.*, 991 F.2d at 522.

153. *See, e.g.*, Warehouse Sols., Inc. v. Integrated Logistics, LLC, 610 F. App'x 881, 885 (acknowledging that the plaintiff presented security measures that served other purposes within the company).

154. *See, e.g.*, Penalty Kick Mgmt. Ltd. v. Coca Cola Co., 318 F.3d 1284, 1291–92 (11th Cir. 2003) (concluding that an oral notice regarding confidentiality in conjunction with a NDA established reasonable efforts).

155. *See, e.g.*, *id.* ("In this case, the surrounding circumstances, namely the *Non-Disclosure Agreement,* clearly gave rise to a duty on the part of Coca–Cola to maintain the secrecy of any Magic Windows trade secrets.").

156. No. 20-4312, 2021 U.S. App Lexis 32413 (6th Cir. Oct. 28, 2021).

157. *See id.* at *4 (finding reasonable efforts to protect a trade secret without the existence of any form of explicit written agreement).

limited employee access as evidence of its reasonable efforts.[158] The plaintiff's efforts were reasonable because they kept the documents from broad distribution given the information was not available to the public and were "the subject of efforts" to maintain secrecy.[159] Courts generally require more substantive measures to establish this element.[160] However, in *RECO Equipment*, the Sixth Circuit interpreted the statute as requiring effort alone, without the implementation of a reasonableness standard.[161]

Courts' analyses shift in circuits where NCAs are prohibited.[162] They place the same weight on written agreements, but instead of only looking to known forms of restrictive covenants, they may analyze the provisions of a more general document, such as a franchise or license agreement for language regarding confidentiality.[163] Statutory prohibition of NCAs does not require a court to extend its analysis to include unique security measures; however, it does broaden the scope of documents it considers.[164]

IV. THE FUTURE IMPACT OF RESTRICTIVE COVENANTS

A. *Shifts in Business Practices*

Companies that believe they are in possession of a trade secret should protect themselves against any future disclosure.[165] As states continue to implement regulations surrounding restrictive covenants, companies will likely shift towards alternate contracts to ensure enforceability.[166] These

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158. *See id.*

159. *See id.*

160. *See, e.g.*, Handel's Enters., Inc. v. Schulenburg, 765 F. App'x 117, 123 (6th Cir. 2019); MAI Sys. Corp. v. Peak Comput., Inc., 991 F.2d 511, 522 (9th Cir. 1993).

161. *See RECO Equip.*, 2021 WL 5013816, at *4 (quoting Ohio Rev. Code § 1333.61(D)(2)) ("This is enough to show the district court did not clearly err in finding that the information is not publicly available and is 'the subject of efforts' to keep it secret.").

162. *See* InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020); *MAI Sys. Corp.*, 991 F.2d at 522.

163. *See InteliClear, LLC*, 978 F.3d at 660–61 (parsing a software license agreement for language regarding confidentiality); *MAI Sys. Corp.*, 991 F.2d at 522 (evaluating a licensing agreement as evidence of reasonable efforts).

164. *See, e.g.*, *InteliClear, LLC*, 978 F.3d at 660–61; Cal. Int'l Chem. Co. v. Sister H. Corp., Nos. 97-15233, 97-16858, 97-16997, 1999 U.S. App. Lexis 868, at *10–13 (9th Cir. Jan. 19, 1999); Direct Techs., LLC v. Elec. Arts, Inc., 836 F.3d 1059, 1070–71 (9th Cir. 2016); Carr v. AutoNation, Inc., 798 F. App'x 129, 130 (9th Cir. 2020).

165. *See* Schwarts & Weil, *supra* note 99, at 2300.

166. *See* Spiggle, *supra* note 2; *cf. id.* at 2346 ("[C]ontractual agreements provide the best (and most comprehensive) protection against . . . unauthorized use of confidential business information, trade secrets and inventions.").

agreements, regardless of form, should include language that requires the signee to acknowledge the information as confidential, valuable, and protected as a trade secret.[167] Trade secret case law proves that documentation is a significant factor in courts' analyses of a plaintiff's reasonable efforts to maintain secrecy.[168] However, companies should not disregard other methods of protecting their secret information, such as labeling documents as confidential or noting the information's status in company manuals.[169]

Furthermore, companies should refrain from instituting blanket agreements that lack specificity.[170] Courts generally require that an agreement provide the signee with sufficient recognition and notice regarding the scope of protected information in order to function as effective evidence in a misappropriation claim.[171] Notice also serves as the employer's acknowledgement of information it considers confidential.[172]

B. *Advancements in Legislation*

A federal ban on all restrictive covenants is improbable because it would conflict with the freedom of contract doctrine.[173] However, the absence of NCAs does not force the court to overextend its parameters or prevent it from placing significant weight on documentation in the evaluation of a trade secret claim.[174] If any of the current efforts to implement federal NCA

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167. Schwarts & Weil, *supra* note 99, at 2300.

168. *See, e.g.*, Farmers Edge Inc. v. Farmobile, LLC, 970 F.3d 1027, 1033 (weighing the lack of a confidentiality agreement against the plaintiff); Penalty Kick Mgmt. Ltd. v. Coca Cola Co., 318 F.3d 1284, 1291–92 (weighing the existence of an NDA in favor of the plaintiff).

169. *See* Schwarts & Weil, *supra* note 99; *see, e.g.*, RECO Equip., Inc. v. Wilson, No. 20-4312, 2021 WL 5013816, at *3 (6th Cir. Oct. 28, 2021) (deeming password protection alone sufficient to establish a trade secret).

170. *See* Schwarts & Weil, *supra* note 99, at 2322.

171. *See id.* ("[T]he courts are disinclined to enforce agreements requiring employees to keep confidential vaguely defined information the company later decides it would like to protect.").

172. *See id.*

173. *See* Ferdinand S. Tinio, Annotation, *Enforceability, Insofar as Restrictions Would Be Reasonable, of Contract Containing Unreasonable Restrictions on Competition* 61 A.L.R.3d 397, § 33[b] (1975).

174. *See, e.g.*, InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020) (finding that the confidentiality provisions included in a software license agreement constitute reasonable steps); Cal. Int'l Chem. Co. v. Sister H. Corp., Nos. 97-15233, 97-16858, 97-16997, 1999 U.S. App. Lexis 868, at *10-13 (9th Cir. Jan. 19, 1999) (limiting licensee access and requiring NDAs is sufficient to establish reasonable efforts); Carr v. AutoNation, Inc., 798 F. App'x 129, 130 (9th Cir. 2020) (refusing to

regulation are successful, the outcome of trade secret litigation would not be largely influenced.[175]

Nevertheless, companies would likely focus on establishing an express duty of confidentiality through measures apart from NCAs.[176] Some employers may choose to continue to utilize NCAs, even if unenforceable, to deceive employees into compliance.[177] Others may use a fixed-term employment agreement or supplementary contracts, such as training repayment, arbitration, or liquidated damages, to impose the cost of leaving on the employee.[178] These reactionary tactics may have a more restrictive effect than the NCA they replaced.[179]

If restrictive covenants suddenly become more difficult to enforce, companies may choose to protect company information with a trade secret claim over breach of contract, resulting in an overall increase in misappropriation claims.[180] While the presence of a restrictive covenant alone will not elevate confidential information to that of a trade secret, courts may still acknowledge unenforceable agreements as evidence of the plaintiff's reasonable efforts.[181] In anticipation of any future legislation,

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accept the plaintiff's business plan as proof of reasonable efforts regardless of the state prohibition on NCAs).

175. *See* Spiggle, *supra* note 2; *see also, e.g.*, *InteliClear, LLC*, 978 F.3d at 660–61; *Cal. Int'l Chem. Co.*, 1999 U.S. App. Lexis 868; *Direct Techs., LLC*, 836 F.3d at 1070-71; *Carr*, 798 F. App'x at 130.

176. *See* Spiggle, *supra* note 2; *Cf.* MILGRIM & BENSEN, *supra* note 4 ("Enterprises commonly entrust trade secrets to persons standing in a specific relationship, such as employees and licensees, subject to written agreements that impose duties of confidentiality and restrict unauthorized use or disclosure both during the relationship and afterwards.").

177. Evan Starr, *The Ties that Bind Workers to Firms: No-Poach Agreements, Noncompetes, and Other Ways Firms Create and Exercise Labor Market Power*, PROMARKET (Jan. 3, 2022), https://promarket.org/2022/01/03/workers-poaching-noncompete-employers-labor-antitrust/; *see* Spiggle, supra note 2 ("[E]mployers will sometimes use them with employees knowing full well they are unenforceable. Yet employers hope that they can scare workers into compliance.").

178. Starr, *supra* note 177 (explaining that a training repayment agreement requires the employee to pay back training costs if she leaves her employer before a set period and a liquidated damages agreement places fines on the employee for leaving).

179. *See id.*

180. *Cf.* 3 LOUIS ALTMAN & MALLA POLLACK, CALLMANN ON UNFAIR COMPETITION, TRADEMARKS AND MONOPOLIES § 14:5 (4th ed. 2022) ("If the obligee loses the contractual right to protect secret information, it retains whatever rights it had to protect the information under the law of trade secrets."). *But see* MILGRIM & BENSEN, *supra* note 4 ("The mere presence of a confidentiality agreement does not elevate nontrade secret matter to trade secret status.").

181. *See* MILGRIM & BENSEN, *supra* note 4 ("[W]ritten agreements . . . have the potential to protect confidential information that may not unequivocally qualify for trade

companies should utilize a variety of channels to protect their confidential information.[182]

The evolving jurisprudence of restrictive covenants lends itself to a variety of solutions.[183] For example, states could continue to enforce restrictive covenants but place legislative restrictions on the employer to ensure contractual equity.[184] Employment would not be contingent on the employee's acceptance of the employer's restrictive covenants.[185] During the application and interview process, the employer could not inquire about the employee's inclination to agree to certain employment contracts, and an offer letter could not be retracted if the employee refuses to sign these agreements.[186] However, the employer could take measures to encourage the employee's consent.[187] These measures might include a compensation increase or additional employee benefits proportional to the base offer to ensure that the financial loss would not force concession.[188]

Additionally, the employer would be required to provide the employee with the current state law and court's enforceability test of the relevant agreement before finalizing the contract.[189] A third-party regulatory body

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secret status.").

182. *See* Spiggle, *supra* note 2 (noting that companies and business organizations will likely challenge any legislative or executive action to place limitations on non-compete agreements); *see also, e.g.*, InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020); Cal. Int'l Chem. Co. v. Sister H. Corp., Nos. 97-15233, 97-16858, 97-16997, 1999 U.S. App. Lexis 868, at *13 (9th Cir. Jan.19, 1999); Direct Techs., LLC v. Elec. Arts, Inc., 836 F.3d 1059, 1070–71 (9th Cir. 2016); Carr v. AutoNation, Inc., 798 F. App'x 129, 130 (9th Cir. 2020).

183. *See, e.g.*, Workforce Mobility Act of 2021, H.R. 1367, 117th Cong. (2021); Freedom to Compete Act, S. 2375, 117th Cong. (2021); S.B. 21-271, 73rd Gen. Assemb., 2d Reg. Sess. (Colo. 2021).

184. *See* Spiggle, *supra* note 2.

185. *See* Mikva, *supra* note 38, at 14 (discussing how applicants should utilize their leverage during offer negotiation to limit the terms of any restrictive covenants).

186. *See id.* at 12 ("Firing an employee for refusing to sign a non-competition agreement is not illegal.").

187. *See* Jeffrey Rhodes, *Court Upholds Strict Noncompete Tied to Incentive Payments*, SHRM (May 6, 2020), https://www.shrm.org/resourcesandtools/legal-and-compliance/employment-law/pages/court-upholds-strict-noncompete-tied-to-incentive-payments.aspx/ (explaining the Fourth Circuit held that a voluntary incentive plan provided to high-level executives was valid in conjunction with company non-compete and non-solicitation agreements).

188. *See id.*

189. *See, e.g.*, Workforce Mobility Act of 2021, H.R. 1367, 117th Cong. (2021) (requiring that, if this bill is enacted, employers must post notice of the general prohibition of and exceptions for non-compete agreement in the workplace).

will draft this literature to ensure impartiality.[190] This tactic will educate employees on their rights in the workplace, bar employers from implementing unenforceable agreements merely to manipulate their employees into compliance, and serve as material evidence of the employee's acknowledgement of efforts to maintain secrecy in any future trade secret claims.[191]

To protect their interests, particularly when employees do not sign the agreements, employers would have the option to file a comprehensive list of confidential information and trade secrets with a regulatory body.[192] If the employer believes any of this specified information was exposed either to a competitor or the general public, the court would offer an expedited and low-cost legal process to resolve these claims.[193] This policy would allow employers to implement protective strategies and employees to safeguard their career interests.[194]

V. CONCLUSION

Trade secret law is designed to protect valuable information and encourage innovation.[195] To ensure this protection under the law, employers have utilized written contracts to impose restrictions on their employees' use of company information.[196] As such, courts place significant emphasis on written agreements in their evaluation of a plaintiff's reasonable efforts to maintain the trade secret, because they are tangible evidence that illustrates the value the plaintiff places on its protected information.[197] While state law

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190. *See id.* ("The Federal Trade Commission or the Department of Labor shall investigate or enforce the provisions of this bill.").

191. *See* Mikva, *supra* note 38, at 14 ("A broad non-compete may preclude the employee from working in any capacity with an employer who competes in any area in which the employee's former employer also does business.").

192. *See* Mallery & Mokros, *supra* note 37, at 10 (concluding that a clear outline of the employer's intent to protect certain interests better helps the court determine whether an agreement is reasonable).

193. See Mikva, *supra* note 38, at 17 (noting that a non-judicial resolution "generally has many advantages for employees, including speed, cost and finality. The supposed advantages of a jury trial are less applicable in contract disputes. However, there are subsidiary issues that may be important.").

194. *See* Spiggle, *supra* note 2 ("Non-competes were originally intended to be 'shields' to protect employers. However, over the years, they've started being used as 'swords' by employers to unreasonably control their workers.").

195. *See Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 481 (1974).

196. *See* BOGIN-FARBER ET AL., *supra* note 31.

197. *See* MILGRIM & BENSEN, *supra* note 4 (observing that while the absence of a written agreement does not preclude a plaintiff from establishing a trade secret, the existence of a confidentiality agreement alone may be sufficient for a plaintiff to succeed

varies in its allowance of restrictive covenants, courts continue to emphasize the need for any form of contractual obligation to provide the signee with notice and expectations; other security measures offered by the plaintiff are often insufficient.[198]

Companies should utilize any applicable form of written agreements with specificity to best protect their trade secrets against future breaches of confidentiality.[199] As the law surrounding restrictive covenants evolves, a federal ban may encourage deceptive business practices.[200] Therefore, future legislation should prioritize the interests of the employer-employee relationship and ensure the intent to encourage invention is well-preserved.[201]

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on the reasonable efforts element at the preliminary stages of litigation); *see also, e.g.*, Handel's Enters., Inc. v. Schulenburg, 765 F. App'x 117, 119 (6th Cir. 2019).

198. *See* MILGRIM & BENSEN, *supra* note 4.

199. *See, e.g.*, InteliClear, LLC v. ETC Glob. Holdings, Inc., 978 F.3d 653, 660–61 (9th Cir. 2020). *But see* MAI Sys. Corp. v. Peak Comput., Inc., 991 F.2d 511, 522 (9th Cir. 1993).

200. Starr, *supra* note 177.

201. *See* Schwarts & Weil, *supra* note 99, at 2300; Spiggle, *supra* note 2.

CHARTER SCHOOLS AND EMOS: WHO'S IN CHARGE?

BRENDAN GLYNN*

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I. INTRODUCTION

Charter schools are a popular sight in the educational field today.[1] For the IRS to consider a charter school a 501(c)(3) organization, nonprofit charter schools must be organized and operated exclusively for educational purposes, meaning purposes relating to the instruction of individuals to improve their capabilities.[2] To be organized for educational purposes, the articles of the organization must limit the entity to educational purposes while also preventing the organization from engaging in substantial non-educational activities.[3] To operate exclusively for educational purposes, an organization's activities must be substantially in furtherance of educational purposes while also not substantially benefitting a private individual.[4] This educational purpose requirement, however, does not preclude a nonprofit organization from participating in activities that are not strictly educational, provided that those activities are in furtherance of the educational goal of the organization.[5]

However, a type of contract, called a sweeps contract, that many charter schools have with educational management organizations ("EMOs") to operate the school calls into question whether these nonprofit charter schools are truly operating only for educational purposes.[6] Inadequate

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1. *See* Phillip Geheb & Spenser Owens, *Charter School Funding Gap*, 46 FORDHAM URB. L.J. 72, 73 (2019) (noting how fast the charter school industry is growing).

2. *See* 26 U.S.C. §§ 501(a), (c)(3) (stating that an organization with educational purposes can be exempt from taxation); 26 C.F.R. § 1.501(c)(3)–1(a)(1) (2017) ("In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."); § 1.501(c)(3)-1(b)(3)(i)(a) (defining educational as "the instruction or training of the individual for the purpose of improving or developing his capabilities").

3. *See* § 1.501(c)(3)-1(b)(1)(i).

4. *See* § 1.501(c)(3)-1(c)(1)-(2).

5. *See* § 1.501(c)(3)-1(c)(1) ("An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.").

6. NETWORK FOR PUB. EDUC., CHARTERED FOR PROFIT: THE HIDDEN WORLD OF CHARTER SCHOOLS OPERATED FOR FINANCIAL GAIN, 4 (2020), https://networkforpubliceducation.org/wp-content/uploads/2021/07/Chartered-for-Profit.pdf (defining a sweeps contract as a contract that locks charter schools into passing virtually all revenue to the EMO operating the school); *see, e.g.*, *id.* at 31 (describing the sweeps contract of Ohio Distance Learning Academy, a charter school, that gives ninety-seven percent of its revenue to the EMO ACCEL Schools).

funding, inexperience with operating a charter school, and the inability to raise capital and take advantage of economies of scale incentivizes charter schools to partner with EMOs.[7] These EMOs then find themselves with the dominant bargaining power and can thus push sweeps contracts onto these schools.[8]

This Comment argues that these sweeps contracts are improper if a charter school files as a 501(c)(3) organization because the charter school, while likely organized for exclusively educational purposes, is not operating solely for those purposes as the school cedes control to the EMO. Part II of this Comment provides background on how EMOs, charter schools, and the requirements of a 501(c)(3) organization interact to create the landscape of EMO-run charter schools that exists today. Additionally, Part II outlines U.S. Tax Court case law concerning partnerships between nonprofit and for-profit organizations and gives two examples of IRS Service Advice Reviews ("SARs"), which are essentially IRS rejection letters, to help understand why a sweeps contract between a nonprofit charter school and for-profit management company is impermissible if the charter school wants to classify itself as a 501(c)(3) organization. Part III then applies the reasoning from U.S. Tax Court cases and IRS SARs to sweeps contracts and concludes that a charter school cannot file as a 501(c)(3) organization if it has a sweeps contract with an EMO.[9] Part IV then recommends that, at the very least, the IRS ban sweeps contracts in the nonprofit charter school context. Alternatively, the IRS could treat the contracts as dispositive of an organization operating for a nonexempt purpose, which would provide the IRS with a way to avoid the controversial issue of charter schools.[10] Ultimately, Part V concludes that

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7. Geheb & Owens, *supra* note 1, at 84, 94 (noting a 2.4% – 39.5% disparity in revenue received by charter and public schools, and "a for-profit entity's ability to 'raise capital and [to] exploit economies of scale' provides them with significant advantages compared to purely nonprofit models") (citing John Morley, *For-Profit and Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1811 (2006)).

8. *See* James Eastman, *Regaining Trust in Nonprofit Charter Schools: Toward Benefit Corporation Branding for For-Profit Education Management Organizations*, 2017 BYU EDUC. & L.J. 285, 289 (2017) (commenting how inexperience in managing schools is the main reason a charter school hires an EMO).

9. *See, e.g.*, 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (operating as a rejection letter to an organization applying for 501(c)(3) classification).

10. *See Do You Support the Use of Public Charter Schools as an Alternative to Traditional Systems?*, WASH. POST, https://www.washingtonpost.com/graphics/politics/policy-2020/education/charter-schools/ (last visited Oct. 14, 2023) [hereinafter Washington Post Poll] (reporting that two candidates in the 2020 Presidential Campaign supported a pause on charter schools

the most effective solution to the sweeps contract problem would be to minimize and close the funding gap between charter schools and public schools, as the available funding EMOs have is an enticing option to underfunded charter schools.[11]

II. UNDERSTANDING CHARTER SCHOOLS, EMOS, 501(C)(3) ORGANIZATIONS, AND THE RELATIONSHIPS BETWEEN THEM

While charter schools that want to contract with a management organization primarily choose charter management organizations ("CMOs"), the nonprofit equivalent of EMOs, the number of EMOs has been increasing since 1998.[12] Further, EMOs usually operate multiple charter schools, meaning the number of schools operated by EMOs is much higher than the number of EMOs currently reported.[13] Mirroring the growth of EMOs, the number of EMOs using sweeps contracts is also increasing.[14]

A. What is a Charter School?

A charter school is a tuitionless, independent public school of choice, meaning students choose to attend.[15] These schools cannot discriminate against students in enrollment but must accept students as they apply, or

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funding).

11. *See* Eastman, *supra* note 8, at 289 (noting that EMOs have funding that traditional public schools do not).

12. *See* NAT'L ALLIANCE FOR PUB. CHARTER SCHS., CMO AND EMO PUBLIC CHARTER SCHOOLS: A GROWING PHENOMENON IN THE CHARTER SCHOOL SECTOR 1 (2011), http://www.publiccharters.org/sites/default/files/migrated/wp-content/uploads/2014/01/NAPCS-CMO-EMO-DASHBOARD-DETAILS_20111103T102812.pdf (defining CMOs as "nonprofit entities that manage two or more charter schools" and EMOs as "for-profit entities that manage charter schools and perform similar functions as CMOs"); NAT'L EDUC. POL'Y CTR., PROFILES OF FOR-PROFIT AND NONPROFIT EDUCATION MANAGEMENT ORGANIZATIONS: FIFTEENTH EDITION 17 (2021), https://nepc.colorado.edu/sites/default/files/publications/RB%20Miron%20EMO%20complete_4.pdf (finding 117 for-profit EMOs); NETWORK FOR PUB. EDUC., *supra* note 6, at 12–13 (2020) (identifying 141 for-profit EMOs but noting that the number is certainly higher in reality as documentation on EMOs is scarce).

13. *See* *ESP, EMO, CMO?*, AM. SCH. CHOICE, http://americanschoolchoice.com/what-is-school-choice/what-purpose-do-network-charter-operators-serve/ (last visited Sept. 19, 2021) ("EMOs are typically for-profit companies with a network of schools under its wing and a successful model that it replicates across the state or country.").

14. *See* NAT'L EDUC. POL'Y CTR., *supra* note 12, at 25.

15. Geheb & Owens, *supra* note 1, at 76.

accept students based on a lottery system if capacity is an issue.[16]

To organize a charter school, teachers, community members, or nonprofit organizations first apply to their state authorizers, which can be the State, local educational agencies, or independent nonprofit organizations.[17] The authorizer then offers a contract to the charter school, giving the school increased freedom from certain regulations in exchange for increased accountability to the authorizer and the State.[18]

This contract, or charter, additionally sets forth academic goals that the school must plan to meet.[19] Failure to achieve these goals can result in the authorizer revoking the charter, thereby closing the school.[20] Once the authorizer approves the school and it opens, the authorizer then periodically reviews the charter school to ensure the school meets its charter goals.[21]

Broadly, charter schools are either nonprofit or for-profit.[22] As only Arizona permits for-profit charter schools, the vast majority of charter schools, or at least the organizations that hold the charters, are nonprofit.[23] However, commenters have noted the existence of a third model: hybrid charter schools.[24] This kind of charter school is one where a nonprofit entity holds the charter, and a for-profit entity either operates the school or provides it with a wide variety of services in exchange for a sizeable portion of the charter school's revenue.[25]

Depending on its management contract with the for-profit entity, a hybrid charter school can either qualify as a for-profit or nonprofit school.[26]

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16. *See What is a Charter School?*, NAT'L CHARTER SCH. RES. CTR., https://charterschoolcenter.ed.gov/what-charter-school (last visited Sept. 19, 2021) (explaining what charter school enrollment is and comparing it to public schools).

17. *See id.* (noting that a single person, group of people, or CMO may apply for a charter).

18. *See* Geheb & Owens, *supra* note 1, at 76–77.

19. *See id.*

20. *See id.* at 77.

21. *See What is a Charter School?*, *supra* note 16.

22. Geheb & Owens, *supra* note 1, at 91.

23. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 3 (stating that only Arizona licenses for-profit charter schools).

24. John Morley, *For-Profit and Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1790 (2006) (arguing that a third type of charter school, hybrid charter schools, exists alongside for-profit and nonprofit schools).

25. *See* Eastman, *supra* note 8, at 299–300 (explaining how EMOs operate the school in exchange for some, or all, of the school's funding); *see also* NETWORK FOR PUB. EDUC., *supra* note 6, at 31 (reporting how one charter school's sweeps contract gave ninety-seven percent of its revenue to their EMO).

26. *See* Geheb & Owens, *supra* note 1, at 93 (providing that whether a hybrid school "leans toward" the nonprofit or for-profit form depends on the extent of services

A hybrid charter school that uses vendors to provide only select services would be a nonprofit entity, while a hybrid charter school that uses an EMO to fully operate the school is a for-profit entity.[27] It is with these latter charter schools using EMOs that sweeps contracts enter the picture.[28] Under sweeps contracts, the EMOs receive almost all the school's revenue in exchange for operating the school, with the leftover balance going to the EMO as profit.[29]

By structuring the relationship between the nonprofit school and the for-profit EMO under a sweeps contract, the charter school may still receive federal funding that would be unavailable if a for-profit entity held the charter.[30] Therefore, the EMO obtains guaranteed revenue.[31]

B. Charter Schools: Then and Now

The charter school movement began as a response to the public's perception that the public school system failed.[32] Today, charter school enrollment is high, having grown eightfold from 2002 to 2020.[33] Despite the bad press for-profit charter schools receive from scandals and politicians, EMOs still remain prevalent.[34]

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provided by the managing organization and the fee arrangement between the organization and the charter-holding entity).

27. *See* Morley, *supra* note 24, at 1791 (noting that hybrid schools that use EMOs for limited services would fall on the nonprofit side of the continuum while those hybrid schools that employ EMOs for substantial uses would fall on the other side).

28. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 5 (noting how an EMO used a sweeps contract with a nonprofit charter school).

29. *See id.* (indicating that an EMO can profit from a sweeps contract by receiving an amount equal to or less than a charter school's total revenue, in exchange for its services).

30. *See* Geheb & Owens, *supra* note 1, at 92 (explaining how hybrid charter schools can circumvent the Department of Education's policy that only non-profit charter schools can receiving federal funding).

31. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 15 (noting the guaranteed revenue provided by taxpayers).

32. *See* Eastman, *supra* note 8, at 293–94 (commenting how states began passing charter school legislation in response to "dissatisfaction among parents over the lack of education options, quality, and diversity in K-12 education"); *see also* Geheb & Owens, *supra* note 1, at 76 (noting that charter schools present parents and students with a school choice program).

33. Proclamation No. 10030, 85 Fed. Reg. 28,831 (May 13, 2020).

34. *See, e.g.*, Valerie Strauss, *The 5 Most Serious Charter School Scandals in 2019 – and Why They Matter*, WASH. POST (Jan. 27, 2020, 4:12 PM), https://www.washingtonpost.com/education/2020/01/27/5-most-serious-charter-school-scandals-2019-why-they-matter/ (reporting on political responses to charter schools scandals); *see also* NAT'L EDUC. POL'Y CTR., *supra* note 12, at 16 (showing that the

While EMOs may face bad press, the typical problems that plague charter schools, namely inadequate funding, inexperience with operating a school, and the inability to raise capital and take advantage of economies of scale, encourage charter schools to contract with EMOs.[35] Further, the federal funding that flows to nonprofit charter schools guarantees revenue and a low-risk investment for EMOs and encourages EMOs, with their superior access to capital and ability to use economies of scale, to partner with charter schools.[36] Some argue that EMOs, which leave charter schools with little to do, use charter schools as a shield from taxation.[37]

C. Nonprofits in the Charter School Context

To qualify as a 501(c)(3) nonprofit entity, a charter school must be "organized and operated exclusively for . . . educational purposes."[38] To determine if an organization meets this requirement, the IRS applies an organizational test and an operational test.[39] The organizational test looks to the instruments of an organization, while the operational test assesses the organization's activities and functions.[40]

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number of EMOs has increased since 1998).

35. *See* Geheb & Owens, *supra* note 1, at 74–75 (discussing the lack of funding charter schools receive in comparison to public schools and noting that the most common reason charter schools close is a "lack of adequate funding and fiscal mismanagement"); *see also* Eastman, *supra* note 8, at 289 (stating that school management inexperience is the main reason a charter school hires an EMO); Morley, *supra* note 24, at 1811–13 (describing how for-profit charter schools and EMOs have an advantage over nonprofit charter schools and CMOs in that the former can better raise funds and utilize economies of scale).

36. *See* Morley, *supra* note 24, at 1811–12 (describing EMOs' superior fundraising ability); *see also* NETWORK FOR PUB. EDUC., *supra* note 6, at 40 (noting how a for-profit charter school is a low-risk investment for entrepreneurs); *see also* Michael Q. McShane, *Ban For-Profit Charters?*, EDUC. NEXT, https://www.educationnext.org/ban-for-profit-charters-campaign-issue-collides-covid-era-reality/#:~:text=The%202020%20Democratic%20Party%20platform,Danny%20Glover%2C%20and%20Michael%20Moore%2C (last visited May 28, 2022) (interviewing an EMO CEO who states that EMOs are better able to exploit economies of scale because they do not have to fundraise).

37. *See* W. Chester Area Sch. Dist. v. Collegium Charter Sch., 760 A.2d 452, 468 (Pa. Commw. Ct. 2000) (reporting an accusation that a charter school was nothing more than a shell for the for-profit corporation that created it); *see also* NETWORK FOR PUB. EDUC. *supra* note 6, at 4 (noting that EMOs "lock in" schools using sweeps contracts).

38. 26 U.S.C. § 501(c)(3).

39. *See* 26 C.F.R. § 1.501(c)(3)-1(a)–(c) (2017) (explaining that "an organization must be both organized and operated exclusively" for educational purposes in order to be exempt).

40. *See* § 1.501(c)(3)-1(b)–(c) (distinguishing between the organizational and

The organizational test analyzes the nonprofit's articles of organization and bylaws to determine if the articles and bylaws commit the organization to at least one exempt purpose without allowing it to engage in substantial nonexempt purposes.[41] As applied to charter schools, the articles of organization and bylaws must relate to providing training or guidance to an individual to better that person's abilities or competence.[42] However, if the articles of incorporation or bylaws allow the charter school, for example, to operate a social club, the charter school would fail the organizational test as operating for a nonexempt purpose.[43]

When using the operational test, the IRS does not regard one factor as dispositive, opting instead to look at the organization's overall purpose.[44] The organization's activities are in turn analyzed as a "useful indicia of the organization's purpose."[45] From here, the IRS then considers the important factors of control and substantial private benefit, which the IRS uses in conjunction with the operational test even though the private benefit analysis may be distinct from the operational test.[46]

For the first of these two critical factors, the IRS examines who is

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operational test).

41. *See* § 1.501(c)(3)-1(b)(1)(i); BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 65 (10th ed. 2011) (stating that the IRS considers "the instrument by which the organization is created (*articles of organization*) and the instrument stating the rules pursuant to which the organization is operated (*bylaws*)"); *see also* § 1.501(c)(3)-1(b)(2) (explaining that articles of organization can be "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.").

42. *See* § 1.501(c)(3)-1(d)(3)(i)(a) (including under the definition of "educational" "the instruction or training of the individual for the purpose of improving or developing his capabilities").

43. *See* HOPKINS, *supra* note 41, at 66 (explaining how an entity that has articles of incorporation or bylaws that permit any nonexempt purpose will always fail the organizational test).

44. *See* Thomas A. Kelley III, *North Carolina Charter Schools' (Non-?) Compliance with State and Federal Nonprofit Law*, 93 N.C. L. REV. 1757, 1816 (2015) (noting the operational test's "all-factor" analysis); *see, e.g.*, 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (turning to previous SARs in analyzing a charter school's purpose).

45. 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (citing Living Faith, Inc. v. Comm'r, 950 F.2d 365 (7th Cir. 1991)).

46. *See id.* ("To the extent that petitioner cedes control over its sole activity . . . petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes."); *see also* est of Hawaii v. Comm'r, 71 T.C. 1067, 1080–82 (1979) (holding that the nonprofit did not operate exclusively for exempt purposes because of the benefits it provided to private individuals).

controlling the applicant organization.[47] The IRS and Tax Court break control into two categories: formal and informal.[48] Formal control refers to legally mandated control that gives one party actual authority over another.[49] Examples of this in practice include when a nonprofit organization gives significant powers to a related for-profit entity or when a nonprofit and for-profit organization share leadership or board members.[50] Informal control, on the other hand, refers to the contextual facts surrounding a nonprofit that allows the for-profit control through its influence.[51] This type of control in practice includes a for-profit company dictating how, when, and how often a spiritual program occurs, or a nonprofit lacking the resources and ability to oversee the activities of its for-profit partner.[52]

The second important factor, substantial private benefit, refers to a doctrine that the IRS and Tax Court developed from the common law rule that a charitable trust must be created to benefit a charitable class, not private individuals.[53] Under this doctrine, the IRS looks to see if the benefits generated by the applicant organization are "more than incidentally" flowing to individuals who are not in the charitable class the applicant organization is meant to serve.[54] If benefits are flowing "more

47. *See* 1997 IRS NSAR 0391R, 1997 WL 33810247 (Jan. 1, 2003) (discussing how various Tax Court cases focus on control).

48. *See, e.g.*, Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 79–88 (1999) (explaining how the nonprofit entity failed to retain both formal and informal control over the surgery center).

49. *See id.* at 79–80 (commenting how Redlands did not have the ability to control the two decision-making bodies it was a part of for the surgery center); *see also Est of Hawaii*, 71 T.C. at 1080 (noting that International did not formally control Est of Hawaii because different people controlled each organization).

50. *See Redlands Surgical Servs.*, 113 T.C. at 85 (describing how a management contract that directed the for-profit to provide management, administrative, and material services to a nonprofit surgery center gave that for-profit organization too much control over the nonprofit); *see also est of Hawaii*, 71 T.C. at 1080 (highlighting how a nonprofit ceded informal control by allowing a for-profit to provide employees who managed the nonprofit).

51. *See Redlands Surgical Servs.*, 113 T.C. at 85 (equating a lack of informal control to the nonprofit entity's inability to influence the for-profit organization).

52. *See est of Hawaii*, 71 T.C. at 1080 (rejecting the idea that the for-profit did not exert control over the nonprofit just because the same individuals did not formally control the for-profit and nonprofit organizations); *see also Redlands Surgical Servs.*, 13 T.C. at 85 (detailing the nonprofit's inability to exert influence in its partnership with the for-profit organization).

53. *See* Kelley, *supra* note 44, at 1786–90 (explaining the origins of the private benefit doctrine).

54. *See* I.R.S. Gen. Couns. Mem. 39,589, at 6 (Jan. 23, 1987) ("If, however, the

than incidentally" to these private individuals, the IRS will reject 501(c)(3) classification for that organization.[55]

The IRS further requires a benefit to be incidental in both a qualitative and quantitative manner.[56] A qualitative benefit is one a private individual receives that is a necessary side effect of the exempt activity the applying organization is carrying out.[57] An example of this is subsidizing the training and salary of recent law school graduates who then provide legal services to indigent clients.[58] While the graduates, individuals outside the charitable class of indigent people, are receiving benefits in the form of training and compensation, these benefits are necessary to achieve the charitable purpose of providing legal services to indigents.[59]

For quantitative analysis, the IRS weighs the charitable benefit against the private benefit to determine if the latter is comparatively significant.[60] An example of this comes from an organization formed in a rural community to attract and pay a doctor to operate within the community.[61] While the doctor benefited from compensation, that benefit was quantitatively incidental, as a doctor would provide medical care to an isolated community that had been without a doctor for at least five years.[62]

D. Tax Court Action Against Organizations Seeking 501(c)(3) Status

The Tax Court provides two examples of organizations that improperly filed as nonprofit entities.[63] First, in *est of Hawaii v. Commissioner,*[64] est

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private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status."); *see also id.* at 1817 (explaining that, for the private benefit doctrine, the IRS assesses whether applying the organization's benefits are substantially passing to individuals not in the intended charitable class).

55. *See* I.R.S. Gen. Couns. Mem. 39,598, at 6 (Jan. 23, 1987) ("An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally.").

56. *Id.*

57. *Id.* ("In order to be incidental in a qualitative sense . . . the activity can be accomplished only by benefitting certain private individuals.").

58. *See generally* Rev. Rul. 72-559, 1972-2 C.B. 247 (explaining that the applying organization, "formed to provide substantial free legal services to low income residents of economically depressed communities through the subsidization of recent law graduates," operated for charitable purposes).

59. *See id.* (holding that the applying organization maintained a charitable purpose even though it benefited private individuals).

60. *See* I.R.S. Gen. Couns. Mem. 39,598, at 6 (Jan. 23, 1987).

61. *See* I.R.S. Gen. Couns. Mem. 35,268, at 1–2 (Mar. 14, 1973).

62. *See id.* at 12–13.

63. *See* est of Hawaii v. Comm'r, 71 T.C. 1067, 1082 (1979) (holding that a self-help organization was not a nonprofit organization); Redlands Surgical Servs. v.

of Hawaii challenged the IRS's determination that it was not operated exclusively for exempt purposes.[65] The dispute involved est of Hawaii, an organization applying for nonprofit classification to promote a self-realization program called Erhard Seminars Training ("EST"), and International, a for-profit organization that licensed the rights to conduct est activities to est of Hawaii.[66]

Ultimately, the Tax Court rejected est of Hawaii's nonprofit status because of the amount of control est of Hawaii gave International; thus, est of Hawaii was operating not for an exempt purpose, but for the private benefit of International.[67] First, the Tax Court dismissed the relevance of est of Hawaii's assertion that International had no formal control over est of Hawaii.[68] Instead, the Court focused on International's informal control by highlighting that International, among other things, paid the salaries of the trainers at est of Hawaii and governed the programs those trainers conducted.[69] Additionally, the IRS noted that the existence of est of Hawaii was dependent upon it achieving nonprofit status, as the licensing agreement required est of Hawaii to obtain this classification.[70] With this 501(c)(3) status requirement, the IRS concluded that the for-profit est organizations were exploiting this nonprofit classification as a business advantage.[71]

In *Redlands Surgical Services v. Commissioner*,[72] Redlands Surgical Services ("Redlands") was a nonprofit corporation that entered into a general partnership in which SCA Management Co. ("SCA Management") operated its surgical center.[73] As in the previous case, the IRS determined that, as a for-profit organization, SCA Centers had too much informal

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Comm'r, 113 T.C. 47, 92–93 (1999) (holding that an organization involved in a surgery center was not a nonprofit entity).

64. 71 T.C. 1067 (1979).

65. *Id.* at 1068.

66. *Id.* at 1069, 1071.

67. *Id.* at 1080.

68. *Id.*

69. *Id.*

70. *See id.* at 1069–70, 1080 (indicating that est of Hawaii only existed to shelter the for-profit from taxes).

71. *Id.* at 1080 ("Moreover, we note that petitioner's rights vis-a-vis EST, Inc., International, and PSMA are dependent on the existence of its tax-exempt status -- an element that indicates the possibility, if not likelihood, that the for-profit corporations were trading on such status.").

72. 113 T.C. 47 (1999).

73. *Id.* at 48.

control over Redlands, and thus the hospital operated for the private benefit of SCA Management.[74] Additionally, the Tax Court also found that Redlands held too little formal control.[75]

In terms of informal control, the Tax Court noted that Redlands held insufficient resources to ensure the surgery center operated for charitable purposes, as Redlands' only assets were in the surgery center itself.[76] Additionally, Redlands was in debt to SCA for the first two years of the partnership.[77] While Redlands claimed that it still maintained enough influence to achieve its charitable purpose, the Tax Court concluded otherwise, noting that Redlands failed to ensure the surgery center provided charity medical care as its nonexempt purpose.[78]

For formal control, the court first looked at the significant responsibilities given to SCA Centers in the management contract, with SCA Management providing managerial, administrative, and any other services needed to operate the surgery center.[79] While Redlands was still technically involved in decision-making for the surgery center through its membership as a managing director and in the Medical Advisory Group, the nonprofit organization failed to exert any influence.[80] Further, the Tax Court took issue with the contract's compensation scheme, which gave SCA Management an incentive to operate the surgery center at a profit.[81]

E. IRS Rulings Against Organizations Seeking 501(c)(3) Status

In published Service Advice Reviews, essentially 501(c)(3) rejection letters, the IRS sheds light on impermissible relationships between charter

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74. *See id.* at 78 (concluding that, because the SCA Centers ceded effective control of the partnership's and the Surgery Centers' activities, it did not operate solely for charitable purposes).

75. *Compare id.* at 85 (holding that Redlands lacked both formal and informal control) *with* est of Hawaii v. Comm'r, 71 T.C. 1067, 1080 (1979) (holding that est of Hawaii did not cede formal control but did so with informal control).

76. *See Redlands Surgical Servs.*, 113 T.C. at 85.

77. *See id.*

78. *See id.* at 86–87 (highlighting that the record failed to show that Redlands provided care to indigent patients and the extent to which the decision to perform surgery was a medical one and not economic).

79. *Id.* at 59, 81–82.

80. *See id.* at 79–80, 84 (stating that Redlands failed to show it controlled the managing directors and Medical Advisory Group).

81. *See id.* at 82 (providing that, even though the management contract was structured based on revenue, SCA Management still had an incentive not just to maximize revenue in its operations related to charity care).

schools and for-profit organizations.[82] Two examples of this both involve similar relationships to the parties involved in a sweeps contract in that the charter school cedes control of the school to a for-profit management organization.[83] In the first example, involving a kindergarten through sixth-grade charter school, the IRS not only took issue with the school ceding control to the for-profit, but also with providing that organization with substantial benefits such as eliminating competition, improving its business through experience, and avoiding issues with school boards.[84] As a result, the IRS determined that the school could not file as a 501(c)(3) entity.[85]

The relationship between a second kindergarten through twelfth-grade charter school and its for-profit management organization was similar to the relationship in the previous example, as the school ceded control of curriculum, development, and staffing to the for-profit entity.[86] However, this charter school also gave the for-profit responsibility for financial issues such as accounting, taxes, and legal matters.[87] This extensive control allowed the management company to give itself excessive compensation, to enter into contracts with parties members of the management company had financial interests in, and to enter the profitable education management world.[88] Like the first example, this impermissible relationship and the benefits it conferred onto a for-profit organization prevented the IRS from allowing the charter school to file as a nonprofit organization.[89]

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82. *See How Does the IRS Interpret Section 501(c)(3)?*, DIGIT. MEDIA L. PROJECT, http://www.dmlp.org/irs/section-501c3 (last visited Sept. 19, 2021) ("Non Docketed Service Advice Reviews constitute non-precedential determinations on tax issues directed to taxpayers in letter form").

83. *See* 1997 IRS NSAR 0391R, 1997 WL 33810247 (Jan. 1, 2003) (highlighting that the charter school allowed the for-profit to take responsibility for the curriculum, staffing, maintenance of the school building, transportation, and food); 2000 IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000) (highlighting how the contract between the charter school and management company gave the latter responsibility for any services needed to run the school).

84. *See* 1997 IRS NSAR 0391R, 1997 WL 33810247 (Jan. 1, 2003) (noting the impressive level of control and the benefits given to the for-profit entity).

85. *See id.* (rejecting the charter school's nonprofit status).

86. *See* 2000 IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000) (explaining the types of services, facilities, and items furnished to the for-profit entity per the management contract).

87. *See id.*

88. *See id.*

89. *See id.* (rejecting the charter school's nonprofit status).

F. Current Examples of Sweeps Contracts

Researchers have highlighted two recent examples of sweeps contracts involving the EMO the National Heritage Academy ("NHA") that highlights the level of control ceded by charter schools using a sweeps contract with an EMO.[90] The first contract ("Bennet Contract"), discovered during a 2019 audit of the Bennet Venture Academy, dictates that NHA is responsible for what amounts to operating the entire charter school.[91] Under the contract terms, NHA provides anything needed to start and then subsequently run the school, like "administration, strategic planning and all labor, materials, equipment, and supervision necessary . . . ."[92] The second contract ("North Carolina Contract"), obtained by a commenter researching charter schools in North Carolina, provided the same services to North Carolina charter schools as the Bennet Contract, but additionally relieved the charter schools of financial responsibilities, such as accounting.[93]

III. ANALYZING A SWEEPS CONTRACT'S EFFECT ON NONPROFIT CHARTER SCHOOLS

The IRS and Tax Court have yet to address, at least publicly, the effect a sweeps contract has on a charter school's nonprofit status.[94] However, the principles the IRS and Tax Court use to deny other organizations' tax-exempt status may also apply to denying 501(c)(3) status to charter schools using a sweeps contract with an EMO.[95] Using these principles, the charter

90. OHIO AUDITOR OF STATE, BENNETT VENTURE ACADEMY LUCAS COUNTY SINGLE AUDIT FOR THE YEAR ENDED JUNE 30, 2018, 6 (2018), https://ohioauditor.gov/auditsearch/Reports/2019/Bennett_Venture_Academy_18-Lucas.pdf (detailing what amounts to a sweeps contract between the charter school and the EMO NHA); Kelley, *supra* note 44, at 1802–03 (detailing the contents of the sweeps contract between a charter school and NHA); *see also* Clare Carroll, *National Heritage Academies: A Case Study of For-Profit Educational Management Organizations*, EDUC. STUDIES, http://debsedstudies.org/national-heritage-academies-a-case-study-of-for-profit-educational-management-organizations/ (last visited Sept. 19, 2021) (defining NHA as the second largest EMO in the United States).

91. *See* OHIO AUDITOR OF STATE, *supra* note 90, at 6 (describing the contents of the sweeps contract between the charter school and NHA).

92. *Id.*

93. Kelley, *supra* note 44, at 1802–03.

94. *See, e.g.*, 2003 IRS NSAR 0391R, 1997 WL 33810247 (explaining issues with the management contract that show it is not a sweeps contract); est of Hawaii v. Comm'r, 71 T.C. 1067, 1068 (1979) (providing details on the improper management contract that make it clear the agreement does not fit the definition of a sweeps contract).

95. *See* 26 C.F.R. § 1.501(c)(3)-1(a)–(c) (2017) (detailing the requirements of the organizational and operational tests); *see, e.g.*, 2000 IRS NSAR 20000753R, 2000 WL

school will likely pass the organizational test, but ultimately fail the operational test due to the control and substantial benefits a sweeps contract passes to an EMO.[96]

A. Organizational Test: Pass or Fail?

The organizational test is the first step in assessing whether an organization deserves 501(c)(3) classification.[97] Theoretically, the use of a sweeps contract, by itself, does not cause a charter school to fail this test.[98] As the IRS and Tax Court generally analyze the articles of incorporation of the applicant organization to determine if they passed the test, the sweeps contract would be irrelevant and possibly nonexistent at this point because the articles of incorporation and sweeps contract are two distinct documents.[99] Further, as the organizational test only considers documents that create an organization, a sweeps contracts would not fall into this category because the charter school must already be organized to have a management contract with an EMO.[100] Consequently, a typical sweeps contract should be able to pass the organizational test.[101]

B. Operational Test: Pass or Fail?

The operational test is the main hurdle for charter schools using a sweeps

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34548359 (Oct. 30, 2000) (rejecting the nonprofit classification of a charter school because of an improper relationship with a for-profit management company).

96. *See* § 1.501(c)(3)-1(a)–(c).

97. *See, e.g.*, 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (analyzing whether the charter school was organized properly first).

98. *See* Geheb & Owens, *supra* note 1, at 76–77 (describing what a charter is); 2000 ISR NSAR 20000753R, 2000 WL 34548359 (referring specifically to articles of incorporation, not a charter); 2003 IRS NSAR 0391R, 1997 WL 33810247 (scrutinizing the bylaws of the charter schools' articles of incorporation).

99. *See* 2000 ISR NSAR 20000753R, 2000 WL 34548359 (examining only the articles of incorporation for the organization test); 2003 IRS NSAR 0391R, 1997 WL 33810247 (assessing the articles of incorporation and bylaws in light of the organization test, but the Management Agreement only against the operational test).

100. *See* § 1.501(c)(3)-1(b)(2) (defining articles of organization, which the organizational test is based on, as "includ[ing] the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created").

101. *See* § 1.501(c)(3)-1(b) (discussing how documents present at the creation of an organization, which state that the organization was formed for non-exempt purposes fitting the definition of section 501(c)(3) of the Code, may be considered to satisfy the organizational test); 2003 IRS NSAR 0391R, 1997 WL 33810247 (reserving the Management Agreement only for the operational test).

contract with EMOs.[102] While the IRS uses an all-factor analysis in determining whether an organization is operating for exempt purposes, a sweeps contract is dispositive of an organization operating for non-exempt purposes, and a single non-exempt purpose negates any claim to operating for exempt purposes overall.[103] To analyze the effect of a sweeps contract, the IRS and Tax Court can look to who controls the operation of the charter school and the existence of a substantial benefit to the EMO as it has done with other applying organizations and their related for-profit entities.[104]

C. *Who Has Control?*

In determining whether the applying organization has sufficient control of its activities, the IRS and Tax Court look at two things: informal and formal control.[105] Formal control in this context refers to the responsibilities designated to the parties in a sweeps contract.[106] Looking at previous IRS and Tax Court decisions, the level of formal control the charter school cedes to an EMO with a sweeps contract is impermissible for that charter school to be a tax-exempt organization.[107] Using the two

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102. *See* § 1.501(c)(3)-1(c)(1) ("An organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."). *Compare* OHIO AUDITOR OF STATE, *supra* note 90, at 6 (describing how NHA was responsible for the operation of the charter school), *with* 1997 IRS NSAR 0391R, 1997 WL 33810247 (detailing how the nonprofit charter school impermissibly ceded control of its operations to a management company).

103. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1064 (1989) (explaining how the Tax Court looks "beyond the four corners of the organization's charter" to determine if the organization passes the operational test); 2003 IRS NSAR 0391R, 1997 WL 33810247 (stating that evidence of control of the organization by a for-profit entity combined with evidence of a private benefit will prohibit exempt status for that organization).

104. *See, e.g.*, 1997 IRS NSAR 0391R, 1997 WL 33810247 (noting control and a benefit to a for-profit organization two principles to consider when deciding if an applying organization should be granted tax-exempt status); est of Hawaii v. Comm'r, 71 T.C. 1067, 1079–1081 (1979) (analyzing the control est of Hawaii ceded to International and the benefit International received from this control).

105. *See, e.g.*, Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 79–88 (1999) (noting a lack of formal and informal control).

106. *See, e.g.*, 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (listing the substantial number of activities the for-profit management company performed for the charter school, making the charter school operate not for an exempt purpose, but rather for the benefit of that management company).

107. *See, e.g.*, 1997 IRS NSAR 0391R, 1997 WL 33810247 (holding that an organization impermissibly ceded control to a for-profit entity by allowing the for-

recent sweeps contracts from NHA-run schools as examples of the relationships between parties in a sweeps contract, the only responsibilities left for the charter school in the Bennet Contract are board governance and financial services such as accounting.[108] Contrasting the Bennet Contract with the North Carolina Contract, the charter school under the North Carolina Contract is only responsible for board governance.[109] However, the Tax Court and the IRS have previously rejected tax-exempt classification from organizations with similar relationships to for-profit organizations.[110] Just as a sweeps contract dictates that the EMO is responsible for operating the charter school, the agreement between International and est of Hawaii left International in charge of operating EST activities at est of Hawaii, and a sweeps contract actually leaves less for charter schools to do.[111] Further, the IRS, in its published SARs, has stated that charter schools ceding similar responsibilities to for-profit companies had relinquished too much control to be considered operating for exempt purposes.[112]

These same Tax Court and IRS decisions also show that charter schools, with their frequent lack of funding and experience, relinquish informal control to EMOs when they use sweeps contracts.[113] In those previous

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profit to manage the charter school); *Redlands Surgical Servs.*, 113 T.C. at 85 (taking issue with the management contract between a nonprofit and for-profit organization that required the for-profit to manage the daily operation of a surgery center).

108. *See* OHIO AUDITOR OF STATE, *supra* note 90, at 6 (describing what is essentially a sweeps contract between the charter school and NHA); Kelley, *supra* note 44, at 1802–03 (detailing the contents of a sweeps contracts between a charter school and NHA); 2000 IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000) (stating that the charter school improperly handed full control of the school to a management company).

109. *See* Kelley, *supra* note 44, at 1802–03

110. *See, e.g.*, *Redlands Surgical Servs.*, 113 T.C. at 81–82, 97 (rejecting Redlands' entitlement to exemption based partly on the fact that Redlands, through a management contract, handed off the day-to-day operations of the surgery center to SCA Management).

111. *Compare* est of Hawaii v. Comm'r, 71 T.C. 1067, 1080 (1979) ("International exerts considerable control over petitioner's activities . . . . [P]etitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc.") *with* Kelley, *supra* note 44, at 1804 (noting that essentially just board governance was handed off to NHA).

112. *See, e.g.*, 1997 IRS NSAR 0391R, 1997 WL 33810247; 2001 IRS NSAR 20010799R, 2001 WL 34818860 (Aug. 31, 2001); 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001); 2000 IRS NSAR 20000753R. 2000 WL 34548359 (Oct. 30, 2000) (detailing several examples of charter schools that inappropriately ceded control to for-profit companies).

113. *See, e.g.*, *Redlands Surgical Servs.*, 113 T.C. at 85–88 (holding that Redlands

decisions, the Tax Court and IRS focused on the related for-profit's ability to control the governing body of the applying organization.[114] With informal control, the IRS looks to the context the organization exists in instead of who has ultimate authority.[115] As charter school organizations are often inexperienced, they have a natural tendency to rely on EMOs, which have experience in operating a school.[116] Further, the lack of funding that charter schools face overall only exacerbates this tendency to depend on EMOs and their easier access to capital and start-up funds.[117] Given this dependence on EMOs, charter schools end up having a similar relationship to that of est of Hawaii.[118] Just as International did not have ultimate, formal control over est of Hawaii's decisions, EMOs theoretically do not have the final say over charter schools, as the charter school still has a board of directors who are responsible for the charter school.[119] However, just like how International could influence est of Hawaii through its control of functions such as staffing and scheduling, an EMO is in a

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failed to demonstrate that it maintained informal control of the surgery center).

114. *See* Greg McRay, *A Nonprofit Board of Directors – What is a Board?*, FOUND. GRP. (Dec. 11, 2014), https://www.501c3.org/nonprofits-board-directors/ (defining the board of directors as the group who supervises the organization's operations); *see also Redlands Surgical Servs.*, 113 T.C. at 79–80, 84 (explaining the petitioner's limited role in appointing managing directors and in reconstituting the Medical Advisory Group).

115. *Compare Redlands Surgical Servs.*, 113 T.C. at 79–80 (commenting how the nonprofit did not have the ability to control the two decision making bodies, the Managing Directors and the Medical Advisory Group, it was a part of for purposes of managing the operations of the surgery center), *with est of Hawaii*, 71 T.C. at 1080 (equating a lack of informal control to the nonprofit entity's inability to influence the for-profit organization).

116. *See* Eastman, *supra* note 8, at 289 (noting that the most common reason a charter school hires an EMO is lack of experience); *What is a Charter School?*, *supra* note 16 (describing how almost anyone can start a charter school); Geheb & Owens, *supra* note 1, at 75 (listing "[l]ack of adequate funding and fiscal management" as the two main reasons charter schools close); 1997 IRS NSAR 0391R, 1997 WL 33810247 (citing one of the benefits the EMO received from working with the charter school was gaining competence in their work); *ESP, EMO, CMO?*, *supra* note 13 (commenting how EMOs typically manage a network of schools).

117. *See* Geheb & Owens, *supra* note 1, at 75 (describing the effect of the funding gap on charter school success); Morley, *supra* note 24, at 1811 (noting the availability of capital and economies of scales to EMOs).

118. *See est of Hawaii*, 71 T.C. at 1080 (stating that International wields significant influence over est of Hawaii by controlling tuition, staffing, and scheduling).

119. *See id.* ("While it may be true that they are not formally controlled by the same individuals, International exerts considerable control over petitioner's activities."); NETWORK FOR PUB. EDUC., *supra* note 6, at 4 (explaining what a sweeps contract is).

position to influence the decisions of its charter schools.[120] EMOs provide teachers, curriculum, material support, and often the real estate. Thus ending the relationship with the EMO would leave the charter school without the necessary resources to operate a school.[121] Thus, charter schools, faced with a decision that could leave their doors closed and their students without a school, can easily be coerced into staying in these contracts.[122]

In sum, the conditions charter schools exist in, combined with a sweeps contract, leaves charter schools in a significantly diminished bargaining position to the point where charter schools jeopardize their existence if they back out of the contract.[123] Consequently, sweeps contracts create a captive market with the charter schools dependent on the services the EMO provides, resulting in the board ceding informal control of the charter school to the EMO.[124]

i. Does the EMO Receive a Significant or Only Incidental Benefit?

In order for an organization to fail the operational test under the private benefit doctrine, something more than an incidental benefit must flow to a for-profit entity.[125] Even if an organization operates for a substantially

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120. *See est of Hawaii*, 71 T.C. at 1080 (noting the extensive sway International held over est of Hawaii); Kelley, *supra* note 44, at 1802–03 (explaining that a sweeps contract left a North Carolina charter school with little responsibility over its own school); Morley, *supra* note 24, at 1819 (noting that the extent to which an EMO takes over operating a charter school would mean that the school would be shut down without the EMO).

121. *See* Kelley, *supra* note 44, at 1802–03 (listing NHA's responsibilities under the sweeps contract with the Academy).

122. *See* Morley, *supra* note 24, at 1819 (highlighting that charter schools' dependency on EMOs under sweeps contracts leave the former with "weak bargaining positions").

123. *See id.* (stressing charter schools' dependency on EMO's); *see also* 2001 IRS NSAR 20010822R, 2001 WL 34818873 (Oct. 25, 2001) (stating that schools run the risk of losing their curriculum and staff if they end their relationships with management companies).

124. *See* 2000 IRS NSAR 20000753R, 2000 WL 34548359 (Oct. 30, 2000) (asserting that the contract between the charter school and for-profit "create[d] a captive market of charter schools dependent upon the L.L.C.'s services"); *see also Captive market – definition and meaning*, MKT. BUS. NEWS, https://marketbusinessnews.com/financial-glossary/captive-market/ (last visited Sept. 19, 2021) (defining captive market as "[a] group of consumers who are obliged through lack of choice to buy a particular product, thus giving the supplier a monopoly") (internal quotations omitted).

125. *See, e.g.*, 1997 IRS NSAR 0391R, 1997 WL 33810247 (Jan. 1, 2003) (revealing that the contract the charter school agreed to passed much more than

exempt purpose, the presence of a significant benefit flowing to a private person will ruin any claim to a 501(c)(3) classification.[126] Under the sweeps contracts, more than one substantial benefit is passed to the EMO, meaning the charter school fails the operational test due to the private benefit doctrine.[127]

The first benefit that an EMO receives from the sweeps contract is deflection from bad publicity.[128] Bad publicity can inflict damage on a company, as evidenced by the fact that only one state allows for-profit organizations to hold a charter and how popular it is for politicians to advocate against for-profit charter schools.[129] Thus, there is little incentive to be a for-profit charter school.[130]

To add to this lack of incentive to be an openly for-profit charter school, the loophole to the prohibition against for-profit charter schools, that hybrid charter schools created, provides a significant benefit to EMOs.[131] By managing the charter school without dealing with publicity issues coming from the press, politicians, or school boards, the for-profit EMO remains in control but out of sight to the outside world.[132]

The second benefit EMOs receive from sweeps contracts is control of a tax-exempt shell, which itself provides the EMO access to federal funding

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incidental benefits to a for-profit organization, leading to the conclusion that the charter school did not operate for exempt purposes).

126. *See* Better Bus. Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279, 283 (1945) (stating that a private purpose disqualifies an entity from 501(c)(3) classification).

127. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (stating that a benefit flowing to a private person that is not merely incidental will result in the loss of 501(c)(3) classification).

128. *See* Strauss, *supra* note 34 (reporting various scandals related to charter schools and political responses to them); *see, e.g.*, *7 Companies Hurt by Bad Publicity*, MARKETWATCH (Aug. 18, 2014, 11:14 AM), https://www.marketwatch.com/story/7-companies-hurt-by-bad-publicity-2014-08-18.

129. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 3 (noting that Arizona is the only state that "allows for-profit entities to be licensed to run charter schools"); Washington Post Poll, *supra* note 10 (listing the various stances of the 2020 Presidential campaign participants towards for-profit charter schools).

130. *See* Peter Greene, *What's The Matter With For Profit Charter School Management?*, FORBES (July 21, 2021, 3:43 PM), https://www.forbes.com/sites/petergreene/2021/07/21/whats-the-matter-with-for-profit-charter-school-management/ (claiming that for-profit schools are inherently flawed because the more money spent on kids means they get to keep less profits).

131. *See id.* (referring to "non-profit charter school[s] hiring a for-profit business" as the loophole charter school operators have found).

132. *See, e.g.*, 1997 IRS NSAR 0391R, 1997 WL 33810247 (describing how a management contract allowed an EMO to avoid school board pressures).

and a shield from taxation.[133] Considering all the responsibilities designated to an EMO through a sweeps contracts, charter schools are left with little to do. What authority is left is further taken away by the informal control the EMO wields over the charter school.[134] With an EMO controlling the school, the only task left to the charter school is to appear as a nonprofit organization, protecting the EMO from taxation it would otherwise face.[135] Looking at the Ohio charter school that employed NHA, NHA is responsible for furnishing the building they themselves must provide, supplying teachers and administrators, and even providing strategic planning for the school.[136] Under the sweeps contract with the charter school in North Carolina, the EMO again provides everything the charter school needs to operate, including the building, teachers, curriculum, but also financial services like accounting.[137]

Further, the existence of a tax-exempt shell itself provides EMOs with another benefit.[138] Because the charter school, a nominally nonprofit organization, holds the charter instead of the for-profit EMO, the charter school receives federal funding.[139] This funding that charter schools receive, which would not be accessible to the EMO without this tax-exempt shell, allows EMOs to receive continuous, significant revenue, making this business venture a low-risk investment that the EMO would not be able to receive on its own.[140]

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133. *See* 26 U.S.C. § 501(a) ("An organization described in subsection (c) . . . shall be exempt from taxation under this subtitle unless such exemption is denied . . . ."); Geheb & Owens, *supra* note 1 (noting that hybrid charter schools receive federal funding that for-profit charter schools cannot access).

134. *See, e.g.*, Kelley, *supra* note 44, at 1802–03 (providing that the sweeps contract enabled NHA to provide everything needed to open and operate a charter school); Morley, *supra* note 24, at 1819 (highlighting the potential for a charter school to depend on the EMO and the services it provides).

135. *See, e.g.*, OHIO AUDITOR OF STATE, *supra* note 90, at 6 (describing the extensive services NHA provides); *see also W. Chester Area Sch. Dist. v. Collegium Charter Sch.*, 760 A.2d 452, 468 (Pa. Commw. Ct. 2000) (highlighting petitioner's argument that a charter school was nothing more than a front for the for-profit corporation that created it).

136. *See* OHIO AUDITOR OF STATE, *supra* note 90, at 6 (listing NHA's responsibilities under the Bennet Contract).

137. *See* Kelley, *supra* note 44, at 1802–03 (listing NHA's responsibilities under the North Carolina contract).

138. *See* Geheb & Owens, *supra* note 1, at 92 (detailing how some charter schools may collect federal funding that they otherwise would not receive, by contracting with EMOs).

139. *See id.*

140. *See id.* at 95–96 (explaining how charter schools are funded); *see generally*

The third benefit comes in the form of the economies of scale that sweeps contracts allow EMOs to exploit.[141] EMOs, with their generally easier access to capital, larger school size, and networks, can spread out fixed costs and make hybrid schools competitive with public schools and truly nonprofit or CMO-run charter schools.[142] Unlike nonprofit charter schools that must rely on donors to obtain the capital needed to create economies of scale, EMOs are able to exploit "profit motive" and the securities market to more effectively raise capital and more fully exploit economies of scale in their schools.[143] With economies of scale, NHA, for example, could better utilize their textbooks, which could be bought in bulk and reused, as compared to a small independent school.[144] Further, NHA is able to centralize strategic planning to one person for multiple schools, freeing up time and resources for other administrators.[145] With these economies of scale, EMOs are able to maintain a competitive advantage in the CMO-dominated charter school market.[146]

Further, EMOs do not receive just an incidental benefit with these three benefits, as the advantages the charter schools receive from the sweeps contracts are certainly not qualitatively incidental.[147] To be quantitatively incidental, the benefit must not be substantial compared to the benefit passed on to the charitable class, and one can certainly argue that successfully educating students is priceless.[148] However, a benefit must also be qualitatively incidental, meaning the benefit to the private

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Funding Status – Charter School Program State Educational Agencies (SEA) Grant, U.S. DEP'T OF EDUC., https://www2.ed.gov/programs/charter/funding.html (last visited Sept. 26, 2016) (listing the amount of federal funding provided to the charter school funding program each fiscal year since 1995).

141. *See* Morley, *supra* note 24, at 1811–13 (noting that for-profit schools are better able to utilize economies of scales effectively).

142. *See id.*

143. *See id.* (explaining why EMOs can utilize economies of scale better than their nonprofit counterpart).

144. *See id.* at 1813 (showing the benefits to economies of scale in education).

145. *See id.* (indicating that large school networks guarantee centralized decision-making).

146. *See* NAT'L EDUC. POL'Y CTR., *supra* note 12, at 16 (charting the number of EMOs from 1998–2020).

147. *See* Kelley, *supra* note 44, at 1817 (explaining how the IRS uses the private benefit doctrine to determine if an entity is truly nonprofit).

148. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) ("To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.").

individual is unavoidable.[149] Yet, the existence of charter schools that do not use sweeps contracts demonstrates that the benefits provided to EMOs by the contracts are clearly not necessary to achieve the school's educational purposes.[150] Unlike the organization formed to bring and pay for a doctor in a rural community, charter schools can survive without sweeps contract-wielding EMOs, and, judging by the dominance of CMOs, charter schools can thrive too.[151] Thus, the benefits are not qualitatively incidental, but are instead substantial.[152] Further, because of a significant benefit passing to a private individual, charter schools using a sweeps contract with an EMO fail the operational test due to the private benefit doctrine.[153]

D. Charter Schools, EMOs, and Sweeps Contracts: Their Report Card

The point of this Comment is not to argue that EMOs should be banned; rather, this Comment argues that EMOs and charter schools are exploiting a loophole in federal and state law with sweeps contracts.[154] In facilitating the federal charter school program, the federal government purposely excluded for-profit companies from starting or controlling charter schools.[155] The States have done the same by prohibiting for-profit companies from holding charters.[156] Yet, EMOs and charter schools have found a way around these prohibitions and exclusions from funding with

149. *See id.* ("A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense.").

150. *See* NAT'L EDUC. POL'Y CTR., *supra* note 12, at 23 (acknowledging that, while the number of charter schools that use EMOs or CMOs has consistently grown, there are charter schools that do not use EMOs or CMOs).

151. *See* I.R.S. Gen. Couns. Mem. 35,268 (Mar. 14, 1973) (explaining how the community lacked a doctor for five years); *id.* at 21 (showing through a graph that the number of students taught by CMOs in 2018 is about double that of EMOs).

152. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (stating that a benefit is incidental only if it is both qualitatively and quantitatively incidental).

153. *See* Kelley, *supra* note 44, at 1817 (explaining that under the private benefit doctrine the IRS determines whether the applying organization's benefits are substantially passing to individuals not in the intended charitable class and rejects nonprofit status if the benefits are substantially passing to private individuals).

154. *See* Geheb & Owens, *supra* note 1, at 92 (stating that for-profit charter schools are not eligible to receive federal funding); NETWORK FOR PUB. EDUC., *supra* note 6, at 9 (describing EMOs as a workaround to bans on for-profit charter schools).

155. *See* Ariz. State Bd. for Charter Schs. v. U.S. Dep't of Educ., 464 F.3d 1003, 1009–10 (9th Cir. 2006) (describing how for-profit charter schools are barred from receiving federal funding).

156. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 3 (explaining how every state with charter school laws banned for-profit charter schools except for Arizona).

sweeps contracts.[157] With the EMOs doing everything needed to operate a charter school except obtaining the charter itself, and receiving significant benefits in return, the nonprofit charter schools using a sweeps contract, in reality, are for-profit schools, meaning these charter schools cannot properly be classified as 501(c)(3) organizations.[158]

IV. NEXT STEPS FOR CHARTER SCHOOLS & EMOS: RECOMMENDATIONS

Because a charter school using a sweeps contract with an EMO cannot classify itself as a nonprofit organization, changes must be made. However, there are recommendations to address the issue of sweeps contracts, and an additional recommendation that addresses the issue underlying the contracts themselves.

The first is an obvious one: ban sweeps contracts between nonprofit charter schools and EMOs. If federal and state governments believe that only nonprofits should be controlling charter schools, evidenced by the ban on for-profit charter schools receiving federal funding and the fact that only Arizona allows for-profit charter schools, then legislatures should ban sweeps contracts.[159] However, if the federal or state governments believe that there is a place for EMOs or for-profit schools, then legislatures should not permit these companies to use a loophole and instead should allow for-profit entities to hold a charter.[160] Regardless, banning sweeps contracts would have the added benefit of saving the IRS time in assessing whether an organization is deserving of 501(c)(3) status, a process that already takes months.[161]

Additionally, the IRS could adopt the stance that a sweeps contract results in the automatic failure of the operational test, which would

157. *See id.* at 3–4 (detailing the "creative workarounds" profit-seeking EMOs and charter schools have found).

158. *See* 26 C.F.R. § 1.501(c)(3)-1(a)(1) (2017) (explaining how an organization that operates for a nonexempt purpose will not be regarded as a nonprofit entity).

159. *See* Geheb & Owens, *supra* note 1, at 92 (noting the U.S. Department of Education's policy of excluding for-profit charter schools from federal funding); NETWORK FOR PUB. EDUC., *supra* note 6, at 3 (reporting that Arizona is the only state where for-profit entities can be licensed to operate a charter school in Arizona).

160. *See* John Chubb, *The Private Can Be Public*, EDUC. NEXT, https://www.educationnext.org/the-private-can-be-public/ (last visited May 29, 2022) (advocating for an increased presence of private businesses in the education landscape).

161. *See* Lena Eisenstein, *How Long Does It Take to Get 501(c)(3) Status from the IRS?*, BOARDEFFECT (Apr. 28, 2021), https://www.boardeffect.com/blog/how-long-does-it-take-to-get-501c3-status-from-the-irs/ (explaining that it takes an average of two to four weeks to achieve 501(c)(3) status but can take three to six months or even a year).

automatically preclude that organization from 501(c)(3) status.[162] While the IRS currently uses an all-factor approach, it could make an exception for sweeps contracts.[163] As sweeps contracts result in a charter school operating for the benefit of the EMO, a nonexempt purpose, the IRS could save the resources it takes to analyze a charter schools application and could instead automatically deny tax-exempt classification for any charter school using a sweeps contract with an EMO.[164] Moreover, if a charter school enters into a sweeps contract after obtaining 501(c)(3) status, the IRS should mandate that the authorizers, who already periodically check on the progress of charter schools, notify the IRS.[165]

Banning sweeps contracts or requiring the contracts result in an automatic failure of the operational test, however, does not necessarily solve the issue.[166] A contract that does not quite meet the definition of a sweeps contract by, for example, only giving the EMO some of the school's revenue in exchange for providing real estate and staffing to the school would still leave the EMO with a significant amount of control over the charter school.[167] Just as with the charter school under a sweeps contract, the school in this example would not be inclined to do anything to jeopardize its relationship with the EMO, as doing so could leave the school without a building and teachers.[168] A better solution would be one that targets the root of the issue: the funding gap.[169]

As this Comment previously mentions, charter schools typically have lower levels of funding in comparison to their public-school counterparts,

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162. *See* § 1.501(c)(3)-1(a)(1) ("In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.").

163. *See* Kelley, *supra* note 44, at 1816 (noting that the IRS uses an "all the factors" analysis for purposes of the operational test).

164. *See* Eisenstein, *supra* note 161 (noting the large amount of time it takes the IRS to process a 501(c)(3) application).

165. *See What is a Charter School?*, *supra* note 16 (noting the role authorizers play in the charter school approval process).

166. *See* Geheb & Owens, *supra* note 1, at 126 (stressing the issue that many charter schools turn to management companies because of a "lack of start-up and facilities funds").

167. *See* NETWORK FOR PUB. EDUC., *supra* note 6, at 4 (defining a "sweeps contract" as a contract that locks charter schools into passing virtually all revenue to the EMO operating the school).

168. *See* Morley, *supra* note 24, at 1819 (noting the power EMOs hold over charter schools as a result of the services EMOs provide under sweeps contracts).

169. *See* Geheb & Owens, *supra* note 1, at 75 (pointing out that one of the most common reasons charter schools fail is a lack of funding).

and one of the main reasons that charter schools close is a lack of funding.[170] EMOs, with their superior access to capital, present an enticing fix to a charter school's funding problem.[171] EMOs, for their part, are encouraged to use sweeps contracts to better utilize their economies of scale and increase profits.[172] However, if state and federal legislatures closed or eliminated this funding gap, charter schools would lose a strong motivating factor to agree to sweeps contracts.[173] Realistically, securing more funding for charter schools is a hot-button political issue, so banning sweeps contracts may be the more viable recommendation.[174]

V. CONCLUSION

Both EMOs and sweeps contracts are prevalent in the charter school landscape today, despite almost all states banning for-profit charter schools, the federal government banning federal funding for for-profit schools, and the numerous scandals surrounding for-profit schools or EMOs. If federal and state legislatures truly believe that for-profit charter schools should be prohibited, then sweeps contracts, which, in reality, turn the nonprofit charter schools that use these contracts into for-profit schools, have no place in the charter school landscape today.

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170. *Id.*

171. *See* Morley, *supra* note 24, at 1785 (noting for-profit entities' superior capital-raising abilities).

172. *See id.* at 1811 (describing how for-profit schools' access to capital allows them to more efficiently use economies of scale).

173. *See* Geheb & Owens, *supra* note 1, at 92 (detailing how hybrid charter schools can circumvent the U.S. Department of Education's policy of excluding for-profit charter schools from federal funding).

174. *See* Washington Post Poll, *supra* note 10 (reporting that Bernie Sanders and Elizabeth Warren supported a pause on charter school funding in the 2020 Presidential race).

COMMUNICATION DECENCY ACT AND THE INTELLECTUAL PROPERTY EXCEPTION

CASEY WINDSOR*

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I. INTRODUCTION

As the internet proliferated in the 1990s, Congress became concerned with courts impeding the advancement of the internet and the distribution of obscene materials.[1] Congress passed Section 230 of the Communication Decency Act (CDA), which was part of the Telecommunications Act of 1996.[2] Section 230(c), known as the "Good Samaritan" provision, gave broad immunity to interactive computer services providers (ISPs) who monitor third-party content posted to their website.[3] Section 230 created the regulatory foundation for modern day ISPs, including social media websites like Facebook.[4]

Recently, Section 230 has been criticized for giving ISPs too much immunity regarding their content moderation practices.[5] Although the immunity given in Section 230 is being re-examined, Congress did not give ISPs unlimited immunity even in 1996.[6] Section 230(e) of the CDA includes a few exceptions to the immunity given to these providers, including the exception for intellectual property claims.[7]

Congress did not specify whether the intellectual property exception includes both federal and state intellectual property laws or only federal laws.[8] This has led to different interpretations and a circuit split between the Ninth and Third Circuits.[9] These circuits have ruled differently based

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1. *See* VALERIE C. BRANNON & ERIC N. HOLMES, CONG. RSCH. SERV., R46751, SECTION 230: AN OVERVIEW 1–2 (2021) (explaining that the CDA "was intended to 'modernize the existing protections against obscene, lewd, indecent or harassing uses of a telephone'" (quoting S. REP. NO. 104-23, at 59 (1995))).

2. *Id.* at 1; Telecommunications Act of 1996 § 230, Pub. L. No 104-104, 110 Stat. 56 (1996) (codified at 47 U.S.C. § 230).

3. 47 U.S.C. § 230(c); BRANNON & HOLMES, *supra* note 1, at 3 (explaining that Section 230(c) does not allow ISPs to be treated as a publisher of third-party content or to be held liable for monitoring third-party content on their website).

4. *See* Megan Anand et al., *All the Ways Congress Wants to Change Section 230*, SLATE (Mar. 23, 2021, 5:45 AM), https://slate.com/technology/2021/03/section-230-reform-legislative-tracker.html (explaining that Section 230 "has been referred to as the '26 words that created the internet' and the 'internet's Magna Carta'").

5. *See id.* ("Many on the left argue that it has enabled tech platforms to host harmful content with impunity, while many on the right argue that it has enabled tech platforms to disproportionately suppress conservative speech.").

6. *See id.* (listing numerous congressional proposals to revise Section 230's immunity provisions); BRANNON & HOLMES, *supra* note 1, at 24 (discussing the five Section 230(e) immunity exceptions).

7. 47 U.S.C. § 230(e); *see also* BRANNON & HOLMES, *supra* note 1, at 24.

8. BRANNON & HOLMES, *supra* note 1, at 26.

9. *See* Hepp v. Facebook, 14 F.4th 204, 210–11 (3d. Cir. 2021) ("We disagree [with the Ninth Circuit] that 'any law pertaining to intellectual property' should be read to mean 'any *federal* law pertaining to intellectual property.'").

on their interpretation of the statutory language and the CDA's policy objectives.[10] The Ninth Circuit ruled that Section 230(e)(2) only includes federal intellectual property laws, but the Third Circuit ruled that Section 230(e)(2) includes both state and federal laws.[11]

Since intellectual property was not defined in Section 230(e)(2), the Ninth Circuit ruled that including state intellectual property laws would run counter to Congress' policy goals because it would allow state law to dictate federal law.[12] In contrast, the Third Circuit, as well as district courts, interpreted the statutory language and structure of the other Section 230(e) subsections to include both state and federal intellectual property laws.[13]

To analyze the circuit split, this Comment will provide background on the case law leading to the split. Part II begins with *Zeran v. American Online, Inc.*[14] and *Gucci America, Inc. v. Hall & Associates*,[15] which both clarified the type of lawsuits that can be brought under Section 230.[16] Then it will discuss the Ninth Circuit's ruling in *Perfect 10, Inc. v. CCBill, LLC*,[17] as well as district court rulings and the Third Circuit's decision in *Hepp v. Facebook*[18] which created the circuit split.[19]

Part III will then evaluate the circuit split by weighing the arguments from both Circuits, as well as the district courts. It will analyze the strengths of each Circuit's arguments by conducting both a statutory and

10. *See id.* at 211 (holding that including state intellectual property laws in Section 230(e)(2) both fits with the plain language and Congress' policy goals); Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1118 (9th Cir. 2007) (holding that Section 230(e)(2) only applies to federal intellectual property since including state laws would be detrimental to Congress' goals).

11. *Hepp*, 14 F.4th at 212 ("[A] state law can be 'any law pertaining to intellectual property,' too."); *Perfect 10*, 488 F.3d at 1119 ("[W]e construe the term 'intellectual property' to mean 'federal intellectual property.'").

12. *Perfect 10*, 488 F.3d at 1118–19 (explaining that allowing state intellectual property laws under Section 230(e)(2) would conflict with the CDA's policy goals).

13. *See Hepp*, 14 F.4th at 211 (explaining that the structure and language of 230(e)(2) includes state intellectual property laws); *see also* Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 294 (D.N.H. 2008); Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 702 (S.D.N.Y. 2009).

14. 129 F.3d 327 (4th Cir. 1997).

15. 135 F. Supp. 2d 409 (S.D.N.Y. 2009).

16. *Zeran*, 129 F.3d at 330 (holding that "[s]pecifically, § 230 precludes courts from entertaining claims that would place a computer service provider in a publisher's role."); *Gucci*, 135 F. Supp. 2d at 412 (explaining that the "Plaintiff's complaint would withstand a motion to dismiss even in the absence of § 230").

17. Perfect 10, Inc., v. CCBill LLC, 488 F.3d 1102 (9th Cir. 2007).

18. 14 F.4th 204 (3d. Cir. 2021).

19. *See Perfect 10*, 488 F. 3d at 1107; *id.*

legislative analysis. Part IV will recommend that Congress or the Supreme Court resolve the split by including state intellectual property rights under Section 230(e)(2).

II. THE BIRTH OF LIABILITY PROTECTION FOR INTERACTIVE COMPUTER SERVICE PROVIDERS

A. The Formation of Modern-Day Protections for Social Media Companies

Section 230 of the CDA gives ISPs broad immunity for content posted on their websites by third parties.[20] Congress passed Section 230 of the CDA to help the development of the internet and eliminate disincentives for ISPs to monitor third-party content.[21] Section 230(c) is known as the "Good Samaritan" clause because it gives ISPs protection for screening third-party content while also protecting them from being treated as a publisher of third-party content.[22] Section 230(f)(3) defines an ISP as "responsible, in whole or in part, for the creation or development of information provided through the Internet or any other interactive computer service."[23] Examples of modern-day ISPs are search engines, social media websites, and message boards, such as Craigslist.[24] For example, "Facebook generates 4 petabytes of data per day," including over 500,000 comments and almost 300,000 status updates per minute.[25] If not for Section 230, Facebook would face enormous liability for any objectionable content it failed to remove.[26] However, Section 230 does not apply when

20. *See* 47 U.S.C. § 230; *see also* BRANNON & HOLMES, *supra* note 1, at 3 (stating that Congress did not want ISPs to be liable for content third parties posted on their websites).

21. *See Zeran*, 129 F.3d at 330; *see also* BRANNON & HOLMES, *supra* note 1, at 2–3.

22. 47 U.S.C. § 230(c)(1).

23. 47 U.S.C. § 230(f)(3).

24. BRANNON & HOLMES, *supra* note 1, at 3 (listing internet companies classified as ISPs by courts).

25. Ankush Sinha Roy, *How Does Facebook Handle the 4+ Petabyte of Data Generated Per Day? Cambridge Analytica – Facebook Data Scandal*, MEDIUM (Sept. 15, 2020), https://medium.com/@srank2000/how-facebook-handles-the-4-petabyte-of-data-generated-per-day-ab86877956f4 (explaining how much content is produced on Facebook per day).

26. *See* Ashley Johnson & Daniel Castro, *Overview of Section 230: What It Is, Why It Was Created, and What It Achieved*, INFO. TECH. & INNOVATION FOUND. (Feb. 22, 2021), https://itif.org/publications/2021/02/22/overview-section-230-what-it-why-it-was-created-and-what-it-has-achieved (explaining that, because of the amount of content produced on social media websites, "without Section 230's legal protections [they] would face large legal expenses").

an internet service company creates the content in question.[27]

Congress cited Section 230(c) in response to a New York court decision in *Stratton Oakmont, Inc., v. Prodigy Services Co.*,[28] which held that an ISP was liable for defamatory comments posted by a third-party because the ISP regulated the content on its website.[29] Congress did not want self-regulation to be penalized, so it created Section 230(c)(2), which provides immunity for ISPs who monitor "objectionable" third-party content on their sites.[30]

A year after Congress enacted the CDA, the Fourth Circuit decided *Zeran*, which laid the foundation for Section 230 cases.[31] In *Zeran*, a plaintiff sued AOL after an anonymous user posted that he was selling offensive Oklahoma City Bombing T-shirts and listed the plaintiff's phone number.[32] The plaintiff argued that AOL was not a publisher, but rather a distributor, and Section 230 did not immunize distributors who had knowledge of defamatory statements.[33] But, the Fourth Circuit reasoned that the word "publisher" in the statute included distributors because if distributors were not entitled to immunity, then that "would defeat the two primary purposes of the statute."[34] Therefore, ISPs cannot be held accountable for "deciding whether to publish, withdraw, postpone or alter content."[35] Many other courts have followed *Zeran's* interpretation of the immunity granted in Section 230.[36]

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27. *See* Fraley v. Facebook, Inc., 830 F. Supp. 2d 785, 802 (N.D. Cal. 2011) (explaining that the CDA did not apply to Facebook when they developed the content since that went beyond the publisher's role).

28. No. 31063/94, 1995 WL 323710 (N.Y. Sup. Ct. May 24, 1995).

29. *Id.* at *7; *see also* Zeran v. Am. Online, Inc., 129 F.3d 327, 331 (4th Cir. 1997) (explaining that the *Stratton* court held the ISP to the strict liability standard instead of the lower standard because the ISP monitored its content making it more like a publisher).

30. 47 U.S.C. § 230(c)(2)(A) (defining objectionable as "obscene, lewd, lascivious, filthy, excessively violent, harassing, or otherwise objectionable").

31. 129 F.3d at 327; *see also* Eric Goldman, *The Ten Most Important Section 230 Rulings*, 20 TUL. J. TECH. & INTELL. PROP. 1, 2–3 (2017) (stating *Zeran* is "the most important Section 230 ruling to date").

32. *Zeran*, 129 F.3d at 329 (explaining how the post led to the plaintiff receiving numerous threatening phone calls daily).

33. *Id.* at 333.

34. *Id.* at 330–31 ("Section 230 was enacted, in part, to maintain the robust nature of Internet communications, and, accordingly, to keep government interference . . . to a minimum.").

35. *Id.* (explaining that under Section 230, lawsuits cannot "hold a service provider liable for its exercise of a publisher's traditional editorial functions").

36. BRANNON & HOLMES, *supra* note 1, at 11; Ian C. Ballon, Zeran v. AOL *and Its Inconsistent Legacy*, L.J. NEWSLETTERS (Dec. 2017),

B. *Immunity Exceptions: Section 230(e)*

Although Congress wanted interactive computer services providers to have broad immunity from most claims, it still intended to create some exceptions to that immunity.[37] Section 230(e) creates exceptions to ISPs' immunity for actions under criminal laws, sex trafficking laws, intellectual property laws, and the Electronic Communications Privacy Act.[38] The intellectual property exception under Section 230(e)(2) states, "nothing in this section shall be constructed to limit or expand any law relating to intellectual property."[39]

One of the first cases to apply Section 230(e)(2) to an ISP was *Gucci America, Inc., v. Hall & Associates*.[40] Gucci sued Mindspring, a website hosting company, when Mindspring failed to take action after Gucci alerted the company that one of its website hosting customers was infringing on Gucci's trademark.[41] Mindspring argued that they should be immune from the trademark infringement claim because trademark infringement had never been imposed on an ISP before.[42] As a result, immunizing them would neither limit nor expand intellectual property under Section 230(e)(2).[43]

The Southern District of New York disagreed with Mindspring's argument by analyzing the statute's plain language.[44] The first step in analyzing a statute is to look at the plain language; if the ordinary meaning of the words are unambiguous, then the statutory analysis is complete.[45]

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https://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2017/12/01/zeran-v-aol-and-its-inconsistentlegacy/?slreturn=20201103124726 ("[T]he rule of Zeran [barring distributor liability] has been uniformly applied by every federal circuit court to consider it and by numerous state courts."); Universal Commc'ns. Sys., Inc. v. Lycos, Inc., 478 F.3d 413 (1st Cir. 2007) (agreeing with the 4th Circuit "that Section 230 immunity should be broadly construed."); Chicago Lawyers' Comm. for C.R. Under L., Inc. v. Craigslist, Inc., 519 F.3d 666 (7th Cir. 2008) (dismissing a lawsuit against a distributor under Section 230(c)(1)).

37. BRANNON & HOLMES, *supra* note 1, at 24 (stating that Section 230(e) contains five exceptions).

38. 47 U.S.C. § 230(e).

39. 47 U.S.C. § 230(e)(2).

40. *See generally* 135 F. Supp. 2d 409 (S.D.N.Y. 2001).

41. *Id.* at 410–11.

42. *See id.*

43. *Id.* at 412–14.

44. *Id.* at 414 ("Mindspring's reading is in conflict with the plain language of the statute.").

45. *Id.* at 412–13 (citing Lee v. Bankers Trust Co., 166 F.3d 540, 544 (2d Cir. 1999) ("[T]he plain meaning of a statute controls its interpretation."); *see also* 73 AM. JUR. 2D *Statutes* § 64 (2022).

The court found that the words of Section 230(e)(2) were unambiguous and that construing Section 230(e)(2) to limit it to intellectual property laws in 1996 would actually be in conflict with the statute because the court would be limiting intellectual property laws.[46] Therefore, the court rejected Mindspring's argument and found that the statute did not immunize Mindspring from intellectual property claims.[47] While *Gucci* established that intellectual property claims fall under Section 230(e)(2), it left ambiguity as to whether Section 230(e)(2) included both federal and state intellectual property claims.[48]

C. *State Versus Federal Intellectual Property Claims*

Many intellectual property laws arise from tort and privacy laws.[49] Federal intellectual property laws protect three main areas: trademarks, patents, and copyrights.[50] However, state intellectual property laws can include other protections, such as the right of publicity.[51]

The right of publicity is defined as "the right of a person to control the commercial use of his or her identity."[52] There is not a federal right of publicity statute, but over thirty states recognize this right either by statute or common law.[53] For example, under Pennsylvania's right of publicity statute, one must invest time and money into their likeness.[54] New Jersey and Delaware, also in the Third Circuit, have not codified the right to

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46. *Gucci*, 135 F. Supp. 2d at 413 ("Immunizing Mindspring . . . would 'limit' the laws pertaining to intellectual property in contravention of § 230(c)(2).").

47. *Id.* ("The plain language of section 230(e)(2) precludes Mindspring's claim of immunity.").

48. *See, e.g.*, Hepp v. Facebook, 14 F.4th 204, 211 (3d Cir. 2021) (ruling that Section 230(e)(2) applies to both state and federal law); Perfect 10, Inc., v. CCBill LLC, 488 F.3d 1102, 1119 (9th Cir. 2007) (ruling that Section 230(e)(2) applies only to federal law); Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 301 (D.N.H. 2008) (disagreeing with *Perfect 10* and ruling that Section 230(e)(2) applies to federal and state law); Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 703 (S.D.N.Y. 2009) (ruling Section 230(e) includes state law claims).

49. 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) ("Intellectual property laws . . . have their origin in state tort law . . . . Rights of publicity are an outgrowth of state common law privacy laws.").

50. KEVIN J. HICKEY, CONG. RSCH. SERV., IF10986, INTELLECTUAL PROPERTY LAW: A BRIEF INTRODUCTION (2018) (stating federal intellectual property protects three "forms of legal protection: patents, copyrights, and trademarks").

51. *See* J. THOMAS MCCARTHY & ROGER E. SCHECHTER, THE RIGHTS OF PUBLICITY AND PRIVACY § 1:2 (2d ed. 2022) (describing how the right of publicity largely grew out of state law protections).

52. *Id.* § 1:7.

53. *Id.* § 1:2.

54. *See* 42 PA. CONS. STAT. § 8316(e).

publicity.[55] New Jersey's right of publicity is recognized at common law, whereas Delaware has not recognized it in either statute or common law.[56]

The U.S. Supreme Court weighed in on an Ohio right of publicity law in *Zacchini v. Scripps-Howard Broadcasting Co.*,[57] where they held that protecting the right of publicity was related to copyright and patent law because it focused on rewarding a person for their work.[58] In some states, *Zacchini* shifted the right of publicity from a privacy law question to an intellectual property law question.[59]

The various state intellectual property laws are one of the concerns courts have when deciding to allow state laws under Section 230(e)(2).[60] Applying state laws that do not have a federal counterpart, such as the right of publicity, presents issues which may limit or counter the goals and purpose of Section 230.[61] This debate has led to a circuit split between the Ninth and Third Circuits.[62]

D. *The Road to a Circuit Split*

Circuit splits regarding whether state intellectual property claims are allowed under Section 230(e)(2) began to emerge in 2007.[63] In *Universal Communication Systems, Inc. v. Lycos, Inc.*,[64] the First Circuit assumed,

55. Janet Reed & Robert D. Ward, *Right of Publicity Laws: Delaware*, *in* PRACTICAL L. STATE Q&A 1-523-1165 (Feb. 5, 2022); Matthew Savare et al., *Right of Publicity Laws: New Jersey*, *in* PRACTICAL L. STATE Q&A 2-517-4824 (Sept. 14, 2021).

56. Reed & Ward, *supra* note 55; Savare et al., *supra* note 55.

57. 433 U.S. 562 (1977).

58. *Id.* at 573 (stating the right of publicity "is closely analogous to the goals of patent and copyright law, focusing on the right of the individual to reap the reward of his endeavors").

59. *See* Jennifer E. Rothman, *The Right of Publicity's Intellectual Property Turn*, 42 COLUM. J.L. & ARTS 277, 306 (2019) ("[T]he Court both created and cemented the right of publicity's break from the right of privacy and its placement into the intellectual property framework.").

60. *See* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1107 (9th Cir. 2007) (stating that since states have different laws that which could be considered intellectual property, litigants will not know if their claims will fall under Section 230(e)(2)).

61. *See id.* at 1108 (stating that including state intellectual property laws "would fatally undermine the broad grant of immunity provided by the CDA"); *see also* Hepp v. Facebook, 14 F.4th 204, 211 (3d Cir. 2021) (stating that state intellectual property laws can support "Congress's pro-free-market goal").

62. *See Hepp*, 14 F.4th at 212 (holding Section 230(e)(2) applies to both state and federal intellectual property laws); *Perfect 10*, 488 F.3d at 1119 ("[W]e construe the term 'intellectual property' to mean 'federal intellectual property.'").

63. *See Perfect 10*, 488 F.3d at 1119 (holding that Section 230(e)(2) does not include state intellectual property rights — only federal).

64. 478 F.3d 413 (1st Cir. 2007).

without deciding, that state intellectual property laws were included in Section 230(e)(2).[65] Since the First Circuit did not interpret Section 230(e)(2) because Plaintiff's claims would have been dismissed regardless, the First Circuit's assumption is regarded as dicta.[66] That same year, the Ninth Circuit interpreted Section 230(e)(2) in *Perfect 10, Inc. v. CCBill LLC*.[67]

Similar to the facts in *Gucci*, in *Perfect 10*, CCBill and CWIE were web hosting sites that provided services to other websites.[68] Perfect 10 alerted them to the fact that some of their clients had used images from Perfect 10's website without permission.[69] Perfect 10 sued both companies under both federal and state intellectual property claims.[70]

When interpreting Section 230(e)(2), the Ninth Circuit noted the statutory language did not include a definition for intellectual property.[71] The Ninth Circuit reasoned that, since state intellectual property laws vary, "permitting the reach of any particular state's definition of intellectual property to dictate the contours of this federal immunity would be contrary to Congress's expressed goal of insulating the development of the Internet from various state-law regimes."[72] Therefore, Congress intended the definition of intellectual property in Section 230(e)(2) to mean "federal intellectual property," immunizing ISPs from state law claims.[73] Although this decision would seem contrary to *Universal Communication*, the Ninth Circuit noted that its decision did not conflict with the First Circuit's since the First Circuit never ruled on the issue of whether state intellectual

65. *Id.* at 421 ("We need not decide whether a claim premised on active inducement might be consistent with Section 230 in the absence of a specific exception."); *see also Perfect 10*, 488 F.3d at 1107 (stating that the parties in *Universal* did not "[raise] the question of whether state law counts as 'intellectual property' for purposes of § 230 and the [*Universal*] court seems to simply have assumed that it does").

66. *See* Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 289–99 (D.N.H. 2008) (stating since the First Circuit "would have upheld the dismissal of the plaintiff's state-law claim regardless of its interpretation of 47 U.S.C. § 230(e)(2), its statement in that regard arguably fits the usual definition of dicta . . . .").

67. *See generally* 488 F.3d at 1108.

68. *See id.* at 1108; *see also* Gucci Am., Inc. v. Hall & Assocs., 135 F. Supp. 2d 409, 410–11 (S.D.N.Y. 2001) (stating that defendant, Mindspring, was a web hosting site that provided services to other websites, including the co-defendant, Hall).

69. *Perfect 10*, 488 F.3d at 1108.

70. *Id.*

71. *Id.* at 1118 ("The CDA does not contain an express[ed] definition of 'intellectual property . . . .'").

72. *Id.* (stating that including state laws would undermine the Congressional intent for ISP immunity).

73. *Id.* at 1119.

property laws were included in Section 230(e)(2).[74]

Following the Ninth Circuit's decision in *Perfect 10*, the District of New Hampshire and the Southern District of New York disagreed with the Ninth Circuit's reasoning.[75] In *Doe v. Friendfinder Network, Inc.*,[76] an anonymous user created a profile on Friendfinder's adult website with background information and a profile photo that were similar to Doe's background and appearance, but Doe herself had not created the profile.[77] Doe sued Friendfinder under state and federal intellectual property laws.[78]

The District of New Hampshire countered the Ninth Circuit's argument that state laws were not included in Section 230(e)(2) by citing U.S. Supreme Court cases that analyzed the word "any" in a statute.[79] *Doe* cited *Harrison v. PPG Industries, Inc.*,[80] and *Ali v. Federal Bureau of Prisons*[81] where the Supreme Court analyzed the use of "any" in a statute and ruled it should be interpreted broadly.[82] The court also noted that other subsections of 230(e) expressly stated when it involved only federal or state law.[83] The court argued that this indicated Congress's intent in articulating clearly when a section only dealt with federal law.[84] For example, Congress applied part of Section 230(e)(1) to "any other federal criminal statute."[85]

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74. *Id.* at 1107 (stating that since the First Circuit did not rule on the issue, the Ninth Circuit "create[d] no conflict with *Universal Communication.*").

75. *See* Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 302 (D.N.H. 2008) ("[T]his court disagrees with the Ninth Circuit's decision in *Perfect 10*. . . ."); *see also* Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 704 (S.D.N.Y. 2009) ("[T]he plain language of the CDA is clear, as 'any law' means both state and federal . . . ." (citing Lee v. Bankers Trust Co., 166 F.3d 540, 544 (2d Cir. 1999)).

76. *Friendfinder Network*, 540 F. Supp. 2d at 288.

77. *Id.* at 292 (stating that, although the photo looked like Doe, it was not a photo of her).

78. *Id.* at 293.

79. *Id.* at 299 ("The Ninth Circuit made no attempt to reckon with the presence of the term 'any.'").

80. 446 U.S. 578 (1980).

81. 552 U.S. 214 (2008).

82. *See Friendfinder Network*, 540 F. Supp. 2d at 299 (quoting *Harrison*, 446 U.S. at 589, ("[T]he modifier 'any' amounts to 'expansive language [that] offers no indication whatever that Congress intended [a] limiting construction.'") and *Ali v. Fed. Bureau of Prisons*, 552 U.S. 214 (demonstrating that the use of any "suggests a broad meaning.")).

83. *Id.* ("Nor did the Ninth Circuit make any effort to reconcile its reading of § 230(e)(2) with other limiting provision of § 230 which specifically identify federal or state law as such.").

84. *Id.* ("[W]here Congress wished to distinguish between state and federal law in § 230, it knew how to do so.").

85. 47 U.S.C. § 230(e)(1).

With the Supreme Court rulings coupled with the fact that Congress had excluded state laws from other subsections, the district court disagreed with the Ninth Circuit in *Perfect 10* and read Section 230(e)(2) to include both state and federal claims.[86]

The Southern District of New York also considered if Section 230(e)(2) includes state laws in *Atlantic Recording Corp. v. Project Playlist, Inc.*[87] The court rejected the Ninth Circuit's argument by arguing that other subsections included when it only applied to state or federal laws, therefore if Congress wanted Section 230(e)(2) to include only federal laws it would have stated that.[88] The court used *Barnhart v. Sigmon Coal Co.*,[89] to support its argument since the Supreme Court stated that when Congress includes a phrase in one subsection and not another, courts should presume Congress did that intentionally.[90] Similarly to *Friendfinder*, *Atlantic Recording Corp.* also cited Supreme Court cases that interpreted the use of "any" in a statute, including *United States v. Gonzales*.[91] *Gonzales* ruled that the use of "any" in "any other term of imprisonment" included both federal and state terms, since there was no language in that statute that showed Congress meant to limit the scope of "any."[92] Based on these two arguments, the court interpreted Section 230(e)(2) to include state laws.[93]

The circuit split occurred in September 2021 with the Third Circuit's ruling in *Hepp v. Facebook*.[94] Hepp sued Facebook under Pennsylvania's

86. *See Friendfinder Network*, 540 F. Supp. 2d at 300; *see also* Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 704 (S.D.N.Y. 2009) (agreeing with the arguments made in *Friendfinder* and ruling Section 230(e)(2) should include state intellectual property laws).

87. 603 F. Supp. 2d at 702–04.

88. *Id.* at 703 ("In four different points in Section 230(e), Congress specified whether it intended a subsection to apply to local, state, or federal law.").

89. 534 U.S. 438 (2002).

90. *See Atl. Recording Corp.*, 603 F. Supp. 2d at 703 (citing *Barnhart*, 534 U.S. at 452); *see also Barnhart*, 534 U.S. at 452 ("[W]hen Congress includes particular language in one section of a statute but omits it in another section of that same Act, it is generally presumed that Congress acts intentionally . . . .").

91. 520 U.S. 1 (1997).

92. *See Atlantic Recording Corp.*, 603 F. Supp. 2d at 703–04 (quoting *Gonzales*, 520 U.S. at 5) ("'[A]ny other term of imprisonment' includes both state and federal because Congress did not add any language limiting the breadth of that word . . . .").

93. *Id.* at 704 (explaining that the Supreme Court cases involving the word "any" plus the language in the other subsection "supports the conclusion that Congress intended the word 'any' to mean any state or federal law pertaining to intellectual property").

94. *See generally* Hepp v. Facebook, 14 F.4th 204 (3d. Cir. 2021) (deciding that the Section 230 intellectual property exception includes state law claims); Kyle Jahner, *Facebook Can't Duck Anchor's Image Rights Suit, 3rd Cir. Says*, BLOOMBERG L. (Sept. 23, 2021, 12:48 PM), https://news.bloomberglaw.com/ip-law/facebook-unable-

right of publicity law after finding photos of herself used for advertisements.[95] The Eastern District of Pennsylvania agreed with the Ninth Circuit's ruling on Section 230(e)(2) since they took into account Congress's "codified policy objectives" in Sections 230(a) and (b).[96] The district court rejected *Friendfinder*'s and *Atlantic Recordings Corp.*'s arguments because they only focused on the words in the statute and not the intended policy goals.[97] The Third Circuit subsequently reversed.[98]

Rejecting the district court's argument, the Third Circuit analyzed the natural meaning and structure of the statute arguing that Congress had excluded state laws in other subsections of 230 and if it intended intellectual property to only include federal laws then they would have stated that.[99] They also used dictionary definitions to discern the meaning of "intellectual property" and found that some definitions included the right of publicity.[100] The Third Circuit also countered the Ninth Circuit's argument that including state intellectual property laws would defeat Congress's "pro-free market goals" because "state property rights can facilitate market exchange."[101] The concurring opinion agreed with the Ninth Circuit and worried that allowing state intellectual property claims may threaten speech protections of Section 230.[102]

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to-duck-anchors-image-rights-suit-3rd-cir-says?context=search&index=1 (stating that, before *Hepp v. Facebook*, "no circuit ever ruled the IP exception covers state IP laws").

95. *See Hepp*, 14 F.4th at 206–07 (explaining that Hepp, a newscaster in Pennsylvania, discovered that a photograph taken of her was being used on Facebook to advertise an erectile dysfunction product and a dating app).

96. Hepp v. Facebook, Inc., 465 F. Supp. 3d 491, 500 (E.D. Pa. 2020) (agreeing with the Ninth Circuit's argument because Section 230's policy goal was to provide broad immunity to ISPs and allowing state intellectual property claims would limit their immunity, which Congress did not intend).

97. *Id.* (stating that *Atlantic Recording Corp.* "focused solely on the language of § 230(e) and declines to consider the codified policy objectives").

98. *Hepp*, 14 F.4th at 215.

99. *Id.* at 211 ("the text and structure tell us that § 230(e)(2) can apply to federal and state laws that pertain to intellectual property.").

100. *Id.* at 213 ("Our survey of legal dictionaries reveals 'intellectual property' has a recognized meaning which includes the right of publicity.").

101. *Id.* (explaining how both trademarks and the right of publicity "secure commercial goodwill").

102. *See id.* at 225 (stating that allowing state intellectual property claims could "pressure [ISPs] to restrict speech").

III. THE CIRCUIT SPLIT ANALYSIS

The Ninth Circuit has ruled that only federal intellectual property laws are included in Section 230(e)(2), whereas the Third Circuit has ruled that it includes both state and federal laws.[103] The Ninth Circuit believed Congress needed to define the plain language of the statute and that interpreting it to allow state intellectual property would be contrary to Congress's goals.[104] But the Third Circuit believed the plain language of the statute did not need to be defined and that allowing state intellectual property laws would not defeat Congress's CDA policy goals.[105] Both the statutory language and legislative history should be examined to analyze the circuit split.[106] Based on this analysis, courts should include state and federal intellectual property law under Section 230(e)(2).

A. *The Statutory Analysis of Section 230(e)(2) Does Not Exclude State Laws*

The Third Circuit, District of New Hampshire, and the Southern District of New York believed the statutory language and structure of Section 230(e)(2) clearly included state intellectual property laws.[107] They argued that the text of the statute is clear based on previous Supreme Court cases analyzing similar uses of "any" in statutes.[108] These jurisdictions all followed the Supreme Court's precedent on the use of "any" in a statute, arguing it should be interpreted broadly to include state intellectual property.[109] The Ninth Circuit, on the other hand, makes no mention of the

103. *See* Perfect 10, Inc., v. CCBill LLC, 488 F.3d 1102, 1119 (9th Cir. 2007); *Hepp*, 14 F.4th at 214.

104. *See Perfect 10*, 488 F.3d at 1118–19 ("In the absence of a definition from Congress, we construe the term 'intellectual property' to mean 'federal intellectual property.'").

105. *See Hepp*, 14 F.4th at 214 (providing that the language of § 230(e)(2) includes state intellectual property laws that pertain to the subject at issue).

106. *See* 73 AM. JUR. 2D. *Statutes* § 64 (2022) (explaining how courts must generally interpret statutes).

107. *See Hepp*, 14 F.4th at 211 ("So the text and structure tell us that § 230(e)(2) can apply to federal and state laws that pertain to intellectual property."); Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 302 (D.N.H. 2008) ("Consistent with its text, § 230(e)(2) applies simply to 'any law pertaining to intellectual property,' not just federal law."); Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 704 (S.D.N.Y. 2009) ("Because the plain language of the CDA is clear, as 'any law' means both state and federal law . . . .").

108. *See Hepp*, 14 F.4th at 214 (citing Ali v. Fed. Bureau of Prisons, 552 U.S. 214, 218–19 (2008)) (noting that the use of "any" in a statute "suggests a broad meaning"); *Atl. Recording Corp.*, 603 F. Supp. 2d at 704 (quoting *Friendfinder*, 540 F. Supp. 2d at 299) ("[T]he modifier 'any' amounts to 'expansive language' . . . .").

Supreme Court's rulings on the use of "any" in a statute.[110]

When analyzing the language of the statute, the Ninth Circuit only stated that "intellectual property" needed to be defined by Congress.[111] For a proper analysis of the statute, the Ninth Circuit needed to consider the word "any" and the structure of Section 230(e) as a whole.[112] As stated above, the Supreme Court provided guidance when interpreting statutes that include the word "any."[113] The Ninth Circuit should have addressed why it was deviating from that guidance and used other Supreme Court cases to support its argument that "any" did not include state intellectual property laws.[114]

When comparing the language of Section 230(e)(2) to the language of the statute, the Supreme Court ruled on in *Gonzales*, the language is very similar.[115] The part of Section 230(e)(2) which states "any law pertaining to intellectual property" should be interpreted broadly, as was the language in *Gonzales,* which stated, "any other term of imprisonment."[116] The Supreme Court did not find the use of "any" to limit the statute to only federal prison terms but that it also included state prison terms.[117] Since the wording of these two statutes are very similar, the language of Section 230(e)(2) should not be viewed as limiting either.[118]

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109. *See Hepp*, 14 F.4th at 214; *Atl. Recording Corp.*, 603 F. Supp. 2d at 704; *Friendfinder*, 540 F. Supp. 2d at 299.

110. *See Friendfinder*, 540 F. Supp. 2d at 299 (noting that the Ninth Circuit did not address the use of "any" in the statute); *see also Perfect 10, Inc.*, 488 F.3d 1102, 1118–19 (9th Cir. 2007).

111. *Perfect 10, Inc.*, 488 F.3d at 1118–19 (interpreting the statute to include only federal laws since Congress did not define "intellectual property").

112. *See Friendfinder*, 540 F. Supp. 2d at 299–300 (explaining that the Ninth Circuit did not analyze the use of "any" or consider the structure of the other subsections of the statute); *see also* 73 AM. JUR. 2D. *Statutes* § 115 (2022) ("The rule is that statutory words are to be given their natural, received, popular, everyday, approved and recognized meaning.").

113. *See Friendfinder*, 540 F. Supp. 2d at 299 (citing Harrison v. PPG Indus., Inc., 446 U.S. 587, 589 (1980) and Ali v. Fed. Bureau of Prisons, 128 S. Ct. 831, 835–37 (2008)) (providing that the use of "any" allows for broad statutory interpretation).

114. *See id.* at 299–300.

115. *See* United States v. Gonzales, 520 U.S. 1, 5 (1997) (interpreting the phrase "any other term of imprisonment" to include both state and federal terms).

116. *See id.*; 47 U.S.C. § 230(e)(2).

117. *Gonzales*, 520 U.S. at 5 (holding that the phrase "any other term of imprisonment" includes both federal and state imprisonment since Congress did not limit the statutory meaning of the word "any"); *see also* Harrison v. PPG Indus., Inc., 446 U.S. 578, 589 (1980) (explaining that Congress did not intend to limit the construction of the statute and that the phrase "any other final action" was "expansive language").

118. *See Friendfinder*, 540 F. Supp. 2d at 299 (citing Ali v. Fed. Bureau of Prisons,

In limiting the word "any" to not include state intellectual property laws, the Ninth Circuit changed the scope of the statute which is generally not allowed.[119] A court should not "change [a statute's] scope by reading into it language it does not contain or by reading out language it does," which is what the Ninth Circuit did when it read "federal" into Section 230(e)(2) and "state" out of that statute.[120] Limiting the scope of intellectual property is also not allowed in the statute because it states Section 230 should not be "construed to limit or expand any" intellectual property law.[121]

Reading Section 230(e)(2) to only include federal laws is similar to what the defendant in *Gucci* attempted to argue: that only including intellectual property laws from 1996 was the only way to neither limit nor expand the section.[122] But the court found this argument actually limited the statute because nothing in the section stated that it only includes 1996 intellectual property laws.[123] Similarly, nothing in Section 230 explicitly states that it should only include federal intellectual property laws.[124] Since "any law pertaining to intellectual property" is broad enough to include both state and federal laws, the natural reading of the statute should include state laws.[125]

Although the Ninth Circuit stated that intellectual property needed to be defined, unlike the Third Circuit, the Ninth Circuit did not attempt to define its meaning by using dictionary definitions to discern the ordinary meaning of the term.[126] The Ninth Circuit could have compared the term "intellectual property" among legal dictionaries from 1996 to see what

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552 U.S. 214 (2008)) (supporting the argument that "any" is not limiting); *see also* 73 AM. JUR. 2D. *Statutes* § 64 (2022).

119. *See* 73 AM. JUR. 2D *Statutes* § 68 (2022) (explaining how courts should interpret statutes).

120. *Id.* § 66; *see* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1117 (9th Cir. 2007) (holding that courts should infer that Congress intends to "incorporate the established meaning of [the] terms" used unless the statute states otherwise).

121. 47 U.S.C. § 230(e)(2)–(3).

122. Gucci Am., Inc. v. Hall & Assocs., 135 F. Supp. 2d 409, 413–14 (S.D.N.Y. 2001) (explaining the defendant's argument that the court should interpret Section 230(e)(2) as including only intellectual property laws as they existed in 1996).

123. *Id.* (finding that the defendant's argument conflicted with the plain language of the statute).

124. *See* 47 U.S.C. § 230.

125. *See* Hepp v. Facebook, 14 F.4th 204, 210 (3d Cir. 2021) (stating that excluding state laws "strays too far from the natural reading"); *see also* 73 AM. JUR. 2D. *Statutes* § 65 (2022) ("[W]here the general language of a statute is broad enough to include a particular subject matter, an intent to exclude it . . . must be definitely expressed.").

126. *Hepp*, 14 F.4th at 215–16 (citing dictionary definitions of "Intellectual Property"); *see also* 73 AM. JUR. 2D *Statutes* § 115 (2022) ("[T]he general rule of construction prefers the ordinary meanings of statutory terms . . . .").

types of laws were included, like the Third Circuit did.[127] This could have supported the Ninth Circuit's argument that state laws were not included if the court found that the majority of dictionary definitions, from the time of enactment, did not include state intellectual property laws.[128] The court could have argued that Congress did not add "federal" to Section 230(e)(2) because they believed state intellectual property laws had already been preempted.[129] This would explain why Congress did not explicitly address state laws in the statute.[130]

When analyzing the structure of Section 230(e) as a whole, all three courts noted that other subsections specifically stated when the statute only applied to federal or state law.[131] The Ninth Circuit did not address the statutory structure of the other subsections which plainly stated when it only dealt with federal or state laws, nor the Supreme Court ruling stating that if one section is missing, language that was included in another indicates that Congress did so on purpose.[132] As stated above, one explanation for why Congress did not explicitly exclude state laws, as in other subsections, was because it considered state intellectual property laws to already be preempted.[133]

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127. *See Hepp*, 14 F.4th at 213 (surveying how legal dictionaries defined "intellectual property"); 73 AM. JUR. 2D *Statutes* § 115 (2022) (citing BP P.L.C. v. Mayor and City Council of Baltimore, 141 S. Ct. 1532 (2021)) ("[T]he Supreme Court generally seeks to discern and apply the ordinary meaning of [a statute's] terms at the time of their adoption.").

128. *See Hepp*, 14 F.4th at 215–16 (showing that many dictionary definitions of intellectual property differed).

129. 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) ("Congress may not have even considered these claims as 'pertaining to intellectual property.'"); *see also Hepp*, 14 F.4th at 213–14 (highlighting that some legal dictionaries explicitly included the right of publicity, which has its origins in state tort law, in their definitions of "intellectual property," while others did so implicitly).

130. *See* 47 U.S.C. § 230(b)(2).

131. *See Hepp,* 14 F.4th at 211 (stating that Congress explicitly excluded state laws from other 230(e) subsections); Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 299–300 (D.N.H. 2008) ("[W]here Congress wished to distinguish between state and federal law in § 230, it knew how to do so."); Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690, 703 (S.D.N.Y. 2009) (explaining how Congress specified in various 230(e) subsections when they applied to only state or federal laws).

132. *See* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1118 (9th Cir. 2007) (explaining their reasoning for excluding state intellectual property, but not mentioning the structure of the other subsections); *see also Atl. Recording Corp.*, 603 F. Supp. 2d at 703 (quoting Barnhart v. Sigmon Coal Co., 534 U.S. 438, 452 (2002) ("[W]hen Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.").

133. 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) ("In all likelihood, Congress never considered the risk of exposure for state law intellectual property

The Ninth Circuit pointed to Section 230(b) to support its argument because the subsection states one of the policy goals of the CDA is "to preserve the vibrant and competitive free market that presently exists for the internet and other interactive computer services, unfettered by Federal or State regulation."[134] When siding with the Ninth Circuit, the District of Pennsylvania pointed to this as "codified policy objectives," which *Atlantic Recording Corp.* and *Friendfinder* did not consider.[135] While having policy objectives expressly stated in Section 230(b)(2) helps the Ninth Circuit's argument, the argument still does not overcome prior Supreme Court precedent interpreting the use of "any" in a statute or the structure of the other Section 230(e) subsections.[136]

Based on the statutory analysis, it is hard to find a legal basis in the Ninth Circuit's interpretation.[137] The arguments in *Hepp, Friendfinder*, and *Atlantic Recording Corp.* are more convincing because, as *Hepp* stated, "the evidence cuts both ways" and the policy objectives stated in Section 230(b)(2) do not change the meaning of "any" in Section 230(e)(2).[138] But, since the Ninth Circuit believed that the plain language of the statute conflicted with the CDA's goals, the court put more weight on the intentions of Congress than the natural meaning of "any" or the structure of the other Sections of 230(e).[139]

B. *The Legislative History is Not Strong Enough to Overcome the Statutory Language of Section 230(e)(2)*

While nothing in Section 230 explicitly states Section 230(e)(2) only includes intellectual property law, there is evidence from the legislative history that Congress wished to avoid extensive government regulation of the internet.[140] The Ninth Circuit argued that including state intellectual

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claims at the time the CDA was enacted.").

134. *Perfect 10, Inc.*, 488 F.3d at 1118; *accord* 47 U.S.C. § 230(b)(2).

135. *See* Hepp v. Facebook Inc., 465 F. Supp. 3d 491, 500 (E.D. Pa. 2020) (citing *Atl. Recording Corp.*, 603 F. Supp. 2d at 703–04) (explaining that the Ninth Circuit "focuse[d] solely on the language of § 230(e) and declines to consider the codified policy objectives").

136. *See Hepp*, 14 F.4th at 211; *Friendfinder*, 540 F. Supp. 2d at 299–300; *Atl. Recording Corp.*, 603 F. Supp. 2d at 1118.

137. *See Hepp*, 14 F.4th at 211; *Friendfinder*, 540 F. Supp. 2d at 299–300; *Atl. Recording Corp.*, 603 F. Supp. 2d at 1118.

138. *Hepp*, 14 F.4th at 211 ("Because the evidence cuts both ways, the structure does not change the natural meaning [of Section 230(e)(2)].").

139. *See* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1108 (9th Cir. 2007) (stating that the inclusion of state intellectual property laws "would fatally undermine the broad grant of immunity provided by the CDA").

140. *See* 47 U.S.C. § 230; BRANNON & HOLMES, *supra* note 1 (highlighting that the

property laws is contrary to the CDA's intended policy goals,[141] whereas the Third Circuit argued that not including state laws would actually harm the CDA's goals.[142] The Ninth Circuit argued that since definitions of intellectual property vary by state, allowing state intellectual property laws to "dictate the contours of this federal immunity would be contrary to Congress's expressed goals of insulating the development of the internet from various state-law regimes."[143] As discussed earlier, the right of publicity statute varies across states, which could lead to the statute being considered intellectual property law in one state, but not in another.[144] This would be counter to the uniformity Congress was attempting to accomplish with the CDA.[145]

The lack of uniformity in state intellectual property laws was the issue the Ninth Circuit attempted to explain in *Perfect 10*.[146] Even within the states of the Third Circuit, there are differences in how the states recognize the right of publicity.[147] Unlike Pennsylvania, Delaware and New Jersey do not have a right of publicity statute.[148] Delaware does not recognize a right of publicity in common law, and New Jersey's common law right of publicity does not require the plaintiff to already have "commercial value" in its identity.[149] The Third Circuit in *Hepp* even limits its conclusion by

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senators who proposed part of the House Bill that would later become § 230 initially stated, "we do not wish to have content regulation by the Federal Government of what is on the Internet").

141. *See Perfect 10, Inc.*, 488 F.3d at 1118 (stating that the inclusion of state intellectual property laws would undermine the CDA's goals).

142. *See Hepp*, 14 F.4th at 211 (stating that including state intellectual property laws "tracks Congress's pro-free-market goal").

143. *Perfect 10, Inc.*, 488 F.3d at 1118 (explaining that websites can be viewed in various states at the same time, which would allow state law to dictate federal immunity).

144. *See id.* at 1107 (suggesting that a defendant will not know if they are immune from a state intellectual property type claim until a court decides the issue).

145. *Compare id.* at 1118 (clarifying that Congress had an "express goal of insulating the development of the Internet from the various state-law regimes"), *with* Hepp v. Facebook, 14 F.4th 204, 211 (3d Cir. 2021) (providing that "interpreting the § 230(e)(2) limitation to include state intellectual property laws tracks Congress's pro-free-market goal").

146. *See Perfect 10, Inc.*, 488 F.3d at 1118 ("[S]uch laws may bear various names, provide for varying causes of action and remedies, and have varying purposes and policy goals.").

147. *See* Reed & Ward, *supra* note 55 (providing an overview of Delaware Right of Publicity law); Savare et al., *supra* note 55 (providing an overview of New Jersey Right of Publicity law).

148. *See* Reed & Ward, *supra* note 55; Savare et al., *supra* note 55.

149. *See* Reed & Ward, *supra* note 55; Savare et al., *supra* note 55.

only applying it to the Pennsylvania right of publicity.[150] Therefore, the Third Circuit may have come to a different conclusion about the right of publicity under Section 230(e)(2) if it was deciding on a New Jersey claim.[151] This interpretation supports the Ninth Circuit's argument that permitting state laws under Section 230(e)(2) allows states to rule on federal immunity.[152] Within the Third Circuit Facebook's immunity to the right of publicity depends on the state in which the claim was brought, and if that court would interpret that state's right of publicity as intellectual property.[153]

Based on the Third Circuit example, the Ninth Circuit's interpretation of the legislative history makes sense considering the policy goals stated in Section 230(b).[154] One reason Congress did not specifically exclude state laws in Section 230(e)(2) was that they may not have realized the liability of state intellectual property laws to ISPs in 1996.[155] Congress may not have considered state intellectual property laws to be a threat to Section 230(e)(2) immunity.[156] The Ninth Circuit could use this to explain why it did not follow the Supreme Court's ruling on the use of "any" in a statute.[157]

The Third Circuit counters the legislative history argument of *Perfect 10*, which asserts that allowing state intellectual property laws would defeat the CDA's free market goal, by citing the Supreme Court case *Zacchini v. Scripps-Howard Broadcasting Co.*, which details the right of publicity.[158] The Third Circuit argued, "if likeness interests are disregarded on the

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150. *See* Hepp v. Facebook, 14 F.4th 204, 214 (3d Cir. 2021) ("[O]ur holding does not open the floodgates. Pennsylvania's statute is limited . . . . And we express no opinion as to whether other states' rights of publicity qualify as intellectual property as a matter of law.").

151. *See id.* (citing 42 PA. CONS. STAT. § 8316(e)) (explaining that the court's holding was limited because Pennsylvania's right of publicity requires a plaintiff to invest in their identity).

152. *See id.*; *see also* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1118 (9th Cir. 2007).

153. *See Hepp*, 14 F.4th at 214; *see also Perfect 10*, 488 F.3d at 1118.

154. 47 U.S.C. § 230(b)(2).

155. *See* 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) (explaining in 1996 "there simply were no cases that held out the risk of vicarious liability being imposed on interactive computer service providers or users for third-party content under state intellectual property laws").

156. *See id.*

157. *See* Harrison v. PPG Indus., Inc., 446 U.S. 578, 589 (1980) ("We have found nothing in the legislative history to support a conclusion that the phrase, 'any other final action' . . . means anything other than what it says.").

158. *See* Hepp v. Facebook, 14 F.4th 204, 211 (3d Cir. 2021) (citing *Zacchini*, 433 U.S. at 573).

internet, the incentives to build an excellent commercial reputation for endorsements may diminish."[159] Thus, not allowing a right of publicity claim would be in contrast to Congress's free market goals, and, therefore, Congress did intend to include state laws.[160] The Third Circuit's argument can also be countered because not every right of publicity statute requires there be commercial value in the plaintiff's identity, as shown with New Jersey's right of publicity law.[161]

Another policy goal of Section 230 was to protect speech on the internet, thus the concurring opinion in *Hepp* was concerned that allowing state intellectual property claims would threaten free speech.[162] Allowing liability under state intellectual property laws for ISPs could lead to a "pressure to restrict speech" and thus tougher content moderation practices.[163] The majority opinion in *Hepp* countered that concern by arguing that since Pennsylvania's right of publicity is similar to trademark, it does not threaten free speech because trademark laws address misappropriations.[164] The majority opinion only addressed how allowing the Pennsylvania right of publicity claim would not threaten free speech, but did not address if more general state intellectual property laws would threaten free speech.[165] This shows that both sides of the debate have valid arguments.[166]

While the Ninth Circuit has a strong argument that the language of the statute does not meet the CDA's goals, the Third Circuit's statutory

159. *Id.*

160. *See id.* (arguing that, because state property rights "can facilitate market exchange," the inclusion of state intellectual property laws supports Congress's free-market goals).

161. *See* Savare et al., *supra* note 55.

162. *See Hepp*, 14 F.4th at 225 (Cowen, J., concurring) (quoting Zeran v. Am. Online, Inc., 129 F.3d 327, 330–31 (4th Cir. 1997)) (explaining that one of the reasons § 230 was enacted was "to maintain the robust nature of internet communication"); *see also* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1118–19 (9th Cir. 2007) (quoting *Zeran*, 129 F.3d at 330) ("[L]awsuits could threaten the 'freedom of speech in the . . . internet medium.'"); *see also* Zeran v. Am. Online, Inc., 129 F.3d 327, 330 (4th Cir. 1997).

163. *Hepp*, 14 F.4th 204 at 225 (suggesting that the inclusion of state intellectual property laws under § 230 would lead to more liability and could cause ISPs to "censor more content").

164. *See id.* at 214 (emphasizing that the court's holding "does not threaten free speech" because it applied only to Pennsylvania's right of publicity).

165. *See id.* (stressing that Hepp's claim was about "the commercial effect on her intellectual property" and not free speech).

166. *See generally* 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) (providing background on the disagreement between various federal courts over whether the CDA's scope covers state intellectual property laws).

argument is more powerful.[167] The Supreme Court decisions regarding "any" cannot be overlooked.[168] Nor can the fact that in other 230(e) subsections Congress explicitly stated when a subsection included only federal or state laws.[169] Legislative history does not need to be considered when a statute is unambiguous.[170] The use of "any" in the statute is not ambiguous; the Ninth Circuit created the ambiguity by considering the policy goals of the CDA.[171] The policy goals of Congress cannot overcome the plain meaning of "any."[172] As stated in *Hepp*, the Ninth Circuit's interpretation "strays too far from the natural meaning."[173] Even if Congress did not intend to include state intellectual property laws, courts should interpret Section 230(e)(2) to include them until Congress amends the statute.[174]

C. *The Significance of the Circuit Split*

This circuit split is significant because the Ninth Circuit includes California's Silicon Valley, the headquarters of many modern-day ISPs, and the Third Circuit includes Delaware, the hub for incorporation.[175] For example, Facebook is headquartered in California, but incorporated in Delaware.[176] A plaintiff could bring a state law intellectual property claim

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167. *See generally Perfect 10, Inc.*, 488 F.3d 1102; Hepp v. Facebook, 14 F.4th 204 (3d Cir. 2021).

168. *See generally* United States v. Gonzales, 520 U.S. 1 (1997); Ali v. Fed. Bureau of Prisons, 552 U.S. 214 (2008) (discussing broadly the statutory interpretation of the word "any").

169. 47 U.S.C. § 230(e); *see also* Doe v. Friendfinder Network, Inc., 540 F. Supp. 2d 288, 299–300 (D.N.H. 2008); *Hepp*, 14 F.4th at 219–20.

170. *See* 73 AM. JUR. 2D. *Statutes* § 64 (2022) ("[I]t is improper to resort to extrinsic circumstances where the statute is plain and unambiguous.").

171. *See id.* (quoting McGirt v. Oklahoma, 140 S. Ct. 2452 (2020)) ("The only role extratextual materials can properly play is to help clear up, not create, ambiguity about a statute's original meaning.").

172. *See* 73 AM. JUR. 2D. *Statutes* § 68 (2022) (quoting Universal Health Servs., Inc. v. United States, 136 S. Ct. 1989 (2016)) ("Policy arguments cannot supersede the clear statutory text.").

173. Hepp v. Facebook, 14 F.4th 204, 210 (3d Cir. 2021) (explaining that Facebook's argument, which relied on the Ninth Circuit's interpretation, was too far off from the "natural meaning" of Section 230(e)(2)).

174. *See Hepp*, 14 F.4th at 204; *Friendfinder*, 540 F. Supp. 2d 288; Atl. Recording Corp. v. Project Playlist, Inc., 603 F. Supp. 2d 690 (S.D.N.Y 2009).

175. *See* Elaine Zelby, *How Delaware Became the State Where Companies Incorporate*, MEDIUM (Jan. 30, 2019), https://medium.com/useless-knowledge-daily/why-most-companies-incorporate-in-delaware-b8eae1e528a3 (explaining that the history and policy behind why so many U.S. companies are incorporated in Delaware).

176. *Facebook Inc.*, SEC, https://sec.report/CIK/0001326801 (last visited July 26, 2022).

against Facebook, but depending on the circuit, the claim may or may not be allowed.[177] This is exactly what happened in *Perfect 10* and *Hepp*, since *Hepp*'s state right of publicity claim was allowed but *Perfect 10*'s was not.[178] This leaves plaintiffs in the Ninth Circuit unable to bring claims allowed in other Circuits under the same law.[179]

The circuit split is also significant because no other court agreed with the Ninth Circuit before the Eastern District of Pennsylvania did so in 2020.[180] Both of these circuits pointed to the policy objectives in Section 230(b)(2), which leaves the interpretation of if allowing state intellectual property laws "preserve[s] 'the vibrant and competitive free market'" up to the courts.[181] Since both the Ninth and Third Circuit decisions are persuasive authority, another district or circuit court could agree with the Ninth Circuit and cause a bigger split.[182]

IV. RECOMMENDING SECTION 230(E)(2) INCLUDE STATE LAWS

Section 230 has come under scrutiny in the last few years due to the spread of misinformation involving U.S. elections and COVID-19 on ISPs, such as Facebook and Twitter.[183] Numerous bills introduced in Congress scale back the protections granted to ISPs under Section 230.[184] Both political parties want to protect users over ISPs, although there is a divide on how to achieve this objective.[185] For example, a Democratic bill, the SAFE TECH Act, wants to expand the exclusions to both federal and state laws such as civil rights, harassment, and wrongful death, and impose additional liabilities if ISPs do not remove content that could cause "irreparable harm."[186] Many Republican bills also focus on limiting

177. *See* Perfect 10, Inc. v. CCBill LLC, 488 F.3d 1102, 1118 (9th Cir. 2007); *Hepp*, 14 F.4th 204, 208 (3d Cir. 2021).

178. *See Perfect 10, Inc.*, 488 F.3d at 1118; *Hepp*, 14 F.4th at 208.

179. *See Perfect 10, Inc.*, 488 F.3d at 1118.

180. *See* 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020) (providing examples of two district courts that did not follow the Ninth Circuit's ruling); *see also* Hepp v. Facebook, Inc., 465 F. Supp. 3d 491 (E.D. Pa. 2020).

181. Hepp v. Facebook, 14 F.4th 204, 208 (3d Cir. 2021) (quoting § 230(b)(2)).

182. *See id.* at 211 (stating that the "structural evidence" of § 230(e)(2) "cuts both ways"); *see, e.g.*, *Hepp*, 465 F. Supp. 3d 491.

183. *See* Anand et al., *supra* note 4.

184. *See id.* (indicating that the introduction of bills that aimed to address the scope of § 230 highlighted political party divisions).

185. *See id.* ("Many on the left argue that [§ 230] has enabled tech platforms to host harmful content with impunity, while many on the right argue that it has enabled tech platforms to disproportionately suppress conservative speech.").

186. SAFE TECH Act, S. 299, 117th Cong. § 1(A) (2021); *see also id.*

Section 230 protections.[187]

Since the focus of many of these bills has to do with content moderation and the spread of misinformation, they do not address Section 230(e)(2).[188] But, as stated in the concurring opinion in *Hepp*, allowing Section 230(e)(2) to include state intellectual property laws could increase content moderation since ISPs could face additional legal liabilities.[189] If Congress wanted to increase content moderation then they could allow state intellectual property laws under the expectation in Section 230(e)(2).

As Congress is already re-examining the scope of 230, it should introduce a bill to clear up the confusion over Section 230(e)(2).[190] Since it seems that Congress's policy goals have changed since the CDA was enacted in 1996, Congress should amend Section 230(e)(2) to explicitly include state intellectual property rights.[191] Although the intellectual property exception is not currently addressed in the current bills, allowing the exception to include state intellectual property laws would align with many of the policy goals of these bills by reducing ISP protections and protecting users.[192] As stated above, the current circuit split disadvantages plaintiffs in the Ninth Circuit because they cannot bring a state intellectual property claim included under Section 230(e)(2) as they could in other circuits.[193] For example, plaintiffs in the Ninth Circuit do not have protection over their right of publicity, whereas it may be protected in the Third Circuit.[194] This is contrary to the new policy goals Congress has for Section 230, since Congress no longer wants to protect ISPs, but protect their users.[195]

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187. *See* Anand et al., *supra* note 4 ("Republicans introduced bills that sought to compel platforms to be more '"neutral"' in their moderation of online content.").

188. *See id.* (explaining the bills that have been introduced to Congress this session involving section 230).

189. Hepp v. Facebook, 14 F.4th 204, 225 (3d Cir. 2021) (suggesting that expanding intellectual property liability under state laws would likely cause ISPs to increase their content moderation).

190. *See generally* Anand et al., *supra* note 4 (providing examples of bills that both political parties have introduced in an attempt to reform § 230).

191. *See id.*; 4 E-COMMERCE AND INTERNET LAW 37.05[5][B] (2020).

192. *See* Anand et al., *supra* note 4

193. *See* Perfect 10, Inc., v. CCBill LLC, 488 F.3d 1102, 1119 (9th Cir. 2007) (interpreting § 230(e)(2) as covering only federal intellectual property claims); *Hepp*, 14 F.4th 204, 210–11 (interpreting § 230(e)(2) as covering both state and federal intellectual property claims).

194. *See Perfect 10, Inc.*, 488 F.3d at 1121 (dismissing the right of publicity claim since it was a state intellectual property claim); Hepp v. Facebook, 14 F.4th 204, 215 (3d Cir. 2021) (reversing the district court's dismissal of a state intellectual property claim, particularly a Pennsylvania right of publicity claim).

195. *See* Anand et al., *supra* note 4 (indicating that both political parties favor the

If Congress does not address the confusion over Section 230(e)(2), then it should be addressed by the Supreme Court. The circuit split exists because the circuits are interpreting statutory language differently.[196] The Supreme Court has already ruled on statutes with similar language and therefore, based on that precedent, it is likely the Court will agree with the Third Circuit that state laws are included under Section 230(e)(2).[197]

V. CONCLUSION

The CDA gives ISPs broad immunity for third-party postings on their website, although that immunity does not extend to intellectual property laws.[198] Since intellectual property was not defined in the statute, the Ninth and Third Circuits are split as to whether state laws are included under Section 230(e)(2).[199] Congress should amend Section 230(e)(2) to explicitly include state laws, since its goals involving the CDA have changed from protecting ISPs to protecting users.[200]

If Congress does not act, then the Supreme Court should resolve the circuit split and include state laws based on the statutory language precedent already established.[201] This would prevent a bigger circuit split and would ensure that plaintiffs in any circuit are allowed to bring state intellectual property claims under Section 230(e)(2).

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protection of users over the impunity granted to ISPs by § 230).

196. *See Perfect 10, Inc.*, 488 F.3d 1102; *Hepp*, 14 F.4th 204.

197. *See, e.g.*, Ali v. Fed. Bureau of Prisons, 552 U.S. 214, 219 (2008) (citing previous U.S. Supreme Court cases interpreting the word "any" in statutes to support the conclusion that "any" has a broad meaning); Harrison v. PPG Indus., Inc., 446 U.S. 578, 588–89 (1980) (holding that the use of "any" in a section of the Clean Air Act did not show that Congress intended for the section to be limiting); Barnhart v. Sigmon Coal Co., 534 U.S. 438, 461–62 (2002) (quoting Rubin v. United States, 449 U.S. 424, 430 (1981) ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

198. BRANNON & HOLMES, *supra* note 1.

199. *See* Perfect 10, Inc., v. CCBill LLC, 488 F.3d 1102 (9th Cir. 2007); *Hepp*, 14 F.4th 204.

200. *See* Anand et al., *supra* note 4.

201. *See, e.g.*, *Ali*, 552 U.S. at 219; *Harrison*, 446 U.S. at 588–89; *Barnhart*, 534 U.S. at 461–62.

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