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COMMENTS

NOTES

COPYRIGHT IN MUSIC IN U.S. INTERPRETATION: THE CASE FOR MOVING AWAY FROM EASY AND NONSENSICAL FINDINGS OF COPYRIGHT INFRINGEMENT

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"I could tell you which writer's rhythms I am imitating. It's not exactly plagiarism; it's falling in love with good language and trying to imitate it."
~ Charles Kuralt

I. INTRODUCTION

The world is filled with music. You can hear music playing almost anywhere you go, at all times of the day. From your car, to the shops you frequent, to the restaurants you eat at, and even in the workplace. With this ever-growing ease of accessing music, it is becoming exceedingly more difficult for musical artists/composers (Artist(s)) not to have at least a minutia of influence from another Artist. You get a catchy hook, harmony, or bass line stuck in your head and write a hit song around a variation on that "feel" or style of music. Should this be considered an infringement of the original Artist's musical copyright? This question has divided courts and been the turning point in several seminal cases.

Part II of this Article will review the history of copyrights and the earliest American cases. Analyzing along the way what the courts got right, what they got wrong, and how this has ultimately produced the *Arnstein* "feels like" test, which has affected the music world as a whole. Part III is a detailed background of "how we got here," spotting the crucial faults in the copyright system both within the Second and Ninth Circuits. This section will illustrate how utilizing expert musicologists' analyses, along with a detailed theoretical analysis of the musical compositions, will help put an end to the "feels like" and intrinsic portions of both Circuits' tests. Part IV explains how by focusing on the extrinsic analysis, along with an educated panel of musicologists, a new standard for the copyright infringement analysis can be born, leading to fewer cases over music infringement claims going to trial.

II. BACKGROUND

A. Copyright Law Through the Ages

1. Coming to America: Copyright and the Earliest American Cases

The Constitution states that "The Congress shall have power . . . [t]o promote the Progress of Science and useful Arts, by securing for limited

Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[1]

The first U.S. federal copyright law gave protections to "maps, charts, and books."[2] While it did not specifically list music as one of the items protected by the copyright law, Judge Thompson concluded in *Clayton v. Stone* that:

> A literary production to be the subject of copyright, need not be a book in the common and ordinary acceptation of the term: a volume written or printed, made up of several sheets and bound together. It may be printed on one sheet, as the words of a song, or the music accompanying it.[3]

While this was the stance and belief held in some courts, music was not officially protected until the Copyright Act of 1831 (the Act).[4] Even then, the Act only afforded composers limited reproduction rights for twenty-eight years, plus a fourteen-year renewal period.[5]

One of the earliest—if not the earliest—American copyright infringement cases tried under the Act was *Millett v. Snowden* in 1844.[6] In *Millett*, the plaintiff claimed that publisher William Snowden reproduced and republished his entire copyrighted musical work entitled "The Cot Beneath the Hill."[7] Snowden, however, claimed he did not know a copyright existed on the musical work.[8] He stated that he was under the impression that since the publication carried no indication of copyright, that he was not liable for any damages.[9] Judge Betts, however, stated that "[i]f a copyright has been invaded, whether the party knew it was copyrighted or not, he is liable to the penalty."[10] The penalty, in this case, was one dollar for every sheet proven to

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1. U.S. CONST. art. I, § 8.
2. Act of May 31, 1790, 1 Stat. 124.
3. Clayton v. Stone, 5 F. Cas. 999, 999 (C.C.S.D.N.Y. 1829).
4. *See Copyright Timeline: A History of Copyright in the United States*, ASS'N OF RES. LIBRS., https://www.arl.org/focus-areas/copyright-ip/2486-copyright-timeline#.W9XgZ_ZFxPY [https://perma.cc/L7P4-NHYG].
5. *Id.*
6. *See* Millett v. Snowden, 17 F. Cas. 374 (C.C.S.D.N.Y. 1844).
7. *Id.* at 374 (The sheet music for "The Cot Beneath the Hill" can be located at https://cpb-us-w2.wpmucdn.com/blogs.law.gwu.edu/dist/a/4/files/2018/12/cotbeneaththehill-28kpsw7.pdf [https://perma.cc/NGH9-T2L7]). Copying and republishing an entire work, instead of a few lines, or a string of memorable notes from a melody—as is common in 20th-century cases—was common in early copyright infringement cases. *See* Reed v. Carusi, 20 F. Cas. 431, 431 (C.C. Md. 1845) (discussing the song entitled "The Old Arm Chair," which was taken in its entirety, without authorization, from a poem entitled "The Old Arm Chair").
8. *Millett*, 17 F. Cas. at 374.
9. *Id.* (the publication was first seen in the Boston newspaper, a popular newspaper to publish musical works).
10. *Id.*

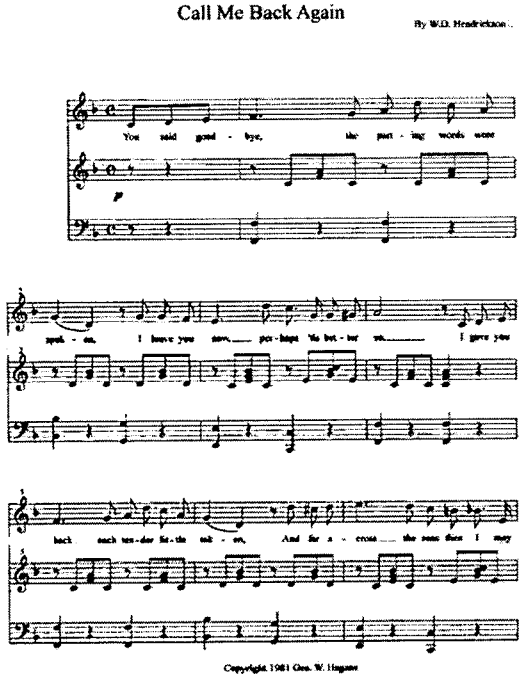
have been sold or offered for sale.[11] The damages amounted to a verdict of six hundred and twenty-five dollars ($625),[12] a hefty sum in 1844.

Before the 1976 Copyright Act, indication and notification of whether something was subject to copyright, was of great importance and central to much litigation. As seen in *Millett*, searching for a copyright on a musical work was not easy during that time, so publishers relied heavily on copyright notices in published works, especially newspapers.

Blume v. Spear, unlike *Millett*, is one of the first music copyright infringement cases where the lyrics were not copied verbatim, and the music was modified slightly to "attempt" to give a sense of a new piece. The musical piece, however, was found to have followed too closely in interval size, phrase lengths, and rhythmic patterns to be set apart as a new composition.[13] *Blume* involved a musical composition entitled "My Own Sweet Darling, Colleen Dhas Machree" written by Fannie Beanne Gilday, and copyrighted by Frederick Blume (Plaintiff), and "Call Me Back Again" written by W.D. Hendrickson (Defendant).[14] In *Blume*, Defendant argued three issues before the court: first, that Fannie Beane did not submit two copies of her musical composition to the office of the Librarian of Congress within ten days after publication; second, that the orator abandoned the composition to the public by publishing it under a different title from that which it was copyrighted; and third, that the music of "Call Me Back Again" did not infringe upon the copyright.[15]

11. *Id.*
12. *Id.*
13. Blume v. Spear, 30 F. 629, 631 (C.C.S.D.N.Y. 1887).
14. *Id.* at 629–30.
15. *Id.* at 629.

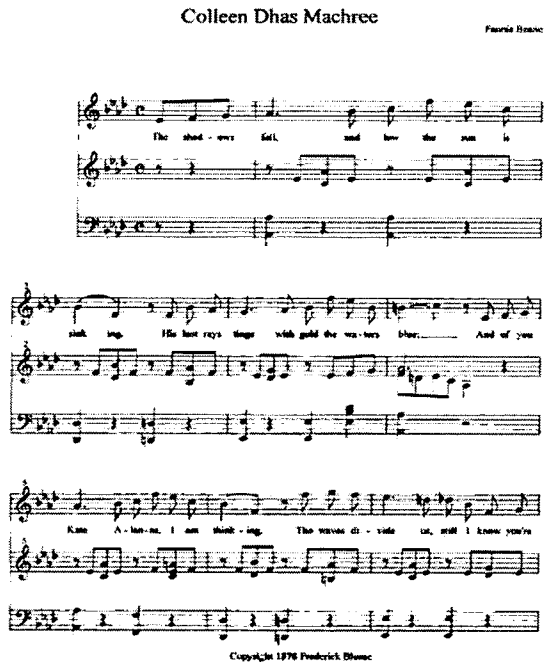
The court found in favor of the Plaintiffs on all three issues brought by the Defendant.[16] For the first two issues, the Plaintiffs proved that two copies of "My Own Sweet Darling" were sent to the Librarian of Congress with a dated acknowledgement of November 29, 1878, and that while the copyright was not on the front cover, or the page immediately following that,[17] it was displayed below the music "Copyright, 1878, by Frederick Blume."[18] The



16. *Id.* at 629–31.

17. *Id.* at 630. Section 1 of the Act of 1874 stated:
That no person shall maintain an action for the infringement of his copyright, unless he shall give notice thereof by inserting in the copies of every edition published, on the title-page, or the page immediately following, if it be a . . . [a] musical composition . . . by inscribing upon some visible portion thereof, or of the substance upon which the same shall be mounted, the following words. . . "Copyright," together with the year the copyright was entered, and the name of the party by whom it was taken out, thus: "Copyright, 18__, by A.B."
Act of June 18, 1874, ch. 301, 18 St. 78, Sup. Rev. St. 40.

18. *Blume*, 30 F. at 630. Judge Wheeler commented that U.S. Rev. St. § 4962, states:
[W]here the notice is to be put, as well as in respect to what it may be, on maps, charts, musical compositions, and other things, except books. By that section it was to be inscribed on "some portion of the face or front thereof, or on the face of the substance on which the same" should be mounted. By the latter act it is to be inscribed "upon some visible portion thereof, or of the substance on which the same shall be mounted."
Id. at 631.



third issue that was brought by the Defendant on how "Call Me Back Again" was not an infringing work was also denied by Judge Wheeler.[19] In Judge Wheeler's opinion—and, as a side by side comparison of the compositions above demonstrates—the two compositions are substantially similar.[20] Although the compositions are set in different keys, the interval sizes in the melodic passages, as well as the rhythmic patterns are substantially the same. Although Defendant's piece used some varying rhythmic structures,[21] along with directional variations in the neighboring notes,[22] it did not differ enough to distinguish it between the two compositions. This similarity, even to the untrained musician's eye, is adamently apparent. For these reasons, the court held that W.D. Hendrickson clearly and deliberately copied Mrs. Gilday's composition.[23]

While copyright infringement litigation over sheet music (of popular songs) was well underway and resulted in hefty verdicts throughout the mid

19. *Id.*
20. *Id.*
21. This slight variation is demonstrated in the third full measure where the defendant added in a dotted eighth followed by a sixteenth note. *See supra* p. 5.
22. This varying direction of neighboring notes is demonstrated in the second half of the sixth measure. *See supra* p. 5.
23. *Blume*, 30 F. at 631.

to late eighteenth century, there was one area where the standard was applied differently from that of sheet music. This area involved the music of the Player Piano. During the early nineteenth century, Player Pianos were sold in the tens of thousands to both households and parlors as a popular form of entertainment.[24] However, this popularity led to an increase in unauthorized copying. One of the seminal cases involving player pianos was that of *White-Smith Music Pub. Co. v. Apollo Co.*

In *Apollo*, the plaintiffs claimed that the Apollo Co. copied their songs "Little Cotton Dolly" and "Kentucky Babe" onto musical rolls, which were then sold to the public to be used on Apollo's player pianos.[25] Apollo did not contest this infringement.[26] Instead, Apollo relied upon previous cases tried in the English courts and the Berne Convention of 1886, where it was found that "the manufacture and sale of instruments serving to reproduce mechanically the airs of music borrowed from the private domain are not considered as constituting musical infringement."[27] While the U.S. was not a party to the Berne Convention, Justice Day stated that Congress must have been aware of this provision in the convention and yet still did not add player pianos and reproducing music mechanically into the Copyright Act.[28] One of the primary arguments brought forth in *Apollo* is that even the creators of these rolls are "unable to read them as musical compositions."[29]

The Court in *Apollo* stated that a copy of a musical composition is a "written or printed record of it in *intelligible notation*."[30] Original tunes reproduced merely for the benefit of the ear are not copies of musical tones that appeal to the eye, and "[i]n no sense can musical sounds . . . be said to be copies . . . ."[31] While, by this point, the public performance of musical compositions had been added through an amendment to the Copyright Act,[32] the Supreme Court in *Apollo* stated that the amendment was not intended to expand and enlarge the meaning of any previous sections.[33] Instead, it was added so that musical compositions could be on the same footing as dramatic compositions.[34] In *Apollo*, the Court concluded that the absence of statutory

24. Player Pianos consisted of a piano with a perforated "musical roll," that when drawn over the tracker board would sound notes through the perforations due to change in air pressure. These perforations, unlike notes on a page of music, had to be skillfully made to create the exact melody or tune of the desired song.

25. White-Smith Music Pub. Co. v. Apollo Co., 209 U.S. 1, 8 (1908).

26. *Id.* at 14.

27. *Id.*

28. *See id.* at 14–15.

29. *Id.* at 18.

30. *Id.* at 17 (emphasis added).

31. *Id.*

32. Copyright Act of Jan. 6, 1897, ch. 4, § 4966, 29 Stat. 481–82.

33. *Apollo Co.*, 209 U.S. at 16.

34. *Id.*

protection allowed manufacturers to enjoy the use of musical compositions without paying, and that it was up to the legislature to address these concerns, not the judicial branch.[35]

This form of backward thinking is found not only in *Apollo*, but can also be seen throughout numerous decisions concerning music copyright infringement within the Ninth and Second Circuits. One of the greatest backward thinking cases, and the seminal case still applied in Second Circuit music copyright infringement lawsuits to this day, is *Arnstein v. Porter*.[36]

2. *Movin' on Up: The Seminal Case That Opened the Copyright Floodgates*

Arnstein v. Porter frayed from the path of clear-cut copyright infringement cases as seen in the 19th and early 20th centuries and, instead, decided to determine copyright based on minimal music similarities and the "lay listener" test.[37] The *Arnstein* lay listener test—also known as the two-prong test—involves: "(a) that defendant copied from the plaintiff's copyrighted work and (b) that the copying (assuming it to be proved) went [too] far as to constitute improper appropriation."[38]

The first prong of the *Arnstein* test consists of either direct evidence or circumstantial evidence.[39] Direct evidence is shown through the defendant's admission that he/she copied the work.[40] Circumstantial evidence, however, consists of showing access to the plaintiff's work.[41] This showing of access is what the trier of fact may reasonably use to infer copying.[42]

In *Arnstein*, the plaintiff could not prove the first prong of the test through either direct or circumstantial evidence. While Arnstein's tunes were sung publicly, and one of the alleged copyrighted pieces "A Mother's Prayer" had sold over one million copies, Cole Porter emphatically denied ever hearing or seeing Arnstein's music.[43] Arnstein insisted, however, that Porter had access to his pieces by having "stooges right along to follow [him], watch [him], and live in the same apartment with [him] . . . ."[44] Even with this com-

35. *Id.* at 18.
36. *See* Arnstein v. Porter, 154 F.2d 464 (1946).
37. *See id.* at 473.
38. *Id.* at 468.
39. *See id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.* at 467.
44. *Id.*

mentary, Judge Frank stated that "[w]e should not overlook the shrewd proverbial admonition that sometimes truth is stranger than fiction."[45] For this reason, Judge Frank stated that the one million copies of the composition being sold was enough evidence to let a jury decide whether such facts reasonably infer access from Porter.[46]

In Porter's time, just as now, access may be inferred in a myriad of different ways. While Judge Frank relied on the one million copies sold by Arnstein to show access, judges today have an even easier time of showing access through radio play, YouTube, and numerous other outlets demonstrated in Part III.

The first prong of the *Arnstein* test is also the only part that allows for expert testimony. To recover damages for infringement of copyrights to musical compositions where evidence of access and similarities exist, "the testimony of experts may be received to aid the trier of the facts" in establishing whether sufficient similarities exist to prove copying.[47] After the first prong of the test, however, melodies, chord structures, and rhythmic structure were of no importance to the relevant "lay listener" who—unlike the refined ear of the musical expert—was the composer's intended audience.[48]

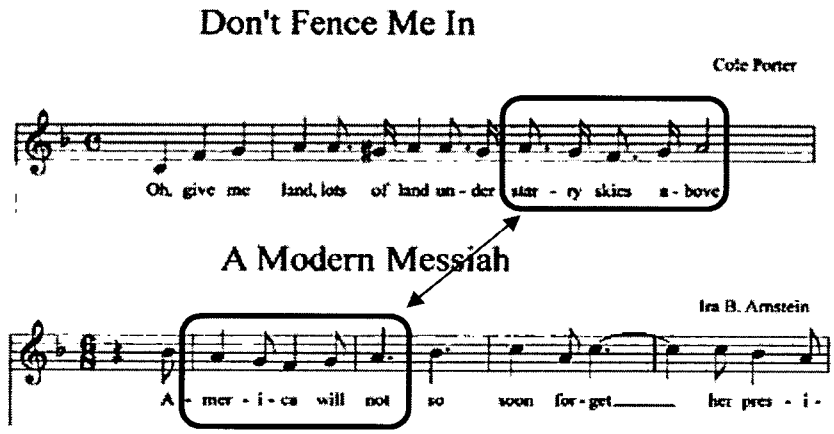
Now, only if copying is established, do we move on to the second prong of the test, unlawful appropriation (illicit copying). The test of unlawful appropriation "is the response of the *ordinary lay hearer*; accordingly, on that issue, 'dissection' and expert testimony are irrelevant."[49] In *Arnstein*, after listening to the recordings submitted, Judge Frank concluded that similarities existed between the pieces involved in the suit.[50] Standing alone, the pieces undoubtedly "d[id] not compel the conclusion, or permit the inference, that [the] defendant copied [the musical works]."[51] However, when placed side by side, the "similarities . . . are sufficient so that, if there is enough evidence of access[,] . . . the jury may properly infer that the similarities did not result from coincidence."[52]

In *Arnstein*, these similarities would not have been considered similarities at all, had a competent music theorist, or musicologist been allowed to help guide Judge Frank in his decision. When analyzing Porter's pieces against Arnstein's pieces, the only similarities that can be found are a few

45. *Id.* at 469.
46. *Id.* at 469–70.
47. *Id.* at 468.
48. *Id.* at 473 ("The impression made on the refined ears of musical experts or their views as to the musical excellence of plaintiff's or defendant's works are utterly immaterial on the issue of misappropriation.").
49. *Id.* at 465 (emphasis added).
50. *Id.* at 469.
51. *Id.*
52. *Id.*

motives (very, very short motives[53]), that most likely match up with at least a dozen or more songs from that time.

The first piece "Don't Fence Me In" had only four notes in common with Arnstein's "Modern Messiah." These four notes—as you can see from the score excerpts below—are commonly used neighboring notes, with a similarly common rhythmic structure attached to them. Nothing in Porter's "Don't Fence Me In" outside of these four notes, matches up with Arnstein's song. To the lay listener, however, when hearing these four notes at the beginning of both pieces they could infer copyright. This is the danger of allowing a lay listener, and not an expert musicologist, listen to, analyze, and determine whether two musical works are substantially similar in nature. An expert musicologist understands that just because a song may have the same notes and rhythmic motives, it does not mean that it infringed upon copyrightable material.[54]



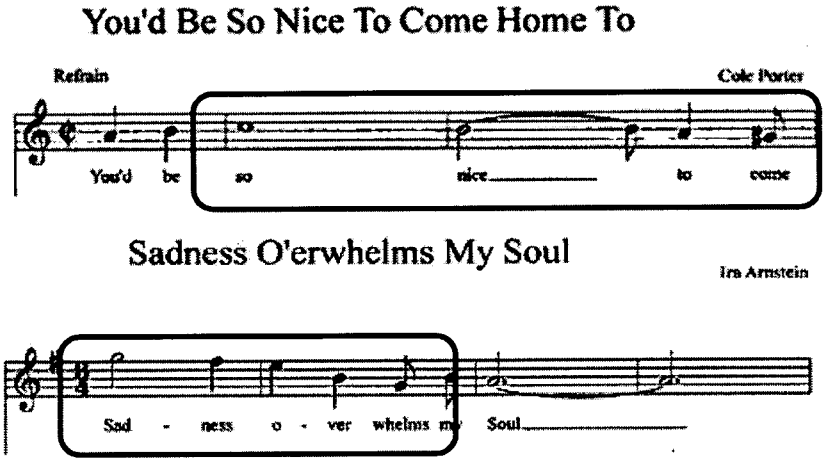
The second piece in controversy was Porters "You'd Be So Nice to Come Home To" and Arnstein's "Sadness O'erwhelms My Soul." Arnstein's piece opens with a half note on "sad" followed by a descending quarter and eighth note motive of a minor second, major second, and a perfect fourth. Porter's tune has a similar rhythmic opening with the same motive.[55] As can be seen from the excerpts of the two scores below, this, just like the four-note

53. A musical motive is the smallest structural unit possessing thematic identity. Think the opening to Beethoven's Fifth Symphony. That is one of the shortest and greatest motives in musical history. Four notes that had a dramatic impact on the classical music world.

54. We will see in Part III in the case of Led Zeppelin, that just because the same notes were used with similar rhythmic interpretations does not mean that the composer infringed on the other composer's musical work. *See infra* Part III.

55. The motive here is the same four notes.

motive shown above, is commonplace and used often in musical compositions. Combinations of non-copyrightable material however, as will be shown in Section III below, is one of the primary bases of copyright infringement cases that should have never gone to trial.



In the dissent offered by Judge Clark, he found the approach given by Judge Jerome Frank to be patently backward, and that established practice and common sense indicate that expert testimony should be permitted to inform the court on the scope of copyrightable expression in the plaintiff's work.[56] Here, and explained in more detail below,[57] I could not agree more. While the lay listener can be an important judge of similarity in feel and texture of a song, it should not be relied upon to determine the scope at which a musical work has been copied. This analytical and extrinsic portion of music copyright law should be left to expert musicologists and theorists, and not that of the lay listener. By establishing one unique higher standard test—utilized only for music copyright cases—courts could eliminate the second prong of the *Arnstein* test, and streamline the entire process for how one must prove copyright infringement.

56. *See Arnstein*, 154 F.2d at 478.
57. *See infra* Section III.

III. THE MODERN MOVEMENT

A. *Copyright Infringement Analysis and How the Second and Ninth Circuit Courts Analyze/Determine Song Similarity*

1. *Step One: Valid Copyright Ownership*

Ownership of a valid copyright is generally the easiest element to establish by proving "the originality and copyrightability of the material and compliance with statutory formalities."[58] The U.S. Supreme Court has stated that "originality is a constitutionally mandated prerequisite for copyright protection."[59] This means that the work must be original to the artist—as opposed to copied from other works—and must exhibit a "minimal degree of creativity."[60] Even if a copyright certificate of registration is obtained for the work(s), this creates only a rebuttable presumption that the copyright is valid.[61]

2. *Step Two: Showing of Actual Copying – When Copying Has Gone Too Far*

After the plaintiff proves that they have ownership of a valid copyright, the plaintiff must show that the defendant actually copied protected elements of the plaintiff's work.[62] To establish actionable copying under the Copyright Act, a plaintiff must prove: (i) the defendant engaged in factually copying the protected material (shown by direct[63] and/or circumstantial evidence), and (ii) that there is a "substantial similarity" between the two works to constitute improper appropriation.[64]

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58. Norma Ribbon & Trimming, Inc. v. Little, 51 F.3d 45, 47 (5th Cir. 1995).

59. Feist Publ'ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 351 (1991).

60. *Norma Ribbon & Trimming, Inc.*, 51 F.3d at 47 (quoting *Feist Publ'ns, Inc.*, 499 U.S. at 345).

61. *See Norma Ribbon & Trimming, Inc.*, 51 F.3d at 47 (arguing that the Littles' obtained copyright certificates of registration for ribbon flowers that were central to the infringement lawsuit, and that these certificates only created a rebuttable presumption and that the ribbon flowers were not "original" as necessary for copyright protection).

62. Three Boys Music Corp. v. Bolton, 212 F.3d 477, 481 (9th Cir. 2000). In determining the scope of these protected elements, some courts look to when the artist registered their composition. *See* Magnuson v. Video Yesteryear, 85 F.3d 1424, 1427 (9th Cir. 1996) ("[T]he Copyright Act of 1909 is the applicable law in this case because the copyright was secured in 1968, prior to the adoption of the 1976 Act.").

63. Direct evidence is the hardest for a plaintiff to show but has been offered up successfully in the past. *See* Rogers v. Koons, 960 F.2d 301, 307 (2d Cir. 1992) (arguing that there was direct evidence "of copying the very details of the photograph that embodied plaintiff's original contribution").

64. *See* Arnstein v. Porter, 154 F.2d 464, 468 (2d Cir. 1946).

Factual copying can be shown through evidence that (i) the defendant had access to the copyrighted work before the creation of the allegedly infringing work, and (ii) the two works are probatively similar to one another.[65] Access has to be more than a mere possibility that the alleged infringer may have seen the prior work.[66] There must have been an " opportunity to view" or listen to the allegedly infringed work.[67] This can be shown through (1) the chain of events theory or (2) the "wide dissemination" and "subconscious copying theory."[68] "[W]here there are striking similarities probative of copying, [however,] proof of access may be inferred."[69] Once factual copying is shown, then the second—and most complicated—part of the analysis begins.

This final step of showing "substantial similarity" is one where the Second and Ninth Circuit Courts differ greatly. The Second Circuit—in determining substantial similarity—follows in the footsteps of *Arnstein* and focuses on the "lay listener,"[70] while the Ninth Circuit uses a two-pronged "extrinsic" and "intrinsic" analysis.[71] Despite this split between the two courts, however, neither has managed to create a system with consistent and strong results, leading to ambiguous and/or contradictory rulings and jury decisions.

B. *The New York State of Mind – The Second Circuit and the Lay Listener Test*

The lay listener test was introduced in the above-mentioned case of *Arnstein v. Porter*.[72] In *Arnstein*—as mentioned previously—the test for substantial similarity between musical composition depends not on the opinion of

65. Positive Black Talk Inc. v. Cash Money Records Inc., 394 F.3d 357, 368 (5th Cir. 2004) (quoting Peel & Co. v. Rug Market, 238 F.3d 391, 394 (5th Cir. 2001)).

66. Ferguson v. Nat'l Broad. Co., 584 F.2d 111, 113 (5th Cir. 1978).

67. *Id.*

68. *See* Three Boys Music Corp. v. Bolton, 212 F.3d 477, 482 (9th Cir. 2000); *see also* ABKCO Music, Inc. v. Harrisongs Music, Ltd., 722 F.2d 988, 998–99 (2d Cir. 1983) (arguing that infringement is "subconscious" or "innocent" and does not affect liability, although it may have some bearing on remedies).

69. Repp v. Webber, 132 F.3d 882, 889 (2d Cir. 1997) ("[I]f the two works are so strikingly similar as to preclude the possibility of independent creation, copying may be proved without a showing of access.") (quoting Lipton v. Nature Co., 71 F.3d 464, 471 (2d Cir. 1995)).

70. *See* Dawson v. Hinshaw Music Inc., 905 F.2d 731, 734 (4th Cir. 1990) ("Under the facts before it, with a popular composition at issue, the *Arnstein* court appropriately perceived 'lay listeners' and the works' 'audience' to be the same."); Arnstein v. Porter, 154 F.2d 464, 473 (2d Cir. 1946). ("The question, therefore, is whether defendant took from plaintiff's works so much of what is pleasing to the ears of lay listeners, who comprise the audience for whom such popular music is composed . . . .").

71. Sid & Marty Krofft Television Prods., Inc. v. McDonald's Corp., 562 F.2d 1157, 1164 (9th Cir. 1977).

72. *See Arnstein*, 154 F.2d at 468.

musical experts, but on the response of the "ordinary lay hearer."[73] In *Arnstein*, substantial similarity between two works in a copyright infringement case alleging musical plagiarism must show that the "defendant took from the plaintiff's works so much of what is pleasing to the ears of the lay listeners, who comprise the audience for whom such popular music is composed, that defendant wrongfully appropriated something which belongs to plaintiff."[74] The argument was made—and established—that expert analysis and dissection were of no importance to the court's determination of whether copying had truly occurred.[75] Melodies, chord structures, and rhythmic structure were of no importance to the relevant "lay listener" who—unlike the refined ear of the musical expert—was the composer's intended audience.[76] These views rely heavily on the notion that the intended audience (i.e. the consumer world at large) is the only—and most important factor—in determining whether or not an artist has infringed on another's work. This notion may be based in economics, seeing the consumer as the ultimate purveyor of success for an artist's music, and therefore, the trier of that which they consume. While this may or may not be true, it is true that the court's inability to draw a clear line has oversimplified the interpretation of music and led to sloppy, inconsistent verdicts throughout the Second Circuit.

1. Repp v. Webber – *The "Phantom Song"*

In *Repp v. Webber*, Ray Repp, a professional composer and performer of liturgical music for more than thirty years brought a copyright infringement claim against world-renowned composer Andrew Lloyd Webber.[77] Repp contends in his claim that Webber, having access to his music, copied the song "Till You,"[78] intentionally or unintentionally, in writing "Phantom Song" from the hit Broadway show "Phantom of The Opera."[79] However, Webber asserts that he wrote the song with his wife, Sarah Brightman, while at their home in England in late 1983.[80] Webber contends that the song was written to showcase Brightman's vocal range, and that she sang the melody

73. *Id.*
74. *Id.* at 473.
75. *Id.* at 468.
76. *Id.* at 473 ("The impression made on the refined ears of musical experts or their views as to the musical excellence of plaintiff's or defendant's works are utterly immaterial on the issue of misappropriation . . . .").
77. Repp v. Webber, 132 F.3d 882, 884–85 (2d Cir. 1997).
78. *Id.* at 884. In 1978, "Till You" was composed and registered with the United States Copyright Office. Twenty-five thousand copies of the work were distributed, along with recordings both on cassette and record. Repp also performed the piece at over two hundred concerts to more than one hundred thousand people. *Id.*
79. *Id.*
80. *Id.* at 885.

as he composed at the piano.[81] While Webber states that the entire song was not finished that day, the whole melody was developed.[82] He and Brightman state that they had never heard of Repp or any of his music until the start of the litigation.[83] Webber dislikes pop church music and therefore would have never listened to Repp's works or attended any of his concerts.[84]

During the proceedings before the district court, both Repp and Webber had expert musicologists testify as to the similarities of the two songs. Webber's musicologist, Dr. Lawrence Ferrara,[85] in analyzing the two songs, noted that two separate music phrases exist in "Till You" while three separate musical phrases exist in "Phantom Song."[86] Ferrara explains that the third phrase in "Phantom Song" is a variant of the first phrase in the work and that in looking back to Webber's earlier works, these musical phrases were derived from earlier pieces Webber had created.[87] The first phrase, Ferrara stated, was derived from an earlier composition "Benjamin Calypso" and "Pilates Dream."[88] This phrase also contained elements from Bach and Grieg which were in the public domain.[89] The second phrase of "Phantom Song" was derived from "Close Every Door" but also from other various works of Webber.[90] Ferrara concluded with the fact that Webber did not take any elements from Repp's work of "Till You" and only used sources that pre-dated Repp's composition.[91]

However, Repp's musicologists, Professors H. Wiley Hitchcock and James Mack, strongly disagreed. "Hitchcock provided a thirty-five-page musicological analysis, with attached charts, to support his conclusion that 'Phantom Song' is based on 'Till You.'"[92] Hitchcock analyzed the "overall structure, rhythm and meter, melody and harmony, and the interaction of these elements in the two pieces as a whole."[93] He discovered that the basic rhythmic character and the basic metrical character of each piece were the same.[94] Even though they are written in different harmonic modes, they revealed significant correspondences, and an absolute identity in harmonic

81. *Id.*
82. *Id.*
83. *Id.* at 886.
84. *Id.*
85. Dr. Ferrara is Professor of Music at New York University. *See Faculty*, NYU, https://steinhardt.nyu.edu/faculty/Lawrence_Ferrara [https://perma.cc/7EPF-P49U].
86. *Repp*, 132 F.3d at 886.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*

rhythm.[95] The most striking similarity, however, was between the two melodies.[96] Hitchcock concluded that "[b]etween 'Till You' and 'Phantom Song' however, the similarities are so many, in so many areas, over such an extraordinary proportion of the compositions, that I [Hitchcock] cannot consider them as insignificant or coincidental, and I must conclude that 'Phantom Song' is based on 'Till You.'"[97]

Professor James Mack confirmed Professor Hitchcock's analysis and added that he found even more similarities between the two pieces.[98] While looking at the works from both a contemporary commercial point of view as well as a traditional academic perspective, Mack concluded that the harmonic similarities between the two pieces, along with what Professor Hitchcock described, were so strikingly similar as to preclude separate creation.[99]

Even with these expert testimonies from very reputable musicologists and professionals in the field of music, the district court stated that:

> Upon *aural examination* of the two songs and consideration of expert testimony submitted by both parties, the Court finds that any similarities between the two works are not so extensive as to support an inference of copying and improper appropriation without more. *While the two melodies share several common notes, the songs differ in tempo and style.* In addition, plaintiffs' expert, Prof. Hitchcock, *concedes that the two pieces differ in harmony, key and mode.* Under the circumstances, the Court finds that the two songs do not share a striking similarity sufficient to justify a finding of copying in the absence of access to the copyrighted work.[100]

The district court went on to accept the defendant's argument of independent creation based on the declaration made by Webber and Brightman as to the creation of the piece, as well as stating that the plaintiffs did not establish a chain of events by which Webber might have gained access, no nexus between Webber and anyone Repp knows, and Repp's failure to show wide dissemination of the work "Till You."[101] Because of the above-mentioned facts, the district court granted Webber's summary judgment motion.[102]

On appeal, the appellate court brought to light several flaws in the district court's analysis. The appellate court stated that, as to the determination of absence of access, "[W]here there are striking similarities probative of

95. *Id.*
96. *Id.*
97. *Id.* at 886–87.
98. *Id.* at 887.
99. *Id.*
100. *Id.* (emphasis added) (quoting Repp v. Webber, 858 F. Supp. 1292, 1301 (S.D.N.Y 1994)).
101. *Id.* at 887–88.
102. *Id.* at 887.

copying, proof of access may be inferred: 'If the two works are so strikingly similar as to preclude the possibility of independent creation, copying may be proved without a showing of access.'"[103] "[T]here was little, if any, evidence demonstrating access, [but] there was considerable evidence that 'Phantom Song' is so strikingly similar to 'Till You' as to preclude the possibility of independent creation and to allow access to be inferred without direct proof."[104] Two highly qualified experts for the plaintiffs made findings on the issue and "gave unequivocal opinions based on musicological analyses."[105] The court stated that "[i]t was not for the district court to make this factual finding [on their own] where such strong competing evidence was before it."[106]

In *Webber*, it is almost as if the district court—who may have been huge fans of Webber—did not want Repp to win a claim against such a prolific composer. This, honestly, is the only assertion that can reasonably be made when such compelling evidence was shown to be before them. The court's blatant disregard of the expert musicologist's findings,[107] along with their own aural analysis of the pieces,[108] shows a flaw in the system. Thankfully, for Repp's sake, everyone gets a second bite at the apple. If not for the Second Circuit Court of Appeals level-headedness and humble understanding that it is not the expert when it comes to musical analysis on this level, courts may have continued following this standard, granting summary judgment on cases that should have gone to trial.

While *Repp v. Webber* demonstrates a music copyright infringement case appropriate for trial, should something as complex as this be left to that of the lay listener test? One could argue that the lay listener test may have resulted in a similar verdict as that of the district court. However, the lay listener, while technically the audience and consumer of such music, would not have been able to determine that even though the harmony, key, and mode were different, the two songs themselves were still nearly identical in all other theoretical and musicological aspects. For these reasons, while the court of appeals final ruling was appropriate, the use of the *Arnstein* lay listener test

103. *Id.* at 889 (quoting Lipton v. Nature Co., 71 F.3d 464, 471 (2d Cir. 1995)).

104. *Id.* at 890.

105. *Id.*

106. *Id.* at 891.

107. *See id.* at 890. The district court's statements using Hitchcock's analysis that only pulled out the part stating that the pieces differ in harmony, key and mode, but that left out the most important part where he states that the two melodies are so similar in so many areas, that "Phantom Song" had to have been based on "Till You" is a blatant disregard for the expert musicologist's testimony.

108. *Id.* at 891. The district court used what I can only assume, are untrained—at best amateur—musical ears.

should not be used as the final determination and another standard must be established.

2. New Old Music Group, Inc. v. Gottwald – *The "Break Beat" Heard Round the World*

In one of the more recent and shocking cases brought before the Second Circuit, *New Old Music Group, Inc. v. Gottwald*[109] may take the prize for strangest cases sent to a jury trial. In *New Old Music Group* (New Old), the plaintiff New Old brought a copyright infringement suit against Lukasz Gottwald (Gottwald), a prolific music producer.[110] In their suit, New Old claimed that Gottwald's hit song "Price Tag" copied one measure of the "breakbeat" drum sequence from their song "Zimba Ku" recorded by the band Black Heat in 1975.[111] Within this one measure, the drum part in question contains the following rhythmic structure: (i) Sixteen consecutive 16th notes on a closed hi-hat cymbal; (ii) bass drum pattern consisting of two 8th notes on the first beat of the measure, followed by three syncopated notes on beats two and three; (iii) snare drum attacks on beats two and three;[112] (iv) a "ghost note" or "drag"[113] on the snare drum at the end of the measure; (v) a hi-hat pattern consisting of alternating accented 16th notes; and (vi) similar tempos of eighty-seven to eight-eight beats per minute.[114] These drum parts are featured at the introduction of both songs and are repeated throughout. To better help in the understanding of these drum elements, provided below is a visual representation showing the similarities between the two drum parts:

109. New Old Music Grp., Inc. v. Gottwald, 122 F. Supp. 3d 78 (S.D.N.Y. 2015).

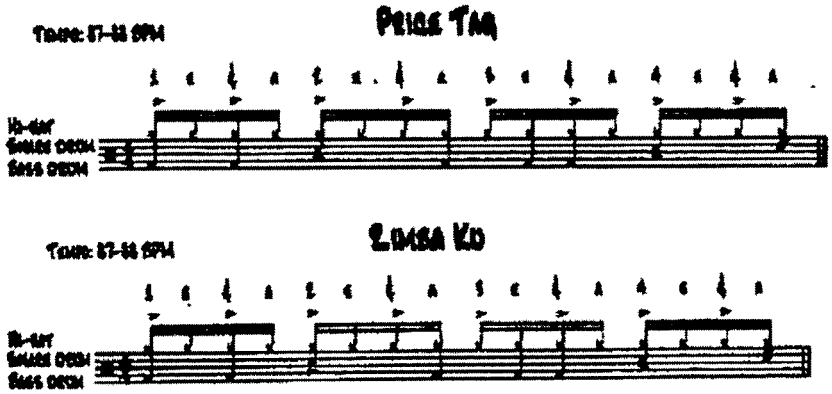
110. *Id.* at 82.

111. *Id.* at 82–83.

112. *Id.* at 83. This is incorrect consistently throughout the court's opinion—the snare drum notes are on beats two and four, *not* two and three. While this is a minor mistake, it shows that the court does not understand that beats two and four is one of the most common places to put a snare drum note in almost any drum composition, especially where breakbeats and popular music are concerned.

113. *Id.* This difference between ghost note and drag are not well defined in any of the cases presented. Ghost note is simply a softer note played on the snare drum, whereas the stick barely touches the snare drum head producing a note so soft that the listener questions whether or not the note was actually played. Hence the term "ghost note." A drag on the other hand is one that is not played necessarily softly and consists of an undefined number of attacks, made by letting the tip of the snare drumstick fall against the head of the snare drum and bounce, or buzz against the head. A drag can be also defined as having two to three distinct notes. This unclear definition presented by many courts concerns many professional musicians, who can easily tell the difference between these two very different forms of attacks on a snare drum presented in this case.

114. *Id.* at 83–84.



As shown above, the two drum parts are exactly the same. However, this does not mean that "Price Tag" infringed on "Zimba Ku." For if the elements of "two works are 'so commonplace that [they are] not unlikely to arise [in] independently created works,' the elements will not be probative of actual copying" as required to establish copyright infringement.[115] Gottwald argues that both of these songs use commonplace elements. Specifically, Gottwald points to the same commonplace elements used in a copious amount of songs pre-dating "Zimba Ku," including: "I'm Gonna Love You Just a Little Bit More Baby" containing the hi-hat portion; "ABC" containing the bass drum rhythm; "Me and Bobby McGee" containing the snare drum rhythm; and "Nautilus" for the "buzz" or "ghost note" involved in both songs.[116]

In the song "Me and Bobby McGee" recorded by Thelma Houston in 1973, the tune contains the same combination of sixteenth notes, an identical bass drum pattern as both songs, and snare drum attacks on beats 2 and 4.[117] Plaintiff's expert, Jim Payne, argued that "Me and Bobby McGee" differs from that of "Zimba Ku," however, in that the drummer plays two "open" hi-hat notes at the end of the measure, instead of keeping the hi-hat closed.[118] These open hi-hat notes, according to Payne, "are compositionally different, . . . [producing a] more legato sound[] and rhythm[]" which "sharply contrasts with the continuous groove in Zimba Ku and Price Tag."[119] Gottwald disagreed, stating that this distinction is irrelevant because "a composition

115. *Id.* at 84–85 (quoting Velez v. Sony Discos, No. 05-CV-0615, 2007 WL 120686, at *10 (S.D.N.Y. Jan. 16, 2007)).
116. *Id.* at 86.
117. *Id.* at 87.
118. *Id.*
119. *Id.*

does not change based upon the instrument which performs it."[120] The court, siding with New Old, relied upon the reasoning in *Swirsky v. Carey*, stating that a musical composition can encompass "*timbre*, *tone*, spatial organization . . . *interplay of instruments* . . . and new technological sounds."[121] Therefore, the court took the song as a whole, looking at the "total concept and feel" of the composition in order to determine whether the works were substantially similar for purposes of copyright infringement.[122]

Similarly, in "ABC" and "I Will Find a Way," recorded by the Jackson 5 and released in 1970, the defense showed that—just as in the previous song—all of the same elements were present in both "Zimba Ku" and "Price Tag."[123] The defense contended that since the sixteenth note pattern was played on a tambourine instead of the hi-hat, this lead to the same compositional component and was therefore similar to that of "Zimba Ku."[124] In continuing with their reliance on *Swirsky*, the court emphasized that instrumentation is a compositional component to a musical work, and the defense failed to provide legal support in favor of the contrary.[125] The court this time went even further stating that Gottwald's argument would "necessitate the conclusion that any song featuring continuous sixteenth notes played by any instrument would contain the same compositional elements as Zimba Ku and Price Tag."[126] Therefore, just as the timbre and tone argument above, "total concept and feel" must be used in determining whether a work is substantially similar.

Due to the *Arnstein* requirement of "total concept and feel" necessary in the Second Circuit, the court set aside the copious amounts of examples provided by Gottwald showing the commonplace rhythmic motive used in both songs. Gottwald failed to show that the drum parts—in this exact totality—existed in prior art, therefore, the court could not conclude that similarities between the two works precluded an inference of copying and stated that it was up to a jury to decide.[127]

Similar to that of *Repp v. Webber*, would a jury be able to decide on something such as this? Perhaps this decision may have been easier than the complexities involved in *Webber*, but here, the court should have granted

120. *Id.*
121. *Id.* (quoting Swirsky v. Carey, 376 F.3d 841, 849 (9th Cir. 2004)).
122. *See id.* at 94–95.
123. *Id.* at 88.
124. *See id.*
125. *See id.*
126. *Id.* (emphasizing that this would defy logic, showing that a composer places sixteenth notes on a tambourine because it produces a more legato sound than that of the hi-hat, and a different compositional element to the song). So, does this mean that if I copy a melody, note for note, but make the notes more legato, that will change the timbre and tone of the composition and therefore be a new piece of music?
127. *Id.* at 87, 98.

summary judgment. Something as simple and commonplace as a break beat containing the above mentioned specified elements, does not show copyrightable material that needs to be put before the lay listener test. The use of the snare drum on two and four, sixteenth notes on the hi-hat, as well as the bass drum pattern and ghost note on beat four, can be found in countless albums and recordings pre-dating that of Zimba Ku. For these reasons, the court erred in sending the case to trial, where clear grounds for summary judgment were presented and the case, therefore, should have been dismissed.

3. Drake – Transformative Use

In *Estate of James Oscar Smith v. Cash Money Records, Inc.*, the plaintiffs, the Estate of James Oscar Smith (the Estate) and Hebrew Hustle, Inc., brought a copyright infringement action against Cash Money Records, Inc. (Cash Money) and Aubrey Drake Graham (Drake) for allegedly infringing on their spoken-word recording titled "Jimmy Smith Rap" (JSR).[128] The plaintiffs contend that Drake's song entitled "Pound Cake/Paris Morton Music 2" (Pound Cake), sampled thirty-five seconds of JSR. Below are both JSR and the Lyrics used in Pound Cake.

JSR Lyrics:

> Good God Almighty, like back in the old days
>
> You know, years ago they had the A&R men to tell you what to play, how to play it and you know whether it's disco rock, but we just told Bruce that we want a straight edge jazz so we got the fellas together Grady Tate, Ron Carter, George Benson, Stanley Turrentine.
>
> Stanley was coming off a cool jazz festival, Ron was coming off a cool jazz festival. And we just went in the studio and we did it.
>
> We had the champagne in the studio, of course, you know, compliments of the company and we just laid back and did it.
>
> Also, Grady Tate's wife brought us down some home cooked chicken and we just laid back and we was chomping on chicken and having a ball.
>
> Jazz is the only real music that's gonna last. All that other bullshit is here today and gone tomorrow. But jazz was, is and always will be.
>
> We may not do this sort of recording again. I may not get with the fellas again. George, Ron, Grady Tate, Stanley Turrentine.

128. *See* Estate of Smith v. Cash Money Records, Inc., No. 14CV2703, 2018 WL 2224993, at *1 (S.D.N.Y. May 15, 2018).

> So we hope you enjoy listening to this album half as much as we enjoyed playing it for you. Because we had a ball.[129]
>
> Pound Cake Lyrics:
>
> Good God Almighty, like back in the old days.
> You know, years ago they had the A&R men to tell you what to play, how to play it and you know whether it's disco rock, but we just . . . went in the studio and we did it.
> We had [] champagne in the studio, of course, you know, compliments of the company, and we just laid back and did it . . .
> So we hope you enjoy listening to this album half as much as we enjoyed playing it for you. Because we had a ball.
> Only real music is gonna last, all that other bullshit is here today and gone tomorrow.[130]

Looking at the two sets of lyrics shows that while some words were deleted or rearranged, none were added to Pound Cake. Also, the JSR composition was not registered with the U.S. Copyright Office at the time of the recordings and was only obtained by Hebrew Hustle after the album's release, on October 23, 2013.[131] Two months after the release of the album, the Estate's counsel sent a cease and desist letter to Cash Money, which was the first time they learned of any alleged composition copyright interest in JSR.[132]

In its discussion, the court states that a copyright initially vests in the author of the copyrightable work, which would be Jimmy Smith.[133] However, the record evidence did not resolve the question of JSR's ownership, since he did not write anything down and only told a relative that he had laid down a great track that day, not describing the piece, or lyrics involved.[134] The court goes on to state that while copyright registration normally constitutes prima facie evidence of validity, that weight—after five years from first publication—shall be within the discretion of the court.[135] Here, since the Estate registered JSR thirty-one years after its initial publication, and only in response to the defendant's sampling of JSR on the Album, "the registration does not

129. Estate of Smith v. Cash Money Records, Inc., 253 F. Supp. 3d 737, 742 (S.D.N.Y 2017).
130. *Id.* at 743 (ellipses and underlined portions added to show which parts were removed (ellipses), rearranged from original JSR lyrics (underlined), and left out (brackets)).
131. *Id.* at 743–44 (after already being assigned a 50% copyright).
132. *Id.* at 744 (Cash Money hired an outside firm to check that all copyrights were correct before the album's release).
133. *Id.*
134. *Id.* at 744–45.
135. *Id.* at 745 (citing 17 U.S.C. § 410(c) (2012)).

constitute prima facie evidence that the copyright is valid, and [plaintiff] has the burden of proving the validity of its copyright."[136] Therefore, the court found that summary judgment was not proper here.[137]

The court offered multiple tests for determining substantial similarity, including the "ordinary observer test," the "comprehensive non-literal test," and the "fragmented literal similarity test."[138] Defendants wished to use the *Arnstein* test of the "ordinary observer" while plaintiffs wished to use the "fragmented literal similarity" test.[139] The court stated that "[u]nder either test, only the protectable portions of the copyrighted works are compared for substantial similarity."[140] The work must be original to the author, independently created by the author, with a minimal degree of creativity.[141] Cliché language is not subject to copyright protection, and events are not protectable elements under the Copyright Act.[142] Therefore, while Pound Cake copied verbatim most of JSR, defendants argued that the sampled portion eliminated most of the factual account, was mainly cliché, and only went "to trivial . . . elements of the original work."[143] On this portion, the court contended again that "persons trained . . . [in] the law . . . [should not] constitute themselves final judges of the worth of [art]," and it is therefore "better suited for a jury than a court [to decide]."[144] Therefore, summary judgment was not appropriate on the elements of infringement.[145]

Here, unlike the previous cases cited in the Second Circuit, the court relied on the fair use doctrine when it granted summary judgment in favor of the defendants.[146] Had this been a purely musical case and not something that turned on the fair use doctrine for the written word, this would most likely have been considered too close to determine and gone to a jury, applying the lay listener test.

From this short sampling of cases, one can see that the Second Circuit is not consistent in their rulings regarding music copyright infringement

136. *Id.* (quoting Tuff 'N' Rumble Mgmt., Inc. v. Profile Records, Inc., No. 95-CV-0246, 1997 WL 158364, at *2 (S.D.N.Y. Apr. 2, 1997)).

137. *Id.* at 746.

138. *Id.*

139. *Id.*

140. *Id.* at 747 (citing Feist Publ'ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 345 (1991)).

141. *Id.*

142. *See* McDonald v. West, 138 F. Supp. 3d 448, 456 (S.D.N.Y. 2015) ("The phrase 'Made in America' is not copyrightable, either as a title, or as a lyric. It is too brief, common, and unoriginal to create any exclusive right vested in Plaintiff.").

143. *Cash Money Records*, 253 F. Supp. 3d at 747 (quoting TufAmerica, Inc. v. Diamond, 968 F. Supp. 3d 588, 598 (S.D.N.Y. 2013)).

144. *Id.* at 748 (quoting Bleistein v. Donaldson Lithographing Co., 188 U.S. 239, 251 (1903)).

145. *Id.*

146. *Id.* at 752.

cases. Too often, the court relies on the overall concept and feel of a song and that of the lay listener test, rather than the expert musicologist's evidence presented. Therefore, a new standard must be introduced, with greater reliance and weight put on expert musicologists' evidence. Now, moving away from the Second Circuit, we will see how the Ninth Circuit took *Arnstein* and applied their own variation on the two-pronged test.

C. *The Ninth Circuit's Extrinsic and Intrinsic Test and the Blurred Lines it Creates*

Unlike the *Arnstein* test of the Second Circuit, the Ninth Circuit—for testing substantial similarity—utilizes a two-pronged extrinsic and intrinsic test.[147] The Ninth Circuit established this two-pronged test in *Sid & Marty Krofft Television Productions Inc. v. McDonald's Corp.*[148] In this case, Krofft Television brought an infringement claim against McDonald's claiming that the McDonaldland characters were an adaptation of characters from its children's television program *H.R. Pufnstuf*.[149] In determining whether copyright infringement had occurred, the court sought to create a limiting principle to preserve the difference between an "idea" and the "expression" of that idea.[150] The court stated that "[i]t is an axiom of copyright law that the protection granted to a copyrighted work extends only to the particular expression of the idea and never to the idea itself."[151] Therefore, the court sought to create a principle that would reconcile the competing social interests of rewarding an individual's creativity, while at the same time permitting the nation to enjoy the benefits from the use of the same subject matter.[152]

In attempting to reconcile these competing issues of idea and expression, the *Krofft* court took the *Arnstein* test and adapted it to an idea-expression dichotomy, which it believed the *Arnstein* court was alluding to, but missed.[153] The court stated that "[w]hen the court in *Arnstein* refers to 'copying' . . . it must be suggesting copying merely of the work's idea, which is not protected by the copyright. . . . [T]he copying must reach the point of 'unlawful appropriation,' or the copying of the protected *expression itself*."[154] The court in *Krofft* first looked at whether there was substantial similarity in

147. *See* Sid & Marty Krofft Television Prods. v. McDonald's Corp., 562 F.2d 1157, 1164–65 (9th Cir. 1977).
148. *See id.*
149. *See id.* at 1161–62.
150. *Id.* at 1163.
151. *Id.* (citing Mazer v. Stein, 347 U.S. 201, 217–18 (1951)).
152. *Id.*
153. *Id.* at 1165.
154. *Id.* (emphasis added).

the ideas.[155] The test for this similarity is a factual one, that is decided by the trier of fact.[156] It called this portion of the test the "extrinsic test."[157] The court stated that it is extrinsic because "it depends not on the responses of the trier of fact, but on specific criteria which can be listed and analyzed. Such criteria [for artwork] include the type of artwork involved, the materials used, the subject matter, and the setting for the subject."[158] Here, analytic dissection and expert testimony are proper.[159]

Next, after determining whether there is substantial similarity in the ideas, "the trier of fact must decide whether there is substantial similarity in the expression of the ideas."[160] The court stated that this determination of expression is much more subtle and complex.[161] It called this second portion of the test the "intrinsic test."[162] It is intrinsic because it does not rely on external criteria and analysis. Therefore, analytic dissection and expert testimony are not appropriate.[163] In coming to this intrinsic test, the court quoted an earlier Twentieth Century-Fox Film case stating that "[t]he two works involved . . . should be considered and tested, not hypercritically or with meticulous scrutiny, but by the observations and impressions of the average reasonable reader and spectator."[164] As shown by the following cases, the Ninth Circuit, in juggling this intrinsic and extrinsic two-pronged test, is plagued by the same shortcomings and rulings as the Second Circuit lay listener test in *Arnstein*.

1. Three Boys Music Corp. v. Bolton – *Weak Access and Subconscious Copying*

In *Three Boys Music Corp. v. Bolton*, plaintiffs, the Isley Brothers, brought suit against Michael Bolton and Goldmark for copyright infringement against their song "Love is a Wonderful Thing."[165] The Isley Brothers

155. *Id.* at 1164.
156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.* (stating that, in many instances, this portion of the test could be decided as a matter of law).
160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.*
164. *Id.* (quoting Twentieth Century-Fox Film Corp. v. Stonesifer, 140 F.2d 579, 582 (9th Cir. 1944)).
165. *See* Three Boys Music Corp. v. Bolton, 212 F.3d 477, 480–81 (9th Cir. 2000).

claimed that Bolton and Goldmark subconsciously[166] copied this song.[167] The Isley Brothers' song was released as a single on a forty-five record, never reached the top 100 charts, and was later re-released on compact disc in 1991.[168] In early 1990, before the re-release of the Isley Brothers' song, Bolton and Goldmark wrote a song similarly entitled "Love Is a Wonderful Thing."[169] This was released as a single in April 1991 and finished at number forty-nine on Billboards year-end pop chart.[170] Early that next year, Three Boys Music Corporation filed a copyright infringement action for damages against Bolton, Goldmark, their music publishing company, and Sony Music.[171]

In determining whether the first part—access—of the copyright infringement test was satisfied, the Isley Brothers created a theory of widespread dissemination and subconscious copying.[172] The Isley Brothers stated that Bolton grew up listening to them and singing their songs; that their music played on the radio and television where Bolton and Goldmark grew up; that Bolton confessed to being a huge fan of them; and that Bolton pondered himself, if he and Goldmark had copied a song by a famous soul singer.[173] The original soul singer Bolton believed they may have been copying, ironically, was Marvin Gaye.[174]

In Bolton and Goldmark's response to the Isley Brothers' claim of access, Bolton stated that they had never heard the song before, or had access to it prior to writing their hit song in 1990.[175] The Isley Brothers' song was never on the top 100 charts, it had only been released as a single on a forty-five record, and the re-release was not until a year after Bolton and Goldmark wrote their hit song.[176] Even after having three well respected and notable rhythm and blues experts testify to having never heard of the Isley Brothers' song before,[177] and pointing out that "129 songs called 'Love is a Wonderful Thing' are registered with the Copyright Office, 85 of them before 1964[,]"

166. *See* ABKCO Music, Inc. v. Harrisongs Music, Ltd., 722 F.2d 988, 998–99 (2d Cir. 1983) (emphasizing that the fact that infringement is "subconscious" or "innocent" does not affect liability).

167. *Three Boys Music Corp.*, 212 F.3d at 483.

168. *Id.* at 480–81.

169. *Id.* at 481.

170. *Id.*

171. *See id.*

172. *Id.* at 483.

173. *Id.* at 483–84.

174. *Id.* at 484 (*See infra* Blurred Lines case).

175. *Id.*

176. *Id.* at 480–81, 484.

177. *Id.* at 484 (noting that these musicians included that of legendary Motown songwriter Lamont Dozier of Holland-Dozier-Holland fame).

the court of appeals still refused to reverse the case, or apply a stricter application of the extrinsic and intrinsic portions of the copyright test.[178] The court itself stated that it may not have reached the same conclusion as the jury with regards to access, but it did not want to disturb the jury's factual and credibility determinations on that issue and establish a new standard for access in copyright cases.[179]

Now that access has been shown, the court turns next to substantial similarity and the two-part extrinsic and intrinsic test applied in *Krofft*. For the extrinsic portion, both sides relied on expert musicologists.[180] The Isley Brothers' expert musicologists, Dr. Gerald Eskelin, testified that "the two songs shared a combination of five unprotectable elements: (1) the title hook phrase (including the lyric, rhythm, and pitch);[181] (2) the shifted cadence; (3) the instrumental figures; (4) the verse/chorus relationship; and (5) the fade ending."[182] Bolton's expert musicologists, Anthony Ricigliano, however, stated that while there were similarities between the two songs, he could not find the combination of the unprotectable elements stated by Dr. Eskelin.[183] The court of appeals, in applying the inverse ratio rule,[184] stated that a weak showing of access, conversely, does not require a stronger showing of substantial similarity.[185] Therefore, Dr. Eskelin's showing of a "combination of unprotectable elements" was enough to satisfy the extrinsic portion of the test.[186]

The court of appeals refused to second-guess the jury's application of the intrinsic portion of the test.[187] Citing *Krofft*, the court agreed that "[s]ince the intrinsic test for expression is uniquely suited for determination by the trier of fact, this court must be reluctant to reverse it."[188]

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178. *Id.* at 484–86.

179. *Id.* at 485.

180. *See id.*

181. "Hook" is a term used in popular and commercial music for the most important melodic material of the work that is the memorable melody by which the song is recognized, and it is usually the part of the chorus in which the title lyrics are sung. *See* Mary Dawson, *The Power of Repetition*, THE INTERNET WRITING J. (June 2003), https://www.writerswrite.com/journal/jun03/the-power-of-repetition-6035 [https://perma.cc/2A2L-5CMZ].

182. *Three Boys Music Corp.*, 212 F.3d at 485.

183. *Id.*

184. *Id.* at 486 ("The Ninth Circuit's inverse ratio rule requires a lesser showing of substantial similarity if there is a strong showing of access.").

185. *Id.* ("We have never held, however, that the inverse ratio rule says a weak showing of access requires a stronger showing of substantial similarity.").

186. *Id.* at 485–86 (holding that the court would not redefine the test of substantial similarity and that "there was substantial evidence from which the jury could find access and substantial similarity in this case.").

187. *Id.* at 485.

188. *Id.* (quoting Sid & Marty Krofft Television Prods. v. McDonald's Corp., 562 F.2d 1157, 1164–65 (9th Cir. 1977)).

After applying both tests, the court still failed to connect the dots. Even with a small number of similarities (five to be exact) shown between the songs,[189] the court failed to show how all of the copied, yet unprotected elements when viewed alone, were enough to pierce the "music veil" of expression and constitute copyright infringement. As we see here, and shall see throughout the Ninth Circuit, the court's unwillingness to look more critically at expert musicologists and forensic musicologists reports and testimony, leads to unnecessary and ridiculous judgments based off the trier of fact's "feel" of the music (intrinsic portion), and their minimal comprehension—if that—of musicology, allowing for a "combination of unprotectable elements" (extrinsic) to pass as copyright infringement. The reluctance by the Ninth Circuit in reversing cases like this shows just how unsafe the world of music copyright has been and where it is headed.

2. Skidmore v. Led Zeppelin

In *Skidmore v. Led Zeppelin*, the legendary rock band Led Zeppelin was sued for copyright infringement by the band Spirit, claiming that the chords of their song "Taurus" were copied and used in the opening chords of Zeppelin's iconic hit "Stairway to Heaven."[190] The estate for Randy Craig Wolfe, the guitarist for Spirit and writer of "Taurus," claimed that Led Zeppelin had access to their song while touring with the band in the late 1960s.[191] The remaining members of Spirit remember talking with Zeppelin during sets and performing in succession at two music shows.[192] While on tour, the band claims that they performed "Taurus" regularly because it was Wolfe's favorite song.[193] The surviving members of Zeppelin, however, stated that they never met the band, didn't listen to their music, and didn't tour with them while in the United States during the late 1960s.[194]

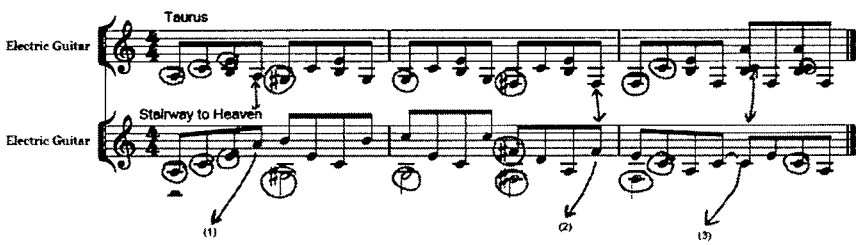
The plaintiffs, however, refuted Zeppelin's statements by proffering up impeaching evidence of two interview excerpts in which "[Jimmy] Page admitted that he was a fan of Spirit and had attended several shows."[195] Similarly, Robert Plant was found to have attended a Spirit show in February 1970 in Birmingham, England, and subsequently going out drinking with the Spirit members after the concert.[196] Finally, the surviving members of Zeppelin

189. *See id.*
190. *See* Skidmore v. Led Zeppelin, No. CV-15-3462 RGK (AGRx), 2016 WL 1442461, at *1, *16 (C.D. Cal. Apr. 8, 2016).
191. *See id.* at *2, *14.
192. *Id.* at *2.
193. *Id.* at *14.
194. *Id.* at *2.
195. *Id.* at *14.
196. *Id.*

confessed to performing a similar bass riff to "Fresh Garbage," a popular song of Spirit that was on the same album as "Taurus."[197] Finding that plaintiffs had proven up enough circumstantial evidence to show access,[198] the court moved on to the extrinsic portion of the two-prong test.

The court, in applying the extrinsic portion of the two-prong test, noted that the Ninth Circuit has "never announced a uniform set of factors to be used. . . . So long as the plaintiff can demonstrate, through expert testimony that . . . the similarity was 'substantial' and to 'protected elements' of the copyrighted work, the extrinsic test is satisfied."[199] Here, the similarities were primarily within the first two minutes of both songs, which the court stated was "arguably the most recognizable and important segments of the respective works."[200] These similarities involved "repeated A-minor descending chromatic bass lines" (lasting 13 seconds) divided by bridges of seven or eight measures, along with "[n]early 80% of the pitches of the first eighteen notes match[ing], along with their rhythms and metric placement."[201] Moreover, "[t]he harmonic setting of these 'A' sections feature the same chords during the first three measures and an unusual variation on the traditional chromatic descending bass line in the fourth measure."[202]

In looking at the sheet music below, it can be seen—from the circled and highlighted notes—exactly what Spirit is claiming was copied.[203]



Zeppelin argued that the descending chromatic bass line (a, g#, g, f#, f) is a "centuries-old, common musical element not entitled to protection, and,

197. *Id.* ("While [Zeppelin] admit[s] to playing a similar bass riff, however, the Led Zeppelin members testified that they heard the song from either the radio or a compilation of assorted American rock songs, not from Spirit's album.").

198. *Id.*

199. *Id.* at *16 (quoting Swirsky v. Carey, 376 F.3d 841, 849 (9th Cir. 2004)).

200. *Id.*

201. *Id.*

202. *Id.*

203. As identified in (1) and (2) above, these are the same notes, but in a different octave. In (3) above, this is technically the same note, but Spirit plays it as a new note, while Zeppelin has the "c" as a tied carryover note.

therefore, [Spirit] ha[d] failed to satisfy the extrinsic test."[204] The court, however, disagreed stating that "[w]hile . . . a descending chromatic four-chord progression[205] is a common convention that abounds in the music industry, the similarities here transcend this core structure."[206] So, despite this common convention which "abounds in the music industry," the Ninth Circuit found it appropriate to bring the case before a jury, apply the intrinsic portion of the two-prong test, and allow "concept and feel" to determine the fate of another musician.[207] The jury, thankfully, found that Led Zeppelin's "Stairway to Heaven" did not infringe on Spirit's song "Taurus."[208]

The jury's conclusion—albeit correct in the eyes of many musicologists—was determined in the end by a "concept and feel" test, rather than a critical analysis of the overall musical elements of both songs. As we will see in *Williams v. Bridgeport Music, Inc.* (Blurred Lines Case) below, this intrinsic portion of the test can be dangerous when too many elements are layered into a song, hiding what truly matters—the theoretical underlying material—by "fluff," or the "hit making" top layer of the song.

3. Williams v. Bridgeport Music, Inc. – *Blurred Lines*

The Blurred Lines Case[209] took *Krofft*'s two-pronged test of the Ninth Circuit to a whole new level. Not only did the jury apply the intrinsic portion of the test to an entire genre of music, but they also found extrinsic similarities—just like in *Bolton*—where none truly existed. This showing of feel and flashy forensic musicology tactics lead the jury to rule in favor of the Gaye Foundation and chill music expression to its core.

The jury took a "sounds like" perspective and applied it to an entire genre and section of music. Theoretically nothing between the two songs matched up 100%, but it did have that "Marvin Gaye" feel, which drove the jury to rule in favor of the Gaye Foundation. Here, I will demonstrate—through music theory—that this case should never have made it to trial. Additionally, I will show why applying the second prong of the *Arnstein* test and letting the lay listener decide a composer/musician's fate is a detrimental idea.

204. *Skidmore*, 2016 WL 1442461, at *16.

205. When looking at both pieces of music, the descending chromatic progression is technically five notes in length.

206. *Skidmore*, 2016 WL 1442461, at *16.

207. *See id.* at *17 (referencing Shaw v. Lindheim, 919 F.2d 1353, 1360 (9th Cir. 1990)).

208. *See* Skidmore v. Led Zeppelin, 905 F.3d 1116, 1121 (9th Cir. 2018).

209. Williams v. Bridgeport Music, Inc., No. LA CV13-06004 JAK (AGRx), 2015 WL 4479500, at *1 (C.D. Cal. July 14, 2015).

Marvin Gaye, an inspirational musician from the 1970s, wrote the hit song "Got to Give It Up" in 1976.[210] After his death in 1984, Gaye's family came into possession of the copyright interest for "Got to Give It Up."[211] After being notified about the song "Blurred Lines" by Robin Thicke and Pharrell Williams, the Gaye family filed a lawsuit claiming that "Blurred Lines" infringed their copyright interest in "Got to Give It Up."[212] Robin Thicke attempted to settle outside of court with the Gaye family unsuccessfully before suit was filed.[213] Settlements outside of court are common practice in the legal field, even if you know that you have done nothing wrong. These settlements can save a tremendous amount on court costs, fees, and time spent filing random motions and litigation.

The trial began in February 2015 and only lasted seven days.[214] After two days of deliberation, the jury returned a verdict against Robin Thicke and Pharrell Williams for roughly $7.3 Million—$4 million in actual damages and $3.3 million in profits received by Thicke and Williams.[215] The court reduced the amount owed to the Gaye family from $4 million in actual damages to $3,188,527.50, and the Williams profits award from $1,610,455.31 down to $357,630.96.[216] The court also granted the Gaye family a "running royalty of 50% of the songwriter and publishing revenue of 'Blurred Lines'" in place of a full injunction, halting the distribution and use of "Blurred Lines" in the future.[217]

When applying the extrinsic portion of the test and analyzing the two pieces from a pure music theory standpoint, "Blurred Lines" and "Got to Give It Up" are two completely different songs. First, starting with the harmony used in both songs, "Got to Give It Up" has a more complex chord structure than that of "Blurred Lines." The chord progression used throughout "Blurred Lines" is a simple I-V chord progression. This progression is not unique and constitutes a majority of popular music. "Got to Give It Up," however, uses a I7-IV7-V7-II7 chord progression throughout. Even one who is not a skilled music theorist can tell simply from the different numbers and symbols that Gaye's song used not only more chords than that of Thicke's

210. *Id.*

211. *See Pharrell Williams and Robin Thicke to pay $7.4m to Marvin Gaye's family over Blurred Lines*, THE GUARDIAN (Mar. 11, 2015), https://www.theguardian.com/music/2015/mar/10/blurred-lines-pharrell-robin-thicke-copied-marvin-gaye [https://perma.cc/4TEC-X66J].

212. *Williams*, 2015 WL 4479500, at *1, *13.

213. *See* Williams v. Bridgeport Music, Inc., No. LA CV13-06004 JAK (AGRx), 2015 WL 6822309, at *1 (C.D. Cal. Apr. 12, 2016).

214. *Williams*, 2015 WL 4479500, at *1.

215. *Id.* at *25.

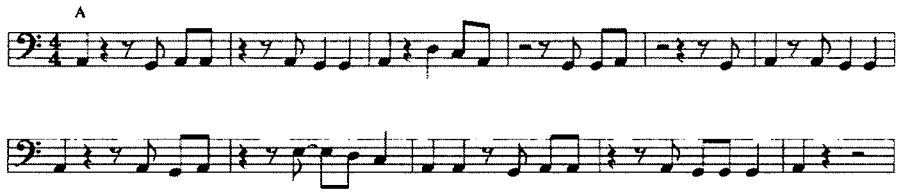
216. *Id.* at *47.

217. *Id.* at *45.

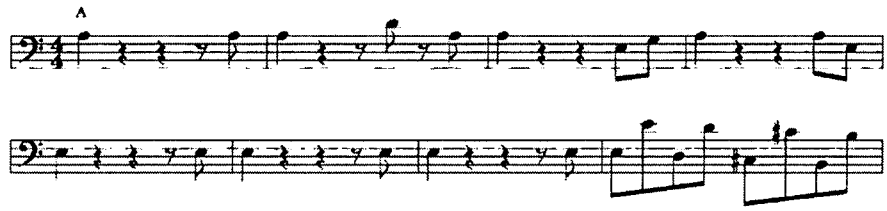
song, but more complex chords as well. As stated and argued in an amicus brief, the songs do not share "a sequence of even two chords played in the same order and for the same duration."[218]

Delving further into the extrinsic test, Thicke argues that the two songs did not have the same turnaround chord, rhythmic complexities or phrase lengths, hooks, bass lines, and vocal melodies.[219] Below, when comparing the bass lines of both songs note for note, the dissimilarities are glaringly obvious:[220]

Got to Give it Up Bass Line:



Blurred Lines Bass Line:



These basslines use different notes, rhythms, and phrasing from each other. They are even taken from different musical scales. The bass notes in "Blurred Lines" are all from the mixolydian mode, while the baseline in "Got to Give it Up" is based around the pentatonic minor scale. The Gayes' argument, however, is based around the fact that Thicke copied the distinctive

218. Brief for 212 Songwriters, Composers, Musicians, and Producers et al. as Amici Curiae Supporting Respondents, Williams v. Gaye, 885 F.3d 1150 (9th Cir. 2018) (Nos. 16-56880, 16-55089, 16-55626), 2016 WL 4592129.

219. *See Williams*, 2015 WL 4479500, at *21. A turnaround is a passage at the end of a section which leads to the next section. This next section is most often the repetition of the previous section or the entire piece or song. The turnaround may lead back to this section either harmonically, as a chord progression, or melodically. The one in Gaye's song was an II7.

220. *See* Joe Bennett, *Did Robin Thicke steal 'Blurred Lines' from Marvin Gaye?*, JOE BENNETT (Mar. 12, 2015), https://joebennett.net/2014/02/01/did-robin-thicke-steal-a-song-from-marvin-gaye [https://perma.cc/QTM3-3MVS]. Bennett discusses how he transposed the basslines to the "same key as 'Got To Give It Up' here for ease of comparison[.] *Id.* He also "notated them in A minor (no sharps or flats) partly for simplicity and partly because both basslines are built on notes of the home key's minor pentatonic scale." *Id.* "This 'normalisation' is intended to highlight any *similarities* that might otherwise be disguised by transcribing 'Blurred Lines' in the original key . . . giving Gaye's side the best possible chance of proving their assertion that the bassline has been copied." *Id.*

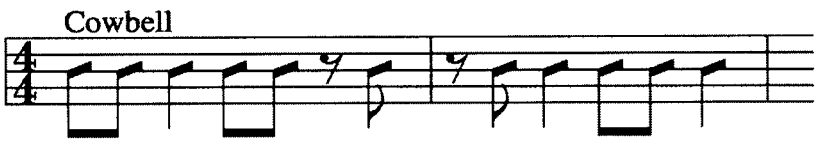
bass line from "Got to Give it Up."[221] If this is true and they copied the bass line, then they "changed most of the pitches, moved lots of notes around, and deleted some notes. Or put another way, they wrote an original bassline."[222]

Similarly, looking at the cowbell parts of both songs below, it can be seen that Thicke's cowbell[223] parts syncopate on the 16th notes (a semiquaver groove); while Gaye's song is very clearly an 8 groove.[224]

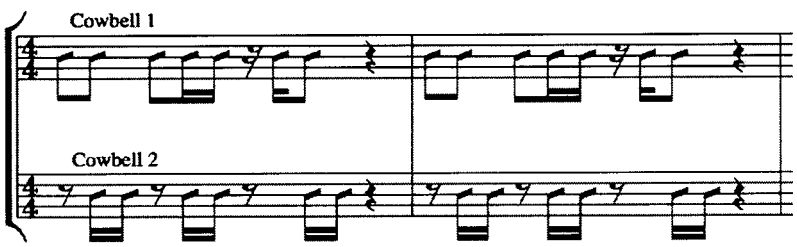
As stated by renowned musicologist Joe Bennett:

> Thicke's song has *more cowbell*. . . . The upper one (panned right in the mix) plays a specific pattern, with a different rhythm from the Gaye song; the lower one (panned left) plays an off-beat, like a reggae "skank guitar" groove. The lower one [also] drops in and out periodically during the track.[225]

Got to Give it Up Cowbell Rhythm:



Blurred Lines Complex Cowbell Rhythms:



The primary point made by the Gaye family about the cowbell parts was that Thicke and Williams copied the "defining funk" of the cowbell accents used in Gaye's song.[226] Most of the accents in "Blurred Lines," however, do not appear on the same beats of the bar as in Gaye's song. This, by any reasonable rhythmic definition, makes them "different accents." Put simply, as above with Thicke's bass line, it is an original composition.

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221. *See Williams*, 2015 WL 4479500, at *21–22.
222. Bennett, *supra* note 220.
223. *Id.* (explaining that the two cowbells are "actually a cowbell and another percussion instrument that sounds . . . more like an electronic clave.").
224. *Id.*
225. *Id.*
226. *Id.*

The court, however, after comparing the expert testimony on both sides, determined that there was a sufficient enough disagreement between the musicologists to allow the case to go to trial.[227] The court, in indicating that these elements all dealt with the extrinsic test analysis, made a ruling that would now involve a jury and the intrinsic portion of the test.[228] Despite Thicke's argument on how the elements analyzed are unprotectable ones, the court maintained precedence—as seen in *Bolton*—allowing for a combination of unprotectable elements to form expression and therefore pass the extrinsic portion of the analysis.

The Ninth Circuit, in allowing this case to go to a jury trial and applying the intrinsic portion of the two-prong test, led to the jury's finding of "feel" as it applies to an entire genre of music, finding Thicke and Williams guilty of copyright infringement. While many musicologists do agree that the two songs sound similar, they also agree that that does not mean Thicke copied anything more than the feel of a generation coupled with the cool groove of a cowbell. The vagrant disregard of clear, concise, and theoretical heavy musicology reports is why the system is broken and why a new standard must be brought forward to help us move away from the chaos. As stated by Joe Bennett: "I'm off now [in] [m]y Delorean [sic] . . . to 1885 . . . when I invented the snare drum backbeat."[229]

IV. EFFECTS ON MUSIC AND THE INDUSTRY MOVING FORWARD

A. Establishing a New Standard in Light of the Chaos

1. Musical Limitations Not Found in Other Art Forms

While artists of other backgrounds have a myriad of options when it comes to crafting their final piece of work, musicians are severally limited when the pen touches the staff paper. An artist may express themselves through different mediums such as watercolor, acrylic, oils, graffiti, mixed media, and the like, with hundreds if not thousands of color options to choose from. Similarly, a writer may express themselves with tens of thousands of different words, constructed in an endless variety and expressed through a plethora of genres. However, a musician is restrained to twelve major keys

227. *See Williams*, 2015 WL 4479500, at *22.
228. *See id.* at *34.
229. Bennett, *supra* note 220.

(with the addition of seven "modes"[230]) and twelve minor keys (with the addition of the harmonic and melodic minor variations[231]). These restrictions on key signatures are quite easy to explain: they are what is pleasing to the ear and non-offensive to the public at large.

Dating as far back as music in the early church, certain notes weren't allowed to be utilized because they were believed to be the devil's interval and offensive to one's ears and sensibility.[232] An entire millennium of music did not change and was restricted to only that which conveyed Christian teachings.[233] Anything outside of this was thought to invoke pagan practice, and if one was moved more by the song than what was sung, that was sinful.[234] As one can see, times have been tough for musicians in expanding their art form and expressing themselves using different tones and harmonic structures. Few have broken this mold and pushed the bounds of what the ear—and the world at large—view as musically pleasing and palatable, including that of Milton Babbitt, John Cage, and Igor Stravinsky to name a few. But, even Stravinsky's "Rite of Spring" caused a riot during its 1913 Paris premiere.[235]

Scales, chords progressions, and harmonies are all an integral part in developing and creating a song that appeals to the listener and their sensibilities. Built on top of these core music theory building blocks are where the melodies, counter melodies, and unique harmonious interpretations sit. With only a limited pool of options to choose from and variations to create,[236] musicians are poised with a unique problem: Do they create something abstract, new, and possibly "riot worthy," or do they borrow from what was once

230. Each mode simply starts on a different scale degree of the major scale. There are eight notes in a scale and not surprisingly seven different "modes" of a major scale. These modes are: Ionian (I), Dorian (II), Phrygian (III), Lydian (IV), Mixolydian (V), Aeolian (VI), and Locrian (VII). *See* PERCY A. SCHOLES, THE OXFORD COMPANION TO MUSIC 651–52 (John Owen Ward ed., 10th ed. 1978) (1938).

231. The harmonic minor scale is simply the natural minor scale with a raised 7th scale degree. Melodic minor, however, has a different pattern ascending than it does descending. Ascending, the 3rd scale degree is lowered by a half-step, and descending the scale reverts to the natural minor form.

232. Lars Fahlin & David Goymour, *Why is the Augmented 4th the "chord of evil" that was banned in Renaissance church music?*, THE GUARDIAN, https://www.theguardian.com/notesandqueries/query/0,,-1767,00.html [https://perma.cc/S3PM-EYL4].

233. *See* DONALD J. GROUT & CLAUDE V. PALISCA, A HISTORY OF WESTERN MUSIC 34 (4th ed. 1988).

234. *Id.* at 34, 36.

235. *See id.* at 838.

236. Remember if you go outside of the tonal structure of a key signature it becomes unpleasing to the ear. Some readers by this point will think you can just slap any note you want on top of these chord progressions and get a song, but all you will get is mush and a headache from the dissonant sounds produced from unorganized music.

pleasing to their ears and build upon it, creating something slightly different and a new variation with a fresh take.

Music borrowing is argued by many musicologists as the core of advancing and creating new musical genres. Marvin Gaye, for example, did not get his signature funk feel from thin air, nor did he produce the bass lines and harmonies from a dove whispering in his ear.[237] He had idols, listened to countless musical genres, borrowed from all of them, and fashioned his own feel and style based on that which he idolized and loved. This borrowing and blending of musical styles to create one's own feel is nothing new. This dates back to the days of Bach, Mozart, and Brahms. Even Brahms, who is widely recognized as one of the great musical masters of the romantic era, borrowed techniques, sounds, and chordal structures from that of Beethoven and other greats before him. Brahms' First Symphony is sometimes called "Beethoven's Tenth Symphony" in the classical music world because when listening to them one after the other, it almost sounds like a continuation of Beethoven's final work. Imagine where we would be today if the current copyright laws of the Second and Ninth Circuits existed back then.

Musicians in all genres of music draw their inspiration and influence from the ones before them. Just as Brahms mimicked the sound and feel of Beethoven many years ago, so too have musicians and artists in today's society. That does not mean, however, that by mimicking this sound and feel they are entering the realm of music copyright infringement. There was a clear "formula" to success back then, and there is a clear "formula" to success now. Create a catchy hook, a simple bass line, some groovy/danceable percussion parts, and put it in an easy time signature people can move to (usually 4/4), and you've got yourself a hit. But, more goes into a song then simply this hit-making formula and what the ear finds pleasing. For these reasons, courts should not be ruling on non-copyrightable music elements placed in a disjunctive combination to try and create copyright infringement, but rather focus on the piece as a whole and the underlying theoretical musical interpretation of all of the elements together.

While one is able to put two pieces of artwork next to one another and visually tell the differences and similarities between them or read two passages of literature and know whether copyright infringement has occurred, it

237. It is believed that Pope Gregory received all of his "Gregorian chants" from a dove flying down, removing its beak, and Pope Gregory transcribing what came from the dove. *See* Richard Taruskin, *The Legend of St. Gregory*, OXFORD HIST. OF WESTERN MUSIC, http://www.oxfordwesternmusic.com/view/Volume1/actrade-9780195384819-div1-001006.xml [https://perma.cc/3VFD-228T]. Pope Gregory, however, in my studies and many other musicologists' studies, has been discredited for creating Gregorian Chant, as it was most likely a synthesis of Roman and Gallican chant. *See* Richard Taruskin, *The Origins of Gregorian Chant*, OXFORD HIST. OF WESTERN MUSIC, http://www.oxfordwesternmusic.com/view/Volume1/actrade-9780195384819-div1-001006.xml [https://perma.cc/EK42-3FNY].

is not the same for music. Music is another language entirely and not one that is understood by all people. While people know what they like and what is pleasing to their ears, they cannot describe it in a concrete way and explain the differences and similarities between two songs, as they would be able to do with pieces of artwork or a piece of literature. For these reasons, and the limitations that have been established above, change needs to occur in music copyright law. The "feels like" portion of both the Second and Ninth Circuits must be thrown out and a new standard put in its place.

2. A New Standard is Born

A logical direction in replacing the extremely low standards of the two-pronged tests in both the Second Circuit and Ninth Circuit could be the determination of copyright based solely on a strict extrinsic, analytical music theory basis. Requiring a very high standard and level of entry brought before a panel of experts, not the "discerning" ear of the lay listener. This would replace both stages of whether copying occurred and whether there was an unlawful appropriation of the musical work. With this higher standard and analytical view of music before a panel of experts, many issues plaguing music copyright cases today would be solved.

This higher standard would allow experts to establish exactly what elements were supposedly copied, whether or not they were protectable, and to what extent they were combined/used throughout the piece of music. Also, by replacing a jury panel with that of expert musicologists and music theorists, it would allow for greater in-depth discussions of critical music elements that could not be had with the common lay listener. These elements include complex chord structures, melodic structures, rhythmic structures, and the overall musical composition. This in-depth discussion and analysis would allow for clearer and more educated conclusions and judgments to be asserted across all music copyright cases. It would no longer leave the analytical portion in the hands of a judge, who just like the lay listener, may know absolutely nothing about the complexities of music theory. Music is a unique language that deserves a unique standard. It is one that needs to be examined by experts and determined by experts. A jury—just like in bankruptcy court—is not necessary in any step of the music copyright infringement process.

AGAINST PUBLIC POLICY: ENFORCEABILITY OF EXCULPATORY CLAUSES

MAGGIE LU†

I. INTRODUCTION

Have you ever downloaded a mobile application on your phone? Maybe it was Candy Crush. Or maybe it was Pokémon Go. Regardless of your game preferences, if you have downloaded an application on your phone or computer, then you have seen a pop-up screen filled with fine print. More likely than not, you scrolled to the bottom of the screen without reading and clicked

† This Comment is dedicated to all of the people in my life that have supported me through this career change. Special thanks to my parents, Danny and May, for their never-ending support.

on "I Agree to the Terms." Congratulations, despite not having read it, you have agreed to an exculpatory clause.

Exculpatory clauses have become a part of our everyday lives. They are not just a part of the software or electronics that we use; exculpatory clauses are everywhere. Even though you may not know it, you agree to exculpatory clauses when you: go rock-climbing; seek medical treatment; go to the spa; valet your car; go on an airplane; swim in your neighborhood pool; sign a lease. Ordinary citizens tend to ignore exculpatory clauses and agree to them without much thought. A common misunderstanding is that exculpatory clauses are form agreements that are not enforceable. If something happens to someone, the public automatically thinks that someone should pay, regardless of a waiver. As scary as it sounds, the truth of the matter is that we agree to exculpatory clauses every day, regardless of whether we understand what an exculpatory clause is or whether it is enforceable in the state we reside in.

II. SYNOPSIS

Determining the enforceability of an exculpatory clause is shrouded in confusion. The problem with determining the enforceability of an exculpatory clause is not a lack of rules or case law—the problem is that there are too many rules. Because exculpatory clauses are a matter of contract law, each state's supreme court is the authoritative interpreter of these provisions. Therefore, the Supreme Court of the United States is only able to promulgate rules dealing with exculpatory clauses where federal statutes are concerned. Since there is not a single bright-line rule to apply, every state has had to come up with their own set of standards, factors, or elements. Some states have chosen to follow California in the usage of the *Tunkl* factors,[1] other states have considered the Restatement (Second) of Contracts,[2] and even more have cherry-picked elements and factors from both to create a new standard.[3] While having so many rules to choose from may not seem like a bad idea, having too many standards can make the process of analyzing exculpatory provisions ineffective.

Several states have created methods for examining exculpatory clauses—resulting in several different tests and numerous unique factors. Unfortunately, having too many tests to choose from only causes confusion when attempting to analyze an exculpatory clause. A better solution may be

1. Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444–47 (Cal. 1963).
2. Restatement (Second) of Contracts § 195 (AM. LAW INST. 1981).
3. *See* Morgan v. South, 466 So. 2d 107, 117 (Ala. 1985); Anchorage v. Locker, 723 P.2d 1261, 1265 (Alaska 1986); *Tunkl*, 383 P.2d at 444–47; Hanks v. Powder Ridge Rest. Corp., 885 A.2d 734, 744 (Conn. 2005); Baker v. Stewarts' Inc., 433 N.W.2d 706, 708 (Iowa 1988); Berlangieri v. Running Elk Corp., 76 P.3d 1098, 1109 (N.M. 2003).

to consolidate the factors and elements into one set of uniform rules for all the courts in the country to follow.

This Comment explores a multitude of tests that states have applied and then suggests a more efficient guide to analyzing exculpatory clauses. Part III defines exculpatory clauses. Part IV explains why there is not a clear rule for dealing with exculpatory clauses. Part V analyzes the different tests. Part VI explains why separate tests for each state is inefficient and confusing. Part VII proposes a solution. Part VIII concludes this Comment.

III. DEFINING EXCULPATORY CLAUSES

As an initial mater, one should determine whether the provision at hand is an exculpatory clause. An exculpatory clause is defined as a contract provision in which one party agrees not to hold the other party liable for certain conduct.[4] In short, a valid exculpatory clause can preclude a party from recovery.[5] However, it is important not to confuse an exculpatory clause with an indemnity clause.[6]

Although many courts have used the terms "indemnity clause" and "exculpatory clause" interchangeably, the two are very different.[7] The stark difference between the two types of contract provisions is the allocation of risk.[8] In an exculpatory clause, there is no allocation of risk because a valid exculpatory clause eliminates liability altogether.[9] When properly drafted, an exculpatory clause shields one party entirely from liability.[10] An indemnity clause, on the other hand, allocates the risks of third party losses to a responsible party.[11] When an indemnity clause is enforced, the party that was designated as the responsible party by contract has to absorb the risk.[12] That responsibility stems from an earlier agreement to pay and not a waiver of rights.[13]

Although exculpatory clauses and indemnity clauses are different, courts have held that the two are similar in that they both are used to shift

4. *Exculpatory Clause*, Bouvier Law Dictionary (Stephen M. Sheppard, ed., 2012).

5. Cathleen M. Devlin, *Indemnity & Exculpation: Circle of Confusion in the Courts*, 33 EMORY L.J. 135, 170–71 (1984).

6. *See id.*

7. Sweeney v. City of Bettendorf, 762 N.W.2d 873, 877 n.1 (Iowa 2009).

8. Neal J. Suit, *Understanding the Differences Between Indemnity and Exculpatory Clauses*, CARRINGTON COLEMAN (Winter 2013), https://www.ccsb.com/pdf/Publications/RealEstate/Differences_Between_Indemnity_and_Exculpatory_Clauses.pdf [http://perma.cc/J53W-HPGZ].

9. *Sweeney*, 762 N.W.2d at 877 n.1.

10. Devlin, *supra* note 5, at 154–55.

11. *Sweeney*, 762 N.W.2d at 877 n.1.

12. Devlin, *supra* note 5, at 154–55.

13. *Id.*

responsibility for negligence and are generally construed by the same principles of law.[14] So, even if the contract reads like an indemnity clause, it would not significantly impact the enforceability of the exculpatory provision. However, the two should still be carefully differentiated when drafting, since a court can change its mind.

IV. LACK OF BRIGHT-LINE SUPREME COURT RULE

The Supreme Court is unable to provide a bright-line rule for exculpatory clauses in non-federal matters. Even with the Supreme Court cases that mention exculpatory clauses, the holdings provided by the Supreme Court have been confusing at best. This Section will examine the various Supreme Court cases regarding exculpatory clauses in specific types of contracts.

A. Concepcion

One notable federal case involving exculpatory clauses is *AT&T Mobility L.L.C. v. Concepcion*.[15] In *Concepcion*, the Court looked at exculpatory clauses that dealt specifically with the Federal Arbitration Act (FAA).[16] At issue was whether the FAA could condition the enforceability of arbitration clauses on the availability of class-wide arbitration procedures.[17] The Concepcions entered into a service agreement for cellphone usage with AT&T.[18] The contract included an arbitration clause that was conditioned on the claims being brought individually rather than as a member of a class-action suit.[19] The Concepcions later brought suit against AT&T for charging a sales tax on the free phone that came with their service plan.[20] When that suit was consolidated with a class-action suit, AT&T moved to compel arbitration.[21] The Concepcions opposed the motion, arguing that the arbitration provision was unconscionable and unlawful under California law.[22] The district court relied on a California Supreme Court decision in denying AT&T's motion.[23] The Ninth Circuit affirmed the decision and held that the case law in California finding class-action waivers involving a party with superior bargaining

14. O'Connell v. Walt Disney World Co., 413 So. 2d 444, 446 (Fla. 5th Dist. Ct. App. 1982).
15. AT&T Mobility L.L.C. v. Concepcion, 563 U.S. 333 (2011).
16. *Id.* at 336.
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.* at 337.
21. *Id.* at 337–38.
22. *Id.*
23. *Id.* at 338 (citing Discover Bank v. Superior Court, 113 P.3d 1100 (2005)).

power to be unconscionable was not pre-empted by the FAA.[24] The FAA, which had been enacted in 1925 stated that:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.[25]

The Supreme Court reversed the Ninth Circuit's decision, holding that the savings clause under 9 U.S.C.S. § 2 did not permit application of the California rule.[26] The California law disallowing the arbitration clause in *Concepcion* directly conflicted with the purpose of the FAA.[27] While the Court in *Concepcion* did note that the arbitration clause violated public policy, it also stated that "refusal to enforce a contract for public-policy reasons does not concern whether the contract was properly made."[28] Therefore, while the Court acknowledged the fact that the contract provision in *Concepcion* violated public policy, it determined that the federal provisions allowing for arbitration trumped state law.

B. Bisso

Another situation in which federal law will apply regarding an exculpatory clause is when the contract has to do with the towing of barges. In *Bisso v. Inland Waterways Corp.*, the Court examined whether a provision in a maritime contract that exculpated a party of its own negligence could be valid.[29] Owners of the oil barge *Bisso* contracted to have the steam towboat *Cairo* tow the *Bisso* up the Mississippi River.[30] However, negligent towage by the crew operating the *Cairo* caused the *Bisso* to collide with a bridge pier and sink.[31] The contract detailing the transaction had included a release-from-liability clause in favor of the owners of the *Cairo*.[32] The Fifth Circuit found that the clause was valid and that it relieved towboat owners of liability.[33]

The Supreme Court examined old case law, such as *The Steamer Syracuse* and *The Wash Gray*, and reversed the Fifth Circuit's judgment, deter-

24. *Id.*
25. *Id.* at 339 (quoting 9 U.S.C.S. § 2 (2011)).
26. *Id.*
27. *Id.*
28. *Id.* at 357 (Thomas, J., concurring).
29. Bisso v. Inland Waterways Corp., 349 U.S. 85, 85–86 (1955).
30. *Id.* at 86.
31. *Id.*
32. *Id.*
33. *Id.*

mining that a judicial rule based on public policy was indeed needed to invalidate contracts that release towers from all liability for their negligence.[34] The purpose of the rule was to discourage negligence and to protect those who had less bargaining power.[35] Therefore, as a matter of public policy, the Supreme Court held that a clause in a towage contact seeking to exculpate the tugboat owner from liability for negligence that occurs during tugging could not be valid.[36] However, a few years later, the Supreme Court distinguished *Bisso* from a case where the towage contract was subject to the Interstate Commerce Commission's regulation.[37] In *Southwestern Sugar*, the Supreme Court held that the rule in *Bisso* called for modification when the bargaining power of a party was controlled by a "pervasive regulatory scheme."[38]

As you can see from *Concepcion* and *Bisso*, even when the Supreme Court attempts to provide a rule, it is neither clear nor easy to understand. If anything, the distinctions and caveats only serve to cause more confusion in an area of law already shrouded with it. If there was a rule or standard that can be used to examine all types of exculpatory clauses, it would make drafting and enforcing contract provisions easier for everyone. Drafters would know what parameters they are working with. An average person signing a contract would have a better understanding of what they are signing. And courts will know exactly how to analyze an exculpatory clause. Essentially, it would make adjudicating any differences in opinion more efficient. Now that we have looked at the federal side of exculpatory clauses, the next Section will examine all of the different rules that the states have developed.

V. ENFORCEABILITY OF EXCULPATORY CLAUSES

Although there is not a single rule that can be applied across the country regarding exculpatory clauses, there seems to be a consensus that examining these clauses requires several steps. First, an exculpatory clause must be clear and unequivocal.[39] Second, an exculpatory clause will not be given effect regardless of how clear it is, if it violates public policy.[40]

34. *Id.* at 90 (citing The Steamer Syracuse, 79 U.S. 167 (1870) and Compania De Navegacion Interior, S.A. v. Fireman's Ins. Co. (*The Wash Gray*), 277 U.S. 66 (1928)).

35. *See id.* at 91 ("[I]ncreased maritime traffic of today makes it not less but more important that vessels in American ports be able to obtain towage free of monopolistic compulsions.").

36. *Id.* at 95.

37. Sw. Sugar & Molasses Co. v. River Terminals Corp., 360 U.S. 411, 417–18 (1959).

38. *Id.* at 418.

39. Sanislo v. Give Kids the World Inc., 157 So. 3d 256, 260–61 (Fla. 2015).

40. *See, e.g.*, Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444–47 (Cal. 1963); Trimble v. Ameritech Publ'g, 700 N.E.2d 1128, 1129 (Ind. 1998); Seigneur v. Nat'l Fitness Inst., Inc., 752 A.2d 631, 639–640 (Md. 2000); Stelluti v. Casapenn Enters., 1 A.3d 678, 686 (N.J. 2010); Vodopest v. MacGregor, 913 P.2d 779, 783 (Wash. 1996).

A. *Clear and Unequivocal Agreements*

Before arriving at the question of public policy, an exculpatory clause must first be unambiguous. An exculpatory clause that is ambiguous is unenforceable regardless of whether it violates public policy.[41] Of the two major steps in analyzing an exculpatory clause, this is easier to satisfy.

An example of when the ambiguity of an exculpatory clause was called into question can be found in *Sanislo*.[42] In that case, the Supreme Court of Florida examined the enforceability of an exculpatory clause that did not expressly contain language releasing a party of liability for the party's own negligence.[43] The exculpatory provision stated:

> I/we hereby release Give Kids the World, Inc. and all of its agents, officers, directors, servants, and employees from any liability whatsoever in connection with the preparation, execution, and fulfillment of said wish, on behalf of ourselves, the above named wish child and all other participants. The scope of this release shall include, but not be limited to, damages, or losses or injuries encountered in connection with transportation, food, lodging, medical concerns (physical and emotional), entertainment, photographs and physical injury of any kind . . . . I/we further agree to hold harmless and to release Give Kids the World, Inc. from and against any and all claims and causes of action of every kind arising from any and all physical or emotional injuries and/or damages which may happen to me/us. . . .[44]

The Supreme Court of Florida found exculpatory clauses to be enforceable if the intention to be relieved from liability was made clearly and unequivocally.[45] Such clauses must be so clear and unambiguous that an ordinary and knowledgeable person would be able to know what he or she was contracting away.[46] The wording of these clauses need not expressly refer to the release of negligence, even if it is a better practice.[47] This is because there is a rule of construction that requires courts to interpret a contract in a way that gives effect to the parties' intent.[48] Therefore, even if an exculpatory clause is missing the terms "negligence" or "negligence acts," it can be enough to bar a negligence action if the clause is otherwise clear and unambiguous in indicating an intent to be relieved from liability.[49]

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41. *Sanislo*, 157 So. 3d at 260–61.
42. *Id.*
43. *Id.*
44. *Id.* at 258–59.
45. *Id.* at 260–61.
46. *Id.* at 261.
47. *Id.* at 261–70.
48. *Id.* at 270.
49. *Id.*

B. *Violation of Public Policy*

Even if an exculpatory clause is crystal clear, it must not violate public policy for it to be enforceable. As a general rule, public policy disfavors exculpatory clauses. This is because a valid exculpatory clause relieves one party of the obligation to use due care and shifts the risk of injury to the victim party.[50] The party that is contracting away their right to recovery is also likely to be the least equipped to bear the risk of loss.[51] There is no going around the consensus among the courts that an exculpatory clause that violates public policy will not be enforced. The problem lies in what exactly constitutes a public policy violation.

The state courts have each adopted their own method to interpret exculpatory clauses. In determining their own standard to apply, state courts have examined each other's rulings, the Restatements, as well as public policy. While there are not quite fifty different tests, there are enough to cause confusion. This subsection will examine the various approaches that the states have developed over time.

1. *California's* Tunkl *Factors*

The most cited method used to determine whether an exculpatory clause violates public policy is a set of factors provided in *Tunkl v. Regents of the University of California*.[52] Other states have adopted California's *Tunkl* factors: Alabama, Alaska, Connecticut, Iowa, New Mexico, and Utah. Maryland has rejected the California *Tunkl* Factors in favor of a more fluid totality-of-the-circumstances test.[53] This Section will explore the application of the California *Tunkl* Factors.

Tunkl, a case that involved a release from liability as a condition for admission to a hospital, provided us with the set of factors that are now known as the *Tunkl* factors.[54] The University of California at Los Angeles Medical Center, a hospital operated and maintained by a nonprofit charitable institution, admitted Hugo Tunkl for treatment after he signed a "Conditions of Admission" document.[55] The provision that the case was based upon stated:

> Release: The hospital is a nonprofit, charitable institution. In consideration of the hospital and allied services to be rendered and the rates charged therefor, the patient or his legal representative agrees to and

50. *Id.* at 260.
51. *Id.*
52. Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444–47 (Cal. 1963).
53. Seigneur v. Nat'l Fitness Inst., Inc., 752 A.2d 631, 639–640 (Md. 2000).
54. *See Tunkl*, 383 P.2d at 444–47.
55. *Id.* at 442.

> hereby releases The Regents of the University of California, and the hospital from any and all liability for the negligent or wrongful acts or omissions of its employees, if the hospital has used due care in selecting its employees.[56]

Tunkl brought a personal injury claim against the hospital to recover damages that allegedly resulted from the negligence of two physicians that the hospital employed. Tunkl passed away after the suit was brought, and his wife substituted as the plaintiff. The trial court ordered that the jury would only try the issue of alleged malpractice if the jury found that the exculpatory clause did not bind Tunkl.[57] The jury found that Tunkl was indeed bound by the contract provision and Tunkl's widow appealed to the Supreme Court of California.[58]

That court, after reviewing both statutes and cases, concluded that exculpatory clauses that affected the public interest could not stand.[59] It acknowledged that the social forces that lead to its characterization of the public interest were volatile and dynamic.[60] Particularly, the Supreme Court of California pointed out that "[n]o definition of the concept of public interest can be contained within the four corners of a formula."[61] That court used past cases to determine whether certain types of contracts fell into categories that were affected by the public interest.[62] Using stare decisis as a rough outline, California came up with six factors to determine whether an exculpatory clause could be enforceable. If an exculpatory clause exhibits some or all of the following characteristics, then the provision is considered to affect the public interest and is void as a matter of public policy.[63]

> [(1)] It concerns a business of a type generally thought suitable for public regulation. [(2)] The party seeking exculpation is engaged in performing a service of great importance to the public, which is often matter of practical necessity for some members of the public. [(3)] The party holds himself out as willing to perform this service for any member of the public who seeks it, or at least for any member coming within certain established standards. [(4)] As a result of the essential nature of the service, in the economic setting of the transaction, the party invoking exculpation possesses a decisive advantage of bargaining strength against any member of the public who seeks his services. [(5)] In exercising a superior bargaining power the party confronts the public with a standardized adhesion contract of exculpation and makes no

56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.* at 444–45.
60. *Id.* at 444.
61. *Id.*
62. *Id.* at 444–45 nn.9–16.
63. *Id.* at 445.

> provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence. [(6)] Finally, as a result of the transaction, the person or property of the purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or his agents.[64]

The court in *Tunkl* determined that the contract between Tunkl and the hospital clearly fell within the categories of agreements affecting the public interest.[65] (1) The court concluded that hospitals are generally thought of as suitable for public regulation.[66] It would be nearly impossible to argue that a hospital should not be subject to public regulation. (2) The court opined that the services a hospital provides are matters of great importance to members of the public.[67] Without hospitals, society would not be able to function as we know it. (3) The court determined that the hospital held itself out as willing to perform its services to members of the public that qualified for its research facility.[68] Hospitals, in general, hold themselves out as willing to perform their medical services to the public and even though the hospital in this case was selective in terms of the types of patients it accepted, it still held itself out to the public to perform such services.[69] (4) Arguably, there are no services more essential than those that a hospital provides. The court found that the hospital's requirement of the waiver places the hospital firmly in a decisive advantage of bargaining strength in comparison to Tunkl, the ill patient.[70] (5) The hospital provided Tunkl with a standard adhesion contract of exculpation and did not include a provision where Tunkl could pay additional fees to obtain protection against negligence.[71] Tunkl was also in severe pain when he entered the hospital and had no means to protect himself from negligence.[72] (6) The court found that by signing the admission papers, Tunkl placed himself completely in the control of the hospital, and thereby subjected himself to the risk of its carelessness.[73]

64. *Id.* at 445–46.
65. *Id.* at 447.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.* at 446–47.
72. *Id.* at 442, 447.
73. *Id.* at 447.

The contract provision in *Tunkl* fulfilled not just some of the six characteristics, but all of them.[74] Therefore, the exculpatory provision was unenforceable.[75] The court in California also specified that only some of the factors need to be met for the exculpatory clause to be void as a matter of public policy.

While the *Tunkl* factors are a good place to start when examining exculpatory factors, it is not the best method—partly because some of the *Tunkl* factors are too similar. The second factor, "[t]he party seeking exculpation is engaged in performing a service of great importance to the public, which is often matter of practical necessity for some members of the public," and the third factor, "[t]he party holds himself out as willing to perform this service for any member of the public who seeks it, or at least for any member coming within certain established standards," are both about what the party seeking exculpation does.[76] In reality, the two could be easily combined into one factor. Also, the majority of the *Tunkl* factors revolve around bargaining power between the contracting parties. And while bargaining power is a major issue in the enforceability of exculpatory clauses, it is not the only one. Some other factors and issues could arise and those would need to be addressed.[77] Having a rigid six-factor test for the enforceability of exculpatory clauses is just not enough.

2. *Restatement (Second) of Contracts*

Another possible method for examining the enforceability of an exculpatory clause is the Restatement (Second) of Contracts.

> (1) A term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy. (2) A term exempting a party from tort liability for harm caused negligently is unenforceable on grounds of public policy if (a) the term exempts an employer from liability to an employee for injury in the course of his employment; (b) the term exempts one charged with a duty of public service from liability to one to whom the duty is owed for compensation for breach of that duty; or (c) the other party is similarly a member of a class protected against the class to which the first party belongs. (3) A term exempting a seller of a product from his special tort liability for physical harm to a user or consumer is unenforceable on grounds of public policy unless the term is fairly bargained for and is consistent with the policy underlying that liability.[78]

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74. *Id.*
75. *Id.*
76. *Id.* at 445.
77. *See infra* Section III.
78. Restatement (Second) of Contracts § 195 (AM. LAW INST. 1981).

Even though no state has adopted this test, many litigants have tried to utilize it.[79] An illustration of a plaintiff attempting to use the Restatement to argue their case can be found in *Waggoner v. Nags Head Water Sports*.[80]

Waggoner rented a two-seater jet ski from Nags Head Water Sports and signed a pre-printed rental agreement that included an exculpatory clause.[81] Waggoner claimed that the attendant who helped her start the jet ski had trouble doing so at first.[82] The jet ski stalled several times, smelled of gas, left a rainbow-colored film on the water, and made a lot of smoke.[83] When Waggoner and her daughter were finally able to ride on the jet ski, it accelerated at a fast pace and threw both of them into the water.[84] Waggoner suffered a fracture to her vertebra during the fall.[85] When she sued Nags Head for negligent maintenance, the district court granted summary judgment in favor of Nags Head on the basis that the exculpatory clause was valid.[86] When the case reached the 4th Circuit, Waggoner attempted to argue that the rental agreement violated the principles in the Restatement (Second) of Contracts.[87] The Fourth Circuit opined that the Restatement was not applicable in Waggoner's situation and concluded that the exculpatory clause should not be invalidated.[88]

The elements laid out in the Restatement (Second) of Contracts are not unlike the other tests that the various states have chosen to adopt. One possible reason that the Restatement has not been adopted is that it is too rigid. The Restatement provides three possible reasons for enforceability on the grounds of public policy and can be difficult to apply. Take *Waggoner*, for example. The Fourth Circuit wrote off the Restatement as inapplicable, but if the court had examined other factors such as bargaining power and the attendant's lack of care, then the result may have been different. Accordingly, most states have chosen tests with more factors and fluidity.

3. *Other Factors and Elements*

States that have not adopted the California *Tunkl* factors or the Restatement (Second) of Contracts have come up with their own elements, factors,

79. *See* Waggoner v. Nags Head Water Sports, Inc., No. 97-1394, 1998 U.S. App. LEXIS 6792, *5 (4th Cir. 1998).
80. *Id.*
81. *Id.* at *1.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.* at *2.
87. *Id.* at *5.
88. *Id.* at *9.

and tests. While some of the factors overlap between states, it seems that most states have cherry-picked the factors they want. This subsection will examine the different tests and standards that have developed.

a. New Jersey's Two-Step Analysis

New Jersey has approached exculpatory clauses in a somewhat complicated two-step process as seen in *Stelluti v. Casapenn Enterprises*.[89] The Supreme Court of New Jersey tied together *Gershon v. Regency Diving Center, Inc.* and *Delta Funding Corp. v. Harris* to create its test for exculpatory clauses.[90] The court in *Gershon* found that an exculpatory agreement is enforceable if: "(1) it does not adversely affect the public interest; (2) the exculpated party is not under a legal duty to perform; (3) it does not involve a public utility or common carrier; or (4) the contract does not grow out of unequal bargaining power or is otherwise unconscionable."[91] In deciding the fourth factor, a sliding-scale analysis that considers the relative levels of procedural and substantive unconscionability is applied to determine overall unconscionability and effect on the public interest.[92]

The sliding-scale analysis is a test developed by the court in *Delta Funding Corp.*[93] In *Delta*, a lendor entered into a mortgage loan contract with a lendee.[94] The loan contract contained an arbitration clause that allowed either party to elect binding arbitration as the forum to resolve covered claims and also included a provision that prohibited class-action suits.[95] The bank instituted a mortgage foreclosure action when the lendee was unable to make the required loan payments.[96] The lendee filed a counterclaim, as well as a third-party complaint, against the lendor, asserting that the arbitration agreement was unconscionable and unenforceable.[97] The Supreme Court of New Jersey held that while certain parts of the clause were unconscionable, the arbitration clause as a whole was not unconscionable.[98] That court pointed out that both the procedural and substantive aspects of a contract need to be analyzed to

89. Stelluti v. Casapenn Enters., 1 A.3d 678, 686 (N.J. 2010) (citing Gershon v. Regency Diving Ctr., Inc., 845 A.2d 720, 727 (N.J. Super. Ct. App. Div. 2004) and Delta Funding Corp. v. Harris, 912 A.2d 104, 111 (N.J. 2006)).

90. *Id.*

91. *Id.* (citing *Gershon*, 845 A.2d at 727).

92. *See Delta Funding Corp.*, 912 A.2d at 111.

93. *Id.*

94. *Id.* at 108.

95. *Id.* at 108–09.

96. *Id.* at 109.

97. *Id.* at 109–10.

98. *Id.* at 117.

determine if a contract is so inconsistent with public policy that it would be considered unconscionable.[99]

In *Stelluti*, the plaintiff fell from her bike on the first day of her gym membership when the handlebars dislodged from the bike during a spin class.[100] Stelluti signed a waiver and release form when she joined the private fitness center that morning.[101] The waiver warned that physical exercise could be strenuous and that members engaged in said physical activity did so at their own risk.[102] The waiver also stated that by voluntarily participating, members assumed all risks of injury, illness, or death.[103] Should one refuse to sign the waiver, the person would have been denied access to the fitness center.[104]

By applying the two-step analysis from *Gershon*[105] and *Delta*,[106] the court in *Stelluti* determined that the waiver was both enforceable and valid.[107] First, the court balanced the risks and benefits of the exculpatory agreement to determine if it affected the public interest.[108] The court found that the requirement of a guarantee of safety from all risks would "chill" the establishment of health clubs.[109] The court opined that allowing gyms to limit their liability created a "positive social value."[110] Next, in contemplating the gym's legal duty to perform, the court found that even if the instructor had failed to check the handlebars, or if the pin had been mistakenly removed by a janitor, those acts did not rise to a reckless or extreme deviation from the duty of care.[111] The court also stated that "injuries are not an unexpected, unforeseeable result of such strenuous activity" when physical activities and sports are concerned.[112] Finally, the court determined that Stelluti was not in a position of unequal bargaining power even though the legal effects of the waiver may not have been explained to her.[113] As a result, the court held that the exculpatory clause in *Stelluti* was not adverse to the public interest.

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99. *Id.* at 111.
100. Stelluti v. Casapenn Enters., 1 A.3d 678, 681 (N.J. 2010).
101. *Id.* at 682.
102. *Id.*
103. *Id.*
104. *Id.* at 683.
105. Gershon v. Regency Diving Ctr., Inc., 845 A.2d 720, 727 (N.J. Super. Ct. App. Div. 2004).
106. Delta Funding Corp. v. Harris, 912 A.2d 104, 111 (N.J. 2006).
107. *Stelluti*, 1 A.3d at 682.
108. *Id.* at 692.
109. *Id.* at 693.
110. *Id.*
111. *See id.* at 686.
112. *Id.* at 691.
113. *Id.* at 688.

The two-step analysis used in *Stelluti* is like the one used in *Tunkl*—albeit slightly more complicated. Where New Jersey used four factors to determine the effect on the public interest, California used six. And while the California test is a tad bid repetitive in determining the effect a clause has on the public interest, it is more efficient than the New Jersey test. New Jersey's method of applying factors and then a sliding-scale analysis is confusing at best. The sliding-scale analysis, at first glance, is used to determine the fourth factor of the *Gershon* test. However, it is also used to look at the effect on the public interest in general. Therefore, the two-step analysis becomes circular and difficult to apply at best, confusing at worst. Consequently, even though California's *Tunkl* factors are not perfect, it does a better job of laying out all the requirements that California believes are unenforceable.

b. Indiana's Reasons and Factors

Indiana is another state that uses a two-step process in analyzing the enforceability of exculpatory clauses. Because Indiana recognizes the freedom of parties to contract and presumes that contracts are freely bargained, there are only three reasons for Indiana courts to find an exculpatory clause unenforceable.[114] Courts in Indiana have "refused to enforce private agreements that [(1)]contravene statute, [(2)] clearly tend to injure the public in some way, [(3)] or are otherwise contrary to the declared public policy of Indiana."[115] When determining whether an exculpatory clause is against public policy, the courts in Indiana look at five factors as part of the second step:

> (1) the nature of the subject matter of the contract; (2) the strength of the public policy underlying any relevant statute; (3) the likelihood that refusal to enforce the bargain or term will further any such policy; (4) how serious or deserved would be the forfeiture suffered by the party attempting to enforce the bargain; and (5) the parties' relative bargaining power and freedom to contract.[116]

Trimble v. Ameritech Publishing Inc. illustrates the application of these reasons and factors.[117] In *Trimble*, an advertising sales representative met with Gary Trimble to sign an agreement allowing Trimble's business advertisement to appear in a directory.[118] However, the ad agency failed to publish Trimble's advertisement and he sought damages against the ad agency for the loss of business caused by the wrongful omission of the advertisement.[119]

114. Trimble v. Ameritech Publ'g, Inc., 700 N.E.2d 1128, 1129 (Ind. 1998) (citing Fresh Cut, Inc. v. Fazli, 650 N.E.2d 1126, 1129 (Ind. 1995)).
115. *Id.* (quoting *Fresh Cut*, 650 N.E.2d at 1130).
116. *Id.* at 1130.
117. *Id.* at 1129–30.
118. *Id.* at 1128.
119. *Id.*

The contract that Trimble signed, unequivocally stated that any damages caused by the agency's failure to publish the advertisement would be limited to the lesser of the amount paid for the advertisement or the contract price.[120] At the time of the lawsuit, Trimble had not paid any money for the advertisement that had allegedly been omitted from publication.[121] The trial court granted summary judgment for the ad agency and the Court of Appeals reversed the decision.[122]

The Supreme Court of Indiana affirmed the trial court's decision to grant summary judgment in favor of the ad agency.[123] Before analyzing the case, the Supreme Court of Indiana expressed that "it is in the best interest of the public not to restrict unnecessarily persons' freedom of contract."[124] It did note, however, that courts would refuse to enforce private agreements, despite the strong presumption of enforceability, if the provision clearly tended to injure the public in some way.[125] Trimble did not argue that the contract contravened a statute or that the contract tended to injure the public, so the court only looked at whether the provision contradicted public policy.[126] The court noted that the second and third factors did not apply to the case at hand.[127] In applying the other factors, the court in *Trimble* cited to the reasoning of a Court of Appeals case, *Pinnacle Computer Services., Inc. v. Ameritech Publishing, Inc.*[128] The facts in *Pinnacle Computer* are very similar to those in *Trimble* in that they both deal with an advertisement that failed to get published.[129] Even though *Pinnacle Computer* occurred before the test in *Fresh Cut* was developed, the reasoning used was very similar.[130] The court in *Pinnacle Computer* determined that even though the publishing company had greater bargaining power, the plaintiff could not demonstrate an uninformed consumer dealing with a coercively fraudulent company.[131] That court also held that the exculpatory clause at issue was not one that would be

120. *Id.*
121. *Id.* at 1129.
122. *Id.*
123. *Id.* at 1130.
124. *Id.* at 1129 (citing Fresh Cut, Inc. v. Fazli, 650 N.E.2d 1126, 1129 (Ind. 1995)).
125. *Id.* (citing *Fresh Cut*, 650 N.E.2d at 1130).
126. *Id.*
127. *Id.* at 1130.
128. *Id.* (citing Pinnacle Comput. Servs., Inc. v. Ameritech Publ'g, Inc., 642 N.E.2d 1011 (Ind. Ct. App. 1994)).
129. *See id.* at 1128; *Pinnacle*, 642 N.E.2d at 1012.
130. *See Fresh Cut*, 650 N.E.2d at 1129.
131. *Pinnacle*, 642 N.E.2d at 1016–17.

considered unconscionable.[132] After applying the reasoning in *Pinnacle Computers*, the court in *Trimble* held that the exculpatory clause limiting liability to the purchase price of the advertisement was valid and enforceable.[133]

Indiana is a state that strongly believes in the freedom to contract. Therefore, their factors, though similar to that of other states, lean towards the enforcement of exculpatory clauses. A state such as Indiana may be against a uniform standard for analyzing exculpatory clauses because it wants to continue its philosophy of letting individuals contract the way he or she sees fit. However, a uniform standard will not stop Indiana from advocating for individuals to freely contract because the courts will still be able to apply the test in a manner consistent with their beliefs. A standardized test is only the backbone of an exculpatory clause analysis and different courts will still reach different conclusions. But at least this way, everyone starts at the same place.

c. Totality of the Circumstances

The Maryland Court of Special Appeals specifically rejected the six-factor test set in *Tunkl*.[134] It argued that the *Tunkl* factors, while worthy of consideration, were not conclusive.[135] That court held that "[t]he ultimate determination of what constitutes the public interest must be made considering the totality of the circumstances of any given case against the backdrop of current societal expectations."[136]

The court in *Seigneur* used the "totality of the circumstances" test to determine that an exculpatory clause in a gym membership contract was enforceable.[137] Gerilynne Seigneur joined National Fitness Institute (NFI) on a one-month trial basis for weight-loss and fitness purposes.[138] NFI had been recommended to Seigneur by her chiropractor.[139] NFI also promoted itself as a fitness club that employed specialists and promised to provide scientific evidence-based advice.[140] Prior to signing the membership contract, which included a clause that exculpated NFI, Seigneur disclosed to NFI that she had serious lower back problems and was in poor general physical condition.[141]

132. *Id.* at 1017.
133. *Trimble*, 700 N.E.2d at 1130.
134. Seigneur v. Nat'l Fitness Inst., Inc., 752 A.2d 631, 640 (Md. Ct. Spec. App. 2000) (quoting Wolf v. Ford, 644 A.2d 522, 527 (Md. 1993)).
135. *Id.*
136. *Id.*
137. *Id.* at 640–41.
138. *Id.* at 634.
139. *Id.*
140. *Id.*
141. *Id.*

After Seigneur signed the contract, a NFI employee performed an initial evaluation of Seigneur, which involved a series of flexibility and strength testing.[142] During the evaluation, Seigneur was told to use a weight machine to lift a ninety-pound weight.[143] When Seigneur attempted to lift the weight, she felt a tearing sensation in her right shoulder.[144] Although Seigneur reported the pain, the instructor failed to seek medical attention and told Seigneur to move on to the next machine.[145] After the incident, Seigneur had to undergo shoulder surgery and her doctor attributed the condition to the use of the weight machine.[146] The trial court granted summary judgment for NFI and Seigneur appealed.[147]

The Maryland Court of Special Appeals affirmed the granting of the summary judgment for several reasons. First, it stated that there are three instances when the public interest renders exculpatory clauses unenforceable:

> (1) [W]hen the party protected by the clause intentionally causes harm or engages in acts of reckless, wanton, or gross negligence; (2) when the bargaining power of one party to the contract is so grossly unequal so as to put that party at the mercy of other's negligence; and (3) when the transaction involves the public interest.[148]

Seigneur did not contend gross negligence but did argue bargaining power and public interest.[149] The Maryland Court of Special Appeals found that there was no gross disparagement of bargaining power because there were other competitors that provided essentially the same non-essential service.[150] When it came time to determine whether the transaction involved the public interest, the Maryland Court of Special Appeals rejected the *Tunkl* factors.[151] While the *Seigneur* court acknowledged that the factors were useful to consider, it pointed out that even the *Tunkl* court recognized the difficulty of defining "public interest."[152] The Maryland Court of Special Appeals held that the "ultimate determination of what constitutes the public interest must be made considering the totality of the circumstances of any given case against the backdrop of current societal expectations."[153] Therefore, the court

142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.* at 635.
148. *Id.* at 638 (citing Wolf v. Ford, 644 A.2d 522, 531–32 (Md. 1993)).
149. *Id.*
150. *Id.*
151. *Id.* at 640 (citing Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444 (Cal. 1963)).
152. *Id.*
153. *Id.*

looked at all the possible factors it could come up with and made the following findings.[154] (1) The service that a health club provides is not an essential public service.[155] (2) The exculpatory provision was expressed clearly and unambiguously.[156] (3) A health club is not on the same level in terms of social importance as innkeepers, public utilities, common carriers, or schools.[157] (5) The contract between NFI and Seigneur is not "patently offensive" because the services offered are not of great importance or necessity to the public in general.[158] (6) The court also concluded that health and spa clubs were recreational activities that did not fall under the categories that would implicate public policy issues.[159] After analyzing all the factors involved in the case, the Maryland Court of Special Appeals held that the exculpatory clause was enforceable.[160]

At first glance, the holding in this case might not seem fair. The facts of this case boil down to a customer being injured after following the instructions of a gym trainer. A layperson's knee-jerk reaction will likely be to demand justice for Seigneur. However, the "totality of the circumstances" test used here was more than fair. It did not just look at a few required factors, it looked at the entire situation. Seigneur did not have to lift the weights. Just because the trainer told her to, does not mean that she had to comply. Since she was at the gym based on a recommendation from her chiropractor for back pain, then she should have known better than to attempt to lift ninety pounds. As the court points out, Seigneur was not forced to give her business to the gym.[161] A gym is not like a hospital in that a gym is not subject to public regulation. Seigneur also had a lot more bargaining power than a patient at a hospital would; there are many fitness gyms in the area, and she could have gone to any one of them for the same service. In rejecting the *Tunkl* factors, the Maryland Court of Special Appeals acknowledges that the public interest cannot be contained inside of a formula.[162] If the Maryland Court of Special Appeals had applied the *Tunkl* test, the outcome might have been different. But since the "totality of the circumstances" test looks at the entire picture, it is hard to argue with the holding of this case.

While the "totality of the circumstances" test is a good idea, the way the Maryland Court of Special Appeals constructs it causes the test to be less

154. *Id.*
155. *Id.* at 639.
156. *Id.*
157. *Id.*
158. *Id.* at 640.
159. *Id.* at 641.
160. *Id.* at 642.
161. *Id.* at 639.
162. *Id.* at 640 (citing Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444 (Cal. 1963)).

efficient than it could be. Because the court first looks at three reasons to invalidate a clause and then the "totality of the circumstances" to analyze one of the reasons, it creates a complicated process. And since bargaining power is often looked at when analyzing the public interest, the process becomes circular and repetitive. The three reasons could all easily be analyzed under a "totality of the circumstances" test and it would make the process much simpler. As a matter of fact, the second and third reasons, bargaining power and the public interest, are both factors in the *Tunkl* factors, which the Maryland Court of Special Appeals agree is worth considering when executing a "totality of the circumstances" test. For that reason, a modified version of Maryland's test would be more effective.

d. Finagin *Factors*

The Supreme Court of Arkansas too developed a test for examining exculpatory clauses. The courts in Arkansas have held that exculpatory clauses may be enforced: "(1) when the party is knowledgeable of the potential liability that is released; (2) when the party is benefitting from the activity which may lead to the potential liability that is released; and (3) when the contract that contains the clause was fairly entered into."[163] A case that demonstrates the usage of these factors is *Finagin v. Arkansas Development Finance Authority*.[164]

The court in *Finagin* utilized a set of factors that it developed to analyze whether a guaranty agreement against stockholders was enforceable.[165] The Arkansas Development Finance Authority (ADFA) was established by Arkansas statute and funded by money derived from interest on investments.[166] The ADFA was to pay bonds from revenues produced by the proceeds of the bonds.[167] It issued revenue bonds for $800,000 to establish a start-up plant and had several guaranties, one of which was secured by the personal guaranties of each individual stockholder of the start-up plant.[168] The guaranty agreement included an exculpatory provision.[169] When the company defaulted, the ADFA made demands on the individual stockholders under the personal guaranty agreements they signed.[170] Because the stockholders, including the Finagins, refused to honor the agreement and make payments, the

163. Finagin v. Ark. Dev. Fin. Auth., 139 S.W.3d 797, 808 (Ark. 2003).
164. *Id.*
165. *Id.* at 799, 808–09.
166. *Id.* at 799.
167. *Id.*
168. *Id.* at 799–800.
169. *Id.* at 800.
170. *Id.*

ADFA brought suit to enforce the personal guaranties.[171] The trial court entered judgment for the ADFA and the stockholders appealed.[172]

The Supreme Court of Arkansas used their three factors to determine that the personal guaranties were enforceable.[173] First, the court makes the assumption that each stockholder read and agreed to the terms listed out in the personal guaranty based on the fact that the Finagins were sophisticated business people.[174] Because the court believed that the Finagins signed the guaranty agreements willingly, it determined that the Finagins benefitted from that waiver of rights in the form of financing for the start-up plant.[175] Since the court found both knowledge and benefit, it concluded that the contract was also fairly entered into.[176] As a result, the court held that the guaranty agreement was enforceable.[177]

The notable difference between the *Finagin* factors and the tests that the other states use is that it does not mention public policy or the public interest at all. When the other states attempt to analyze exculpatory clauses, one of the first things they look at is whether the provision violates public policy. Arkansas, however, does not even mention it. It is particularly interesting that the courts in Arkansas never articulate the term "public policy," especially since the factors they created are used in other states to assess whether public policy was violated. While it may not seem like a big deal that the test is not named after what is being tested, this may add to the confusion surrounding exculpatory clauses. When states are looking to each other for guidance, a quick glance at Arkansas law might cause one to think that the public interest is not important to an exculpatory clause analysis. Since we know that public policy is extremely important to the analysis of such provisions, Arkansas' lack of a properly-named test becomes yet another reason for a uniform test.

e. Oklahoma's Gauntlet of Judicially-Crafted Hurdles

As if exculpatory clauses were not confusing enough to analyze, the Supreme Court of Oklahoma created a "gauntlet of judicially-crafted hurdles" for exculpatory clauses to pass.[178] In Oklahoma, an exculpatory clause must pass the following test:

> (1) [T]heir language must evidence a clear and unambiguous intent to exonerate the would-be defendant from liability for the sought-to-be-

171. *Id.* at 800–01.
172. *Id.*
173. *Id.*
174. *Id.* at 808.
175. *Id.*
176. *Id.*
177. *Id.*
178. Schmidt v. United States, 912 P.2d 871, 874 (Okla. 1996).

> recovered damages; (2) at the time the contract (containing the clause) was executed there must have been no vast difference in bargaining power between the parties; and (3) enforcement of these clauses must never (a) be injurious to public health, public morals or confidence in administration of the law or (b) so undermine the security of individual rights vis-à-vis personal safety or private property as to violate public policy.[179]

This test, though complicated at first glance, is not too different from the ones used by other states.

In *Schmidt*, an exculpatory clause releasing a government stable from liability was examined.[180] Schmidt rented a horse from a government stable and signed a release that exculpated the government.[181] Schmidt claimed that an employee of the stable negligently rode up behind her and caused her horse to throw her to the ground.[182] The Supreme Court of Oklahoma created an Olympic-worthy test with multiple subparts to determine whether the government could be exculpated.[183] The case was remanded for fact-finding, but the court specifically noted that an exculpatory contract would pass the test by being unambiguous, containing no disparity of bargaining powers, and not violating public policy.[184]

When one first reads about Oklahoma's "gauntlet of judicially-crafted hurdles," it can be daunting. Having so many different tests is confusing enough without including a gauntlet for these clauses to go through. However, the test is not much different from any of the others analyzed in this Comment. It is still looking at ambiguousness, bargaining power, and public policy. If one had to critique it, it would be the numerous subparts written unnecessarily into the test. This test, like many of the others, is too repetitive and not efficient enough.

f. Washington's Two-Prong Test

Washington uses a three-prong test to determine the enforceability of exculpatory clauses.[185] Exculpatory clauses in Washington are generally enforceable, unless: "(1) they violate public policy; (2) the negligent act falls greatly below the standard established by law for protection of others; or (3)

179. *Id.*
180. *Id.* at 872.
181. *Id.*
182. *Id.*
183. *Id.* at 874.
184. *Id.*
185. Vodopest v. MacGregor, 913 P.2d 779, 783 (Wash. 1996).

they are inconspicuous."[186] When determining whether public policy was violated, the Supreme Court of Washington used the *Tunkl* factors as an outline.[187] However, instead of restricting itself to the six factors in *Tunkl*, it used the factors as a starting point.[188]

In *Vodopest*, the Supreme Court of Washington examined a preinjury agreement that attempted to exculpate a researcher from liability while conducting medical research.[189] Patricia Vodopest joined a study with MacGregor that required her to trek to the Himalayas base camp in order to test a breathing technique used at high altitudes.[190] Prior to the trip, Vodopest signed a "release from liability and indemnity agreement" which stated that Vodopest had been informed of all the dangers and possible illnesses associated with the trek and that she released MacGregor from all liability.[191] After Vodopest signed the release, the university in charge of the study returned the form to MacGregor with the words "invalid form" stamped on it.[192] The university informed MacGregor that releases from liability for negligence were not allowed due to the nature of the study.[193] MacGregor did not inform Vodopest of the rejected release and conducted the study anyways.[194] When Vodopest began showing symptoms of altitude sickness, MacGregor informed her that it might be a "food problem."[195] Because of that, Vodopest continued to climb and her symptoms worsened.[196] Throughout the trek, Vodopest continuously reported her illnesses to MacGregor, and MacGregor disregarded her complaints each time.[197] When Vodopest's symptoms eventually became life-threatening, she was sent down from the trek and was ultimately diagnosed with cerebral edema and permanent brain damage.[198]

Vodopest sued for negligence and MacGregor moved for summary judgment based on the executed exculpatory agreement.[199] The trial court granted the summary judgment and the Court of Appeals affirmed, stating that trekking was a high-risk, adult recreational activity.[200] Yet the Supreme

186. *Id.*
187. *Id.* at 785–86 (citing Tunkl v. Regents of Univ. of Cal., 383 P.2d 441, 444–47 (Cal. 1963)).
188. *See id.* at 786 ("*Tunkl* warns that no definition of the concept of public interest can be contained within the four corners of any formula . . . .").
189. *Id.* at 780–81.
190. *Id.*
191. *Id.* at 781.
192. *Id.* at 781–82.
193. *Id.*
194. *Id.* at 782.
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.*

Court of Washington concluded that medical research involving ways to avoid high altitude sickness was a matter of public importance.[201] It noted that just because a disease is uncommon does not mean that the medical research involved to cure it is not important to the public.[202] The court also stated that medical research requires strict regulation since the research subject would be under the control of the researcher.[203] Using their three-prong test, the court determined that the exculpatory clause violated public policy and was therefore unenforceable.[204]

The main problem with the three-prong test in *Vodopest* is that the court changes the name of the *Tunkl* factors.[205] Halfway through its analysis, the Supreme Court of Washington begins referring to the *Tunkl* factors as the *Wagenblast* factors.[206] *Wagenblast* is the case in which Washington adopted the California *Tunkl* factors.[207] Although it is reasonable for the Supreme Court of Washington to refer to its own binding precedent rather than that of a California case, it does not take away from the fact that the renaming of a well-known test is confusing. If the naming snafu is disregarded, the three-step process and inclusion of the *Tunkl* factors is not an inefficient method. However, it could still benefit from being both simplified and expanded. The willingness to look at the factors fluidly is effective, but a three-step process could cause a bit of confusion. And while the *Vodopest* court acknowledges that the factors are only there as a guide, it does not quite look at all aspects and factors of the case. A standardized test would help lessen the uncertainty of having multiple names for the same set of factors.

g. Wisconsin's Strict Construction Against Relying Party

One state that cannot be overlooked when studying the validity of exculpatory clauses is Wisconsin. This is because Wisconsin case law does not favor exculpatory agreements at all. As a matter of fact, in 2005 the Supreme Court of Wisconsin stated that for the previous twenty-five years, it has held every single exculpatory contract that it has looked at to be unenforceable.[208]

201. *Id.* at 788.
202. *Id.*
203. *Id.*
204. *Id.* at 789.
205. *Id.* at 786.
206. *Id.* (citing Wagenblast v. Odessa Sch. Dist., 758 P.2d 968, 971 (Wash. 1988)).
207. *See Wagenblast*, 758 P.2d at 971.
208. Rainbow Country Rentals & Retail, Inc. v. Ameritech Publ'g, Inc., 706 N.W.2d 95, 105 (Wis. 2005).

Even though exculpatory clauses are not per se invalid in Wisconsin, the Supreme Court of Wisconsin was clear that such provisions must be construed strictly against the relying party.[209]

While Wisconsin does not favor exculpatory clauses, it has still developed its own method to analyze these types of provisions. An analysis of an exculpatory clause begins with an examination of the facts and circumstances surrounding the agreement to determine if the contract covers the activity at issue.[210] If the provision does cover the activity, then a public policy analysis is conducted.[211] The Supreme Court of Wisconsin defines public policy as "that principle of law under which freedom of contract or private dealings is restricted by law for the good of the community."[212] In general, exculpatory clauses in Wisconsin are found to be invalid if it contains misrepresentations, too broadly defines the location and actions covered, or if it is ambiguous and uncertain.[213] Wisconsin also looks at factors such as: whether the waiver was too broad; whether the form served multiple functions, causing the signer not to have adequate notification of the waiver's significance; and whether there was little to no opportunity for negotiation.[214] An example of how to apply the strict construction test can be found in *Roberts v. T.H.E. Insurance Co.*[215]

In *Roberts*, a hot air balloon company required a waiver prior to allowing customers ride.[216] This case is slightly unique in that Roberts signed the waiver while waiting in line to ride the balloon, but never returned the waiver.[217] While waiting in line, a strong wind caused one of the balloon's tether lines to snap.[218] The untethered hot air balloon's basket struck Roberts and knocked her to the ground.[219] The waiver was recovered on the grounds after Roberts was injured.[220] The trial court dismissed the claim and the Court of Appeals affirmed the decision.[221] The Supreme Court of Wisconsin analyzed the case by strictly construing everything against the hot air balloon company.[222] It found that the waiver was overly broad and provided Roberts

209. *Id.* at 108.
210. *Id.*
211. *Id.*
212. *Id.* (quoting Merten v. Nathan, 321 N.W.2d 173, 178 (Wis. 1982)).
213. *See* Roberts v. T.H.E. Ins. Co., 879 N.W.2d 492, 501 (Wis. 2015); *see also Merten*, 321 N.W.2d at 178.
214. *Roberts*, 879 N.W.2d at 502 (citing Atkins v. Swimwest Family Fitness Ctr., 691 N.W.2d 334, 339–40 (Wis. 2005)).
215. *Id.* at 501.
216. *Id.* at 494–95.
217. *Id.* at 495.
218. *Id.*
219. *Id.*
220. *Id.* at 502.
221. *Id.* at 494.
222. *See id.* at 501.

with no opportunity to bargain.[223] The court points out that the waiver was unclear on whether being injured while waiting in line was something that Roberts could have contemplated.[224] Therefore, the exculpatory waiver was held to be void as a matter of law.[225]

The method used by Wisconsin to examine exculpatory clauses is entirely inefficient. Besides knowing that such provisions are construed strictly against the relying party, Wisconsin does not give us much to work with. It only gives a few examples of what is generally considered a violation of public policy. And while the provided samples are found in many factors and tests, there needs to be a more clear-cut test. The fact that the Supreme Court of Wisconsin went twenty-five years without enforcing a single exculpatory clause says a lot. Having a more standardized test, as opposed to a set of ideologies, may produce completely different results and give exculpatory clauses a fighting chance.

VI. INEFFECTIVENESS OF HAVING TOO MANY RULES

With only a handful of states adopting the California *Tunkl* factors and all the other states coming up with their own set of rules, there are just too many different standards for enforcing exculpatory clauses. Having too many standards is not only confusing but can be counterproductive. While some areas of law may require more rules and regulations, having too many rules is detrimental to the analysis of exculpatory clauses.

Take this hypothetical for example: A woman from Milwaukee visits Princeton and decides to join one of the many bike tours to sightsee. As she's filling out the paperwork, which includes an exculpatory provision and a forum selection clause, she overhears the conversation between two men who are also taking the tour. The two men talk about how the exculpatory clause would never hold up in court if something bad were to happen. Based on her limited knowledge of Wisconsin law and what the men said, the woman signs the papers and gets on a bike. Shortly after the tour group begins riding down Main Street, one of the handlebars dislodges from the woman's bike and she crashes into a nearby building, causing her to break her arm. Believing that the paperwork she signed was invalid, the woman files suit against the tour company. However, despite the woman's misguided knowledge of contract law, the exculpatory clause will likely be enforceable.[226]

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223. *Id.*

224. *Id.* at 503.

225. *Id.*

226. *See* Stelluti v. Casapenn Enters., 1 A.3d 678 (N.J. 2010) (holding exculpatory clause limiting liability arising out of bike cycling activity at fitness club enforceable and not against public policy).

A New Jersey court would apply their two-step analysis and more likely than not determine that a bike tour does not affect the public interest. Like in *Stelluti*, the court would likely find that allowing a tour guide company to limit its liability would create "positive social value."[227] Also, falling from a bike is not an unforeseeable event and the woman was not in a position of unequal bargaining power, as she could have taken her business elsewhere. And because tourist attractions are important to a city, it is doubtful that the court will want to "chill" tourism by scaring off companies like the one in our hypo.[228] Since the bike tour does not affect the public interest, the contract will probably be enforced, and it would not make a difference that the woman misunderstood the law.

This hypo illustrates the downfall of having too many rules. The woman signed the papers thinking that it would not matter. She did not know anything about the above analysis. All she knew was that in Wisconsin, there would be a high probability that the courts there would void the exculpatory provision. She had no way of knowing that in New Jersey, where she was at the time, the courts are more likely to find such provision to be valid. The two strangers who were discussing the exculpatory provision did not have any actual knowledge about contract law and were only discussing what they thought was "right." This dangerous mix of law from multiple states combined with "law" passed through word-of-mouth makes it difficult for a layperson, such as the woman in the hypo, to make a well-informed decision when presented with an exculpatory clause.

When there are too many rules and tests in one area, the law can get muddled. This can easily lead to misinformation finding its way to the general public. With the current age of social media, information, both correct and wrong, can travel nationally in a matter of minutes. If a news station in one state reports and analyzes one case, people in the other forty-nine states may read it and take the word as gospel. This can lead to a lot of misinformation and ill-informed decision making, such as in the case of the woman from the hypo. A uniform test used by all fifty states to analyze exculpatory clauses will help minimize such situations from occurring.

VII. PROPOSED SOLUTIONS

The only way for there to be a rule that is binding on all 50 states is if Congress passes a statute under its Commerce Clause power, but it is highly unlikely that Congress would take on such a task. Therefore, we are stuck with each state's interpretation of exculpatory clauses. However, it can be

227. *Id.* at 693.
228. *Id.*

remedied if each state adopts the same set of rules. Having a uniform law that all the courts can apply will not only make analyzing exculpatory clauses more efficient, but there would also be a decrease in litigation of these types of clauses. If drafters have one set of standards to follow, businesses will be able to know up front what type of contract they can and cannot enforce. This would also make educating the public much more efficient.

The fifty states have adopted various standards and factors throughout the history of contract law. Some standards are too simple, while others are repetitive and complicated. By keeping the parts of tests that work and removing those that do not, this proposed solution will provide states with an easier way to analyze exculpatory clauses.

After reviewing the numerous tests that have been used in this country, the "totality of the circumstances" test used by the Special Court of Appeals of Maryland seems to be the most effective in determining a violation of public policy. The *Tunkl* factors also provide a good backbone for examining the public interest. Therefore, this Comment suggests a two-prong test for exculpatory clauses based on both the *Tunkl* factors and the "totality of the circumstances" test.

Under this proposed solution, an exculpatory clause is enforceable if it: (1) is clear and unambiguous and (2) does not violate public policy. When determining the second part of the test, the "totality of the circumstances" should be examined. By looking at the entire situation and using a list of factors as a guide, courts can better determine the enforceability of exculpatory clauses. Instead of looking at any one deciding factor, the "totality of the circumstances" test will look at factors such as but not limited to: (1) whether it concerns a type of business generally thought suitable for public regulations; (2) whether the party seeking exculpation is engaged in and willing to perform an essential public service; (3) whether the party invoking exculpation possesses a decisive advantage of bargaining strength against any member of the public who seeks its services; (4) whether as a result of the transaction, the person or property of the purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or his agents; (5) whether the business a public utility or common carrier; (6) the social importance of the business; (7) the inconspicuousness of the clause; (8) whether the negligence was reckless or intentional; etc.

Courts will use the "totality of the circumstances" test with the factors listed in the previous paragraph as a guideline only. Unlike the *Tunkl* factors, the factors in this proposed solution are not rigid and much more forgiving. And in contrast to the process adopted by Maryland, this "totality of the circumstances" test will be applied for all public policy issues. The reason that this proposed solution will be more efficient than any of the ones the states are currently using is that this list of factors is not exhaustive and that each

case will be judged based on the circumstances at that point in time. Every case is different. No matter how similar some fact patterns can be, there will always be particularities and nuances that can change the analysis of a case. Therefore, this proposed solution will be better equipped to examine each individual case.

VIII. CONCLUSION

Exculpatory clauses are a necessary evil in today's world. These types of provisions have become a part of our everyday lives and are absolutely everywhere. There is not much a person can do these days without agreeing to an exculpatory clause. Most businesses would not be able to function properly without these types of clauses due to the risk. Can you imagine someone willing to open a recreational park or a fitness center without the protection of a valid exculpatory clause? That is not to say that some businesses do not use exculpatory clauses to take advantage of ordinary consumers. Because in reality, there are plenty of "big companies" using exculpatory clauses to get away with murder. So, to balance the need of exculpatory clauses with the want of avoiding power disparities, there needs to be a set standard by which exculpatory clauses can be analyzed. The solution proposed in this Comment will be able to analyze exculpatory clauses in a way that is fair to both the exculpator and the exculpatee.

If every state adopted this test for examining exculpatory clauses, then there would be considerably less confusion when encountering them. Those seeking to be exculpated will know exactly what they can and cannot include in their contracts of adhesion. And those signing away their rights will be able to know exactly what they are doing when they sign on the dotted line. With a set standard for exculpatory clauses, it will be harder for a layperson to get the wrong information from social media and word-of-mouth. This proposed solution will be beneficial to all parties of a contract.

BETTING IT ALL ON THE FLIP OF A COIN: REGULATING CRYPTOCURRENCY INITIAL COIN OFFERINGS AND PROTECTING INVESTORS

NATHAN VRAZEL†

I. INTRODUCTION

Businesses and investors are constantly developing new ways to raise capital and turn profits. The rise of the digital age has provided financial markets with an even greater arsenal of tools with which new investment methods are created. One such method is the use of cryptocurrencies. However, be-

† I would like to thank and dedicate this work to those who have encouraged me throughout my long journey of pursuing a career in the law: my wife, Whitney Vrazel, my parents, Gerald and Michelle Vrazel, my aunt and uncle, Mary and Andy Chan, and in a special way my uncle, Wesley Vrazel.

cause the creation of cryptocurrencies is so recent, and their nature is so complex,[1] many people are confused as to what cryptocurrencies are and how they are used. As a result, government regulatory authorities, such as the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), are trying to catch up with the technology.[2] Because the law has not adapted yet, businesses have discovered that cryptocurrencies present a new way to raise funds while circumventing the cumbersome regulations and safeguards for other financial instruments put in place to protect investors.[3] Instead of companies releasing more stock or becoming publicly traded through Initial Public Offerings (IPOs) to raise capital, many are releasing their own cryptocurrencies in Initial Coin Offerings (ICOs).[4]

While ICOs can be extremely profitable,[5] the lack of government regulation has exposed investors to numerous risks.[6] Currently, issuers of ICOs file little to no paperwork before launch, leaving investors with unclear pictures of what they are funding.[7] Another factor making ICOs even more confusing is the complex nature of what is being offered. Although stocks can carry different rights, dependent upon how the company classifies them, they all still represent the same thing: a share in the ownership of the company.[8]

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1. *See* Ameer Rosic, *What is Cryptocurrency? [Everything You Must Need to Know!]*, BLOCKGEEKS, https://blockgeeks.com/guides/what-is-cryptocurrency [https://perma.cc/DU3J-SRGD] (last updated Sept. 13, 2018) [hereinafter Rosic, *What is Cryptocurrency?*].

2. *See infra* Part III (discussing how government agencies have haphazardly applied existing regulations to cryptocurrencies).

3. *See* Energy Premier, *ICO vs IPO: Major Differences*, HACKERNOON (Apr. 24, 2018), https://hackernoon.com/ico-vs-ipo-major-differences-bd23890cb83b [https://perma.cc/C9QW-5CS7]; Bryan Smith, *ICOs and IPOs: The Major Differences, Regulations and Results*, COIN INSIDER (Apr. 25, 2018), https://www.coininsider.com/ico-vs-ipo-major-differences [https://perma.cc/FF5Y-9KK7]; Aziz Zainuddin, *Crypto ICO vs. Stock IPO: What's the Difference?*, MASTER THE CRYPTO, https://masterthecrypto.com/crypto-ico-vs-stock-ipo [https://perma.cc/6Q6L-HMRR] [hereinafter Zainuddin, *Crypto ICO*].

4. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

5. *See, e.g.*, Oscar Williams-Grut, *The 11 Biggest ICO Fundraises of 2017*, BUS. INSIDER (Jan 1, 2018, 4:18 AM), https://www.businessinsider.com/the-10-biggest-ico-fundraises-of-2017-2017-12 [https://perma.cc/7VT6-HZUY] (giving examples of lucrative ICOs).

6. *See, e.g.*, Shane Shifflett & Coulter Jones, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, WALL ST. J. (May 17, 2018, 12:05 PM), https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115 [https://perma.cc/TPX4-GDTF].

7. *Id.*

8. *See Stock*, BLACK'S LAW DICTIONARY (10th ed. 2014); Zainuddin, *Crypto ICO*, *supra* note 3.

What cryptocurrencies represent can vary greatly.[9] Because of this, the SEC has yet to clearly define what cryptocurrencies are.[10]

This Comment argues that the government should adopt uniform regulations for ICOs. As ICOs become a more popular means of fundraising, the risks posed by them also grow.[11] Regulations treating each cryptocurrency in the same manner would not be the best solution, given their unique characteristics. However, the process of creating and issuing them could be regulated uniformly. By doing so, the government would allow most of the appealing versatile natures of cryptocurrencies to remain intact, while at the same time providing security to investors who currently face exorbitant financial risks.

Part II of this Comment will explain what cryptocurrencies are and how they operate. It will first describe the technology that makes cryptocurrencies possible. Next, it will identify the different types of cryptocurrencies and the utilities they can provide to investors.

The first and second sections of part III will argue that cryptocurrencies share many traits with two types of financial instruments. Specifically, it will compare cryptocurrencies to securities and commodity contracts. The third section will then address the similarities between ICOs and IPOs.

Part IV will discuss the history and policies for securities regulation and how the same rationales for investor protection apply to ICOs.[12] It will then identify the problems that ICOs have created for investors. It will address specific cases of ICO fraud and how it was accomplished. In addition to fraud, it will also describe the security risks that ICO investors now face. Specifically, it will analyze how the Decentralized Autonomous Organization (DAO) ICO was compromised.[13] The final section will discuss the SEC's case by case approach to ICOs.[14] It will argue that the CFTC's and SEC's current methodologies for regulating ICOs are unclear and insufficient to protect investors.

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9. *See infra* Parts II and III.B (discussing how cryptocurrency can represent physical goods or function as a medium of exchange).

10. Edmund Mokhtarian & Alexander Lindgren, *Rise of the Crypto Hedge Fund: Operational Issues and Best Practices for an Emergent Investment Industry*, 23 STAN. J.L. BUS. & FIN. 112, 124 (2018).

11. *See infra* Part IV.B–C (discussing the propensity for fraud and the security risks associated with ICOs).

12. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (stating that the purpose of the Securities Act of 1933 was to prevent fraud and encourage honesty).

13. *See* SEC, RELEASE NO. 81207, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934: THE DAO 1–2 (2017), https://www.sec.gov/litigation/investreport/34-81207.pdf [https://perma.cc/R27W-YAM2] [hereinafter DAO REPORT] (describing how a hacker stole one-third of the DAO's assets by taking advantage of its token's ICO program).

14. *Id.* at 11–13 (determining that the DAO tokens were securities under the *Howey* test).

Part V will offer three possible solutions the government could adopt to protect investors. Namely, it will posit that the government could outlaw ICOs (as China has),[15] the SEC could apply IPO regulations to ICOs, or Congress could create new regulations uniquely tailored to cryptocurrencies.

Part VI concludes that the SEC should, at the very minimum, apply IPO regulations to ICOs. It will argue that eliminating ICOs is not effective or wise since they have proven to be lucrative for investors and businesses.[16] Additionally, it will advocate that Congress should adopt legislation that regulates ICOs similarly to IPOs—but treat the trading of cryptocurrencies in line with their characteristics. Such regulation would allow cryptocurrencies to keep most of the traits that make them appealing while sufficiently protecting investors. The heart of the ICO issue is the need for regulators and Congress to adapt quickly to technological advances in finance, to prevent investors from suffering exponential losses.

II. AN INTRODUCTION TO CRYPTOCURRENCY

The first decentralized cryptocurrency created was Bitcoin (BTC).[17] It was invented by an anonymous person or group of people under the pseudonym Satoshi Nakamoto.[18] BTC's creation in 2008 marked an important milestone in finance because it was the first successful form of digital cash.[19] Nakamoto's invention, which allows cryptocurrencies to function, is referred to as the "blockchain."[20] Blockchain technology not only made digital currency possible, but it also has allowed companies to create and sell their own digital tokens for fundraising.[21] This fundraising is accomplished through

15. *See* Saheli R. Choudhury, *China Bans Companies from Raising Money Through ICOs, Asks Local Regulators to Inspect 60 Major Platforms*, CNBC (Sept. 4, 2017), https://www.cnbc.com/2017/09/04/chinese-icos-china-bans-fundraising-through-initial-coin-offerings-report-says.html [https://perma.cc/6KLZ-6YZ4].

16. *See, e.g.*, *WSJ Top 25 Tech Companies List Sees Blockchain & Crypto Companies Dominate*, BITCOIN EXCHANGE GUIDE (June 14, 2018) https://bitcoinexchangeguide.com/wsj-top-25-tech-companies-list-sees-blockchain-crypto-companies-dominate [https://perma.cc/Y4MJ-RJKA].

17. Aziz Zainuddin, *Altcoins vs. Tokens: What's the Difference?*, MASTER THE CRYPTO (Aug. 6, 2017), https://masterthecrypto.com/differences-between-cryptocurrency-coins-and-tokens [https://perma.cc/TJ83-ZG6P] [hereinafter Zainuddin, *Altcoins*].

18. Ameer Rosic, *What is Blockchain Technology? A Step-by-Step Guide For Beginners*, BLOCKGEEKS, https://blockgeeks.com/guides/what-is-blockchain-technology [https://perma.cc/264V-HBGQ] (last updated Mar. 1, 2019) [hereinafter Rosic, *Blockchain Technology*].

19. Rosic, *What is Cryptocurrency?*, *supra* note 1.

20. Rosic, *Blockchain Technology*, *supra* note 18.

21. Zainuddin, *Altcoins*, *supra* note 17.

ICOs.[22] A basic understanding of cryptocurrencies' technology and functions is necessary before analyzing how an ICO operates.

A. *Blockchain Technology*

Blockchain technology can be technically complex,[23] but the idea behind it is simple. The purpose and function of the blockchain is to act as a digital ledger that records every single transaction of the cryptocurrency for which it was created.[24] This is no different than what a bank does with its customer accounts.[25] What is unique and revolutionary about blockchain technology is that it accomplishes this without a single server keeping track of account balances.[26] For traditional currency, the central server would be with whatever bank holds the accounts.[27] Blockchain technology eliminates the need for a central server altogether.[28] Hence, cryptocurrencies are decentralized in nature and considered to be peer-to-peer (P2P) networks.[29]

Instead of one server hosting a master ledger and keeping track of all transactions, multiple computers simultaneously host a single ledger.[30] The data on the ledger is accessible to anyone with an internet connection.[31] The host computers are referred to as nodes.[32] Nodes act as administrators of the blockchain by confirming transactions and sharing them with other nodes.[33] Operators of nodes volunteer their computers for this function.[34] Users are distinguished by pseudonymous public keys that function like usernames and addresses on blockchains for transactions, while private keys function like passwords giving access to the funds stored at the digital location.[35] Transactions are initiated by users signing each transaction with their unique private

22. Ameer Rosic, *What is an Initial Coin Offering? Raising Millions In Seconds*, BLOCKGEEKS, https://blockgeeks.com/guides/initial-coin-offering [https://perma.cc/E7VH-BEU6] (last updated Feb. 21, 2019) [hereinafter Rosic, *What is an ICO?*].

23. *See* Rosic, *Blockchain Technology*, *supra* note 18; Rosic, *What is Cryptocurrency?*, *supra* note 1.

24. Rosic, *Blockchain Technology*, *supra* note 18.

25. *See id.*

26. Rosic, *What is Cryptocurrency?*, *supra* note 1.

27. Rosic, *Blockchain Technology*, *supra* note 18.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*; Rosic, *What is Cryptocurrency?*, *supra* note 1.

34. *Bruno Skvorc*, *What's a Bitcoin Node? Mining vs. Validation?*, BITFALLS (Nov. 26, 2017), https://bitfalls.com/2017/11/26/whats-bitcoin-node-mining-vs-validation [https://perma.cc/3U7S-X6SG].

35. Ameer Rosic, *Cryptocurrency Wallet Guide: A Step-By-Step Tutorial*, BLOCKGEEKS, https://blockgeeks.com/guides/cryptocurrency-wallet-guide [https://perma.cc/G75M-8RWA] [hereinafter Rosic, *Cryptocurrency Wallet Guide*].

key.[36] These keys are stored in software programs called "wallets" that allow users to engage in transactions and keep a personal record of their various cryptocurrency account balances.[37] Cryptocurrency cannot be traded without utilizing a wallet.[38] The public and private keys stored in wallets rely on encryption technology, specifically key cryptography, to ensure a user's digital assets cannot be manipulated by someone else.[39] Additionally, because there is no central server for a hacker to target and compromise, blockchain technology is regarded as extremely secure and virtually incorruptible.[40] Hence, the more nodes there are in the network, the more secure the network is.[41]

The node network periodically updates the shared ledger with every confirmed transaction that has occurred.[42] The batches of transactions that are confirmed and shared within each interval are referred to as "blocks."[43] Once a block has been confirmed, it is then permanently and unalterably added to the previously recorded chain of blocks, known as the "blockchain."[44] It is impossible to change a block that has been added to the blockchain.[45]

The cryptographic aspect of blockchain technology is the key element of how cryptocurrency functions. It not only protects user privacy and validates transactions, it is also the means by which new units of a blockchain's cryptocurrency are generated.[46] This is accomplished through "mining."[47] Miners are individuals who operate types of nodes, called "mining nodes," that confirm transactions, thus balancing the digital ledger.[48] Confirmation is achieved by miners solving the complex mathematical equations required before a block can be added to the chain.[49] The equations involve each block of

36. Rosic, *What is Cryptocurrency?*, *supra* note 1.
37. Rosic, *Cryptocurrency Wallet Guide*, *supra* note 35.
38. *Id.*
39. Rosic, *Blockchain Technology*, *supra* note 18 (explaining how encryption technology is used on blockchain networks); Rosic, *What is Cryptocurrency?*, *supra* note 1 (stating that cryptocurrency transactions utilize "key cryptography").
40. Rosic, *Blockchain Technology*, *supra* note 18.
41. Daniel Cawrey, *What Are Bitcoin Nodes and Why Do We Need Them?*, COINDESK (May 9, 2014, 6:12 AM), https://www.coindesk.com/bitcoin-nodes-need [https://perma.cc/R4WT-BZCQ].
42. Rosic, *Blockchain Technology*, *supra* note 18.
43. *Id.*
44. Rosic, *What is Cryptocurrency?*, *supra* note 1.
45. *Id.*
46. *See id.*
47. *See id.*
48. Skvorc, *supra* note 34.
49. *See* Ameer Rosic, *What Is Hashing? [Step-by-Step Guide-Under The Hood Of Blockchain]*, BLOCKGEEKS, https://blockgeeks.com/guides/what-is-hashing [https://perma.cc/T8Y9-F49Y] [hereinafter Rosic, *What is Hashing?*].

transactions being assigned a random string of characters consisting of numbers and letters.[50] The miners must then find a corresponding number that, once entered into the equation, will produce another number that the blockchain's algorithm will accept.[51] If a miner submits an acceptable input, then the block is confirmed and added to the chain.[52] The miners are incentivized to solve these equations, sometimes called "cryptographic puzzle[s]," by being awarded newly generated units of cryptocurrency.[53] Only a set number of units are released for each block that is created.[54] Hence, miners are competing for a limited supply of cryptocurrency units.[55] Mining is the only way in which new units are generated.[56] The supply of units for each brand of cryptocurrency is controlled by a schedule written into the blockchain's code.[57] Most brands of cryptocurrency, including BTC, have a limited supply of units.[58] All units of BTC will have been released approximately in the year 2140.[59]

A good analogy to blockchain ledger technology is the use of Google Docs.[60] When a document is uploaded to or created on Google Docs, it is accessible and visible to every party with which it is shared.[61] Each party can edit the document and has simultaneous access to the most current form of it.[62] This reduces the time spent sending documents back and forth between parties until all are satisfied with the final product.[63] Similarly, the transactions made on the blockchain are accessible to everyone.[64] All nodes must reach a consensus, thus ensuring that accounts stay balanced and that there is

50. *See id.*; Kiran Vaidya, *Decoding the Enigma of Bitcoin Mining—Part I: Mechanism*, MEDIUM (Dec. 14, 2016), https://medium.com/all-things-ledger/decoding-the-enigma-of-bitcoin-mining-f8b2697bc4e2 [https://perma.cc/4KY5-GYQH].

51. *Id.*

52. Rosic, *What is Hashing?*, *supra* note 49.

53. Rosic, *What is Cryptocurrency?*, *supra* note 1.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. *Id.*

60. *See* William Mougayar, *Explaining the Blockchain via a Google Docs Analogy*, STARTUP MGMT. (Sept. 6, 2016), http://startupmanagement.org/2016/09/06/explaining-the-blockchain-via-a-google-docs-analogy [https://perma.cc/GKY3-BYR9].

61. *See Get Started with Docs*, G SUITE LEARNING CTR., https://gsuite.google.com/learning-center/products/docs/get-started/#! [https://perma.cc/X7RG-HVEY].

62. *Id.*

63. *See* Mougayar, *supra* note 60.

64. *Id.*

only one version of the ledger.[65] Instead of having to use a bank to authenticate and transfer funds, blockchain technology allows for transactions to be approved and transferred almost instantaneously.[66]

B. *Coins versus Tokens*

Once a basic understanding of blockchain technology is grasped, the next step in understanding cryptocurrency is to explore the various types. The term cryptocurrency encompasses more than just digital cash that substitutes for traditional fiat currency.[67] There are two main types of cryptocurrency: coins and tokens.[68] Coins operate on independent blockchains and can be thought of as different brands of cryptocurrency, such as BTC.[69] In fact, the term "altcoin" refers to any coin other than BTC.[70] Tokens are part of and function in coordination with an altcoin's blockchain.[71] Tokens represent a specific asset or utility.[72] When most companies or individuals want to launch an ICO, they are creating a cryptocurrency token.[73]

A majority of altcoins function only as a medium of exchange like any other traditional currency, such as BTC.[74] However, altcoins can have other features built into them.[75] The Ethereum blockchain network was created specifically for having tokens built on top of it and facilitating companies' ICOs.[76] At the same time, Ether (ETH), Ethereum's coin, is used as currency and the incentive for Ethereum miners confirming the transactions on the network.[77] ETH must be paid in the form of a transaction fee for each transfer made on the Ethereum blockchain.[78] The NEO blockchain network was created to facilitate ICOs as well, but it also allows owners of the different tokens built on its network to earn dividends in the form of its coin, GAS.[79] Another example of how coin may be used is found on the Dash network.[80]

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65. Rosic, *What is Cryptocurrency?*, *supra* note 1.
66. *See* Rosic, *Blockchain Technology*, *supra* note 18.
67. Zainuddin, *Altcoins*, *supra* note 17.
68. *Id.*; Ray King, *Token vs Coin: What's the Difference?*, BITDEGREE, https://www.bitdegree.org/tutorials/token-vs-coin [https://perma.cc/4F3N-J327] (last updated Nov. 9, 2018).
69. Zainuddin, *Altcoins*, *supra* note 17 (giving examples of various brands of coin).
70. *Id.*
71. King, *supra* note 68.
72. Zainuddin, *Altcoins*, *supra* note 17.
73. *Id.*
74. *Id.*; King, *supra* note 68.
75. King, *supra* note 68.
76. *Id.*; Rosic, *What is an ICO?*, *supra* note 22.
77. King, *supra* note 68.
78. Ameer Rosic, *What is An Ethereum Token: The Ultimate Beginner's Guide*, BLOCKGEEKS, https://blockgeeks.com/guides/ethereum-token [https://perma.cc/2MPX-Y62L].
79. King, *supra* note 68.
80. *Id.*

In addition to functioning as currency, the Dash network allows holders with enough of its coin, DASH, to vote on whether projects should be funded.[81] The commonality between all altcoins, however, is that each has an independent blockchain network.[82]

Tokens can represent a variety of tangible or intangible tradeable assets.[83] A token is categorized according to what it represents.[84] Since there is little regulatory guidance with the newly created cryptocurrency market,[85] there is disagreement about how many types of tokens there are and what they should be called.[86] Security tokens represent an investment in a company with the expectation of a return.[87] Equity tokens represent stock or equity in their issuing company.[88] Equity and security tokens are often lumped together into the same category and the terms are used interchangeably at times.[89] Utility tokens represent the right of the bearer to use the issuing company's service or product.[90] Asset-backed tokens, or commodity tokens, represent physical tangible objects such as gold.[91] Finally, there are reward tokens, or reputation tokens, that symbolize a user's standing in a blockchain's ecosystem.[92] Typically, the more reward tokens a user has, the more that user is respected or trusted by other users.[93] Despite their wide range of uses, the common denominator between all tokens is that they are stored and traded on an altcoin's blockchain network.[94]

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81. *Id.*; *Understanding Dash Governance*, DASH, https://docs.dash.org/en/stable/governance/understanding.html [https://perma.cc/7ZHA-6YNW].

82. King, *supra* note 68; Zainuddin, *Altcoins*, *supra* note 17.

83. *Id.*

84. King, *supra* note 68.

85. *See infra* Part IV.D (discussing how the government's current manner of regulating cryptocurrencies is inadequate).

86. *Compare* King, *supra* note 68 (listing four types of tokens: security, equity, utility, and payment tokens), *with* Alex Lielacher, *Tokenomics: Discover Five Types of Digital Tokens*, CRYPTONEWS (Mar. 2, 2018), https://cryptonews.com/exclusives/tokenomics-discover-five-types-of-digital-tokens-1315.htm [https://perma.cc/5B9N-QT63] (listing five types of tokens: digital currencies, utility tokens, tokenized securities, asset-backed tokens, and reward tokens), *and* ICOscoring, *Types of Tokens. The Four Mistakes Beginner Crypto-Investors Make*, MEDIUM: THE STARTUP (Mar. 6, 2018), https://medium.com/swlh/types-of-tokens-the-four-mistakes-beginner-crypto-investors-make-a76b53be5406 [https://perma.cc/CKH6-K54E] (listing three types of tokens: security or asset tokens, utility tokens, and cryptocurrencies or payment tokens).

87. King, *supra* note 68.

88. *Id.*

89. *See* Lielacher, *supra* note 86.

90. *Id.*

91. John Lewis, *Token Terms You Should Know in 2018: Utility vs Security vs Commodity*, TOKENTARGET (Apr. 11, 2018), https://www.tokentarget.com/utility-vs-security-vs-commodity [https://perma.cc/FZF7-CEDQ]; Lielacher, *supra* note 86.

92. Lielacher, *supra* note 86.

93. *Id.*

94. King, *supra* note 68.

III. CLASSIFYING CRYPTOCURRENCIES

Having analyzed blockchain technology and the various types of cryptocurrencies, one can see why the SEC has struggled to define cryptocurrencies. Due to their various functions, cryptocurrencies do not fit neatly into any current existing category of financial law.[95] To understand why cryptocurrencies are different from other traditional financial instruments, a comparison must be made between cryptocurrencies, securities, and commodity contracts. Cryptocurrencies bear unique characteristics while sharing others with both securities and commodity contracts.[96] Additionally, many similarities can be drawn between ICOs and IPOs, but with several nuances.[97]

A. A Comparison of Cryptocurrencies with Securities

Before a comparison between cryptocurrencies and securities can be made, an introduction to securities under existing law is necessary. A good starting point is to examine the definitions of securities in the legal community. According to *Black's Law Dictionary*, a "security" is "[a]n instrument that evidences the holder's ownership rights in a firm (e.g., a stock), the holder's creditor relationship with a firm or government (e.g., a bond), or the holder's other rights (e.g., an option)."[98] While this definition encompasses an enormous number of financial instruments, the federal statutory definition is even broader:

> The term "security" means any note, *stock*, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt

95. *See* DAO REPORT, *supra* note 13, at 17–18 (stating that whether a cryptocurrency falls under securities law depends on subjective facts and circumstances).

96. *See infra* Part III.A–B (discussing how some cryptocurrencies represent tangible assets like commodity contracts while others function more like stock or other securities).

97. *See* Eric Pesale, *ICOs vs. IPOs: the Big Differences Explained, Plus Other Financing Options*, FUNDERA (Feb. 28, 2018), https://www.fundera.com/blog/icos-vs-ipos [https://perma.cc/NL7D-U635]; Zainuddin, *Crypto ICO*, *supra* note 3.

98. *Security*, BLACK'S LAW DICTIONARY (10th ed. 2014).

> for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[99]

Congress chose such a broad definition to ensure it would "encompass virtually any instrument that might be sold as an investment."[100] Two of the financial instruments in the statutory definition bear resemblances to cryptocurrency tokens: stocks and investment contracts.

Although there is no federal statutory definition of "stock," one may look to *Black's Law Dictionary* to discern the meaning of legally operative terms.[101] *Black's* defines stock as "[a] proportional part of a corporation's capital represented by the number of equal units (or shares) owned, and granting the holder the right to participate in the company's general management and to share in its net profits or earnings."[102] Hence, stock represents a fungible right to equity and ownership in a company. The term "investment contract" lacks a statutory definition as well.[103] However, the Supreme Court has outlined a two-part analysis, known as the *Howey* test, for determining whether a financial instrument is an investment contract.[104] First, the instrument must involve "an investment of money in a common enterprise."[105] The investment need not take the form of cash.[106] Second, the profits from the investment must "come solely from the efforts others."[107] The term "profits" refers to what investors seek to gain and "not the profits of the scheme in which they invest."[108] The profits may come in the form of "dividends, other periodic payments, or the increased value of the investment."[109] Additionally, the Supreme Court has held that for any instruments to be considered securities, they must have equivalent value and the ability to be publicly traded.[110] In other words, stocks and investment contracts must be fungible to fall under the definition of a security.

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99. Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012) (emphasis added).

100. S.E.C. v. Edwards, 540 U.S. 392, 393 (2004) (quoting Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)).

101. *See, e.g.*, F.A.A. v. Cooper, 566 U.S. 284, 292, 306–07 (2012) (exemplifying how the Supreme Court of the United States uses *Black's Law Dictionary* to help discern the meaning of legal terms).

102. *Stock*, BLACK'S LAW DICTIONARY (10th ed. 2014).

103. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

104. *Id.* at 301.

105. *Id.*

106. Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel, 439 U.S. 551, 560 n.12 (1979).

107. *Howey*, 328 U.S. at 301.

108. S.E.C. v. Edwards, 540 U.S. 389, 394 (2004).

109. *Id.*

110. Marine Bank v. Weaver, 455 U.S. 551, 560 (1982).

Both cryptocurrency tokens and coins are fungible—just as all securities must be.[111] Also, tokens can represent fungible assets or utilities.[112] However, most cryptocurrency coins do not meet the definition of either stocks or investment contracts.[113] This is because coins that serve no other purpose than to be used as a medium of exchange, like BTC, do not provide the holder with any rights to ownership, voting, or returns on investment from the managerial efforts of others.[114] Hence, those cryptocurrency coins do not fit under the definition of securities. Other digital coins that have additional functions are more likely to fall under the statutory definition.[115] The Dash coin, for example, is similar to stock because it gives management rights to some of the operators of its network nodes if they own at least 1,000 DASH.[116]

Often a token derives its value by providing access to applications.[117] An example is the company Storj's (pronounced "storage") token.[118] Its token, STORJ, is a utility token that gives the holder the right to store digital data on a blockchain network.[119] Other tokens, like the Decentralized Autonomous Organization (DAO) token, may represent management and voting rights, similar to DASH.[120] The plan for the DAO token was that its possessors would vote on what proposed business projects should be funded by the DAO.[121] The profits from the ventures would then either be distributed proportionally to holders or invested in other approved projects.[122]

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111. *See id.* (stating that a security is an instrument that can be commonly traded); King, *supra* note 68 (stating that digital coins are used as money in addition to occasionally having other uses); Zainuddin, *Altcoins*, *supra* note 17 (stating that tokens are fungible).

112. Zainuddin, *Altcoins*, *supra* note 17.

113. *See* King, *supra* note 68 (stating that, generally, coins are used as substitutes for traditional currency).

114. *See id.* (explaining that, often, coins only function as a medium of exchange).

115. *See id.* (discussing how the DASH and NEO altcoins provide voting rights and dividends to their respective holders).

116. *See Masternodes*, DASH, https://docs.dash.org/en/stable/masternodes/index.html [https://perma.cc/84CL-V56S] (stating that one of the requirements to operate a masternode is possessing at least 1,000 DASH); *Understanding Dash Governance*, *supra* note 81 (explaining that operators of masternodes vote on what projects to fund).

117. King, *supra* note 68.

118. Bennett Garner, *What is Storj?:Beginner's Guide*, COIN CENT. (Feb. 14, 2018), https://coincentral.com/storj-beginners-guide [https://perma.cc/GS2R-EMBH].

119. *Id.*

120. *See* CHRISTOPH JENTZSCH, DECENTRALIZED AUTONOMOUS ORGANIZATION TO AUTOMATE GOVERNANCE FINAL DRAFT – UNDER REVIEW 2 (Mar. 2016), https://download.slock.it/public/DAO/WhitePaper.pdf [https://perma.cc/9YFA-ZV2Q].

121. *Id.* References to the DAO and its token are in the past tense because the business model was discontinued following the DAO ICO debacle where a hacker stole its investors' money. Steve Stecklow & Anna Irrera, *The Blockchain That Wouldn't Die*, REUTERS (Dec. 23, 2017, 11:28 AM), https://www.reuters.com/article/us-bitcoin-booster-classic/the-blockchain-that-wouldnt-die-idUSKBN1EH0K4 [https://perma.cc/289Y-4CHM].

122. Jentzsch, *supra* note 120, at 7.

The Storj token does not function like stock, but it is an investment contract under the *Howey* test. STORJ acts as a form of payment allowing users to store files on the Storj network.[123] During Storj's ICO, 73 million STORJ were sold to the public for the purposes of "expand[ing] [its] technical and non-technical staff, fund[ing] business growth and product development, and [to] continue working toward[] [its] goal of becoming the largest distributed, decentralized cloud storage platform."[124] Therefore, the first step of the *Howey* test is satisfied because investment payments were made to a common enterprise. The profit aspect of the second step is also satisfied because the STORJ purchasers' profit from the token's increase in value over time. The profit to STORJ investors also comes from the managerial efforts of others, because Storj stated that it would use the ICO funds to finance and grow itself into the largest decentralized cloud storage platform.[125] Thus, STORJ is both an investment contract and a security.

Significantly, the DAO token has already been classified as a security by the SEC.[126] On July 25, 2017, the SEC released a report that analyzed the properties and functions of the DAO token and ultimately concluded that it was an investment contract under the *Howey* test.[127] First, the SEC determined that ETH paid to the ICO issuer, the DAO, was money paid to a common enterprise for an investment.[128] Second, the SEC found that the investors had a reasonable expectation of profits because the "[t]oken holders stood to share in potential profits from" the DAO's business projects.[129] Finally, the SEC reasoned that the potential profits would come from the managerial efforts of others.[130] Even though the holders did have limited voting rights, the investors still relied on the DAO's creators and curators to develop the business model and present them with proposals that were already vetted and screened.[131] Consequently, the SEC stated that the DAO could have violated federal securities laws because it failed to register its token as a security.[132]

The NEO coin is similar to an investment contract in that it pays holders dividends in the form of GAS tokens.[133] The NEO coin satisfies the first prong of the *Howey* test because the initial purchase involves a payment of

123. Shawn Wilkinson et al., *Storj: A Peer-to-Peer Cloud Storage Network*, STORJ 9 (Dec. 15, 2014), https://storj.io/storj2014.pdf [https://perma.cc/4VR8-WC5D].

124. *FAQ*, STORJ, https://web.archive.org/web/20180816065846/https://storj.io/faq#headingSeven [https://perma.cc/NG6X-STF6].

125. *Id.*

126. DAO REPORT, *supra* note 13, at 11.

127. *Id.* at 11–15.

128. *Id.* at 11.

129. *Id.* at 12.

130. *Id.*

131. *Id.* at 12–15.

132. *Id.* at 1, 17–18.

133. King, *supra* note 68.

money in the form of BTC or altcoin.[134] This purchase is an investment because there is an expectation of return in the form of GAS tokens by merely holding the NEO coins.[135] The second prong is also satisfied because GAS tokens are automatically generated and distributed proportionately to NEO holders for each block added to the blockchain.[136] GAS tokens derive their value from being the required unit of payment for transactional fees on the NEO blockchain.[137] One cannot transact on the NEO network without paying in GAS.[138] Therefore, purchasers of NEO coins are profiting from their investment solely by the efforts of others who are trading on the network.

Another altcoin example is Musicoin. Musicoin is still relatively new, and its coin, MUSIC, only serves the purpose of tipping artists when their music is streamed on the network.[139] The business plan for MUSIC is that it will eventually be used to purchase downloads and merchandise.[140] Musicoin's purpose is to eliminate the need for record companies acting as intermediaries between artists and patrons.[141] It is unclear whether MUSIC is a security under the *Howey* test. It could satisfy the first prong, investment in a common enterprise, because listeners must purchase MUSIC to tip musicians,[142] and Musicoin keeps a portion of the coins generated by the mining of each block to finance itself.[143] Musicoin facilitates a "Universal Base Income" (UBI) pool into which a portion of the mined coins go, and from which it pays musicians and takes out fees for itself.[144] When transactions are updated on the Musicoin blockchain, the miners retain 79.6% of the total coins mined, with the remainder going into the UBI pool.[145]

However, Musicoin never launched an ICO, and there were no premined coins for listeners to buy directly from Musicoin.[146] Instead, all

134. Rohit Kukreja, *How To Buy NEO Cryptocurrency On Bittrex Exchange | Guide To Buy NEO Coin*, KRYPTOMONEY (Apr. 3, 2018), https://kryptomoney.com/guide-buying-neo-bittrex-exchange [https://perma.cc/6Q8Y-28PN].

135. *What is NEO Cryptocurrency?A Beginner's Guide to NEO Cryptocurrency*, KRYPTOMONEY (Aug. 10, 2017), https://kryptomoney.com/what-is-neo-cryptocurrency-neo-coin-explained [https://perma.cc/H4BU-JMNB].

136. *Id.*

137. *See id.*

138. *Id.*

139. *FAQ*, MUSICOIN, https://musicoin.org/resources/faq [https://perma.cc/534W-FZGJ].

140. *Id.*

141. *Id.*

142. *Id.*

143. MUSICOIN FOUNDATION, MUSICOIN: A DECENTRALIZED PLATFORM REVOLUTIONIZING CREATION, DISTRIBUTION AND CONSUMPTION OF MUSIC 16–17, 19 (Oct. 2017), https://musicoin.org/resources/faq [https://perma.cc/JCJ5-ABZA] [hereinafter MUSICOIN WHITE PAPER].

144. *Id.* at 15–17.

145. *Id.* at 16–17.

146. MUSICOIN, *Roadmap of Musicoin Blockchain*, MEDIUM (June 28, 2017), https://medium.com/@musicoin/roadmap-of-musicoin-blockchain-4a65620fefce [https://perma.cc/76H9-EXX3].

MUSIC went directly to musicians and was initially mined by volunteers seeking to change the music industry until the UBI business model was adopted.[147] As a result, all purchases of MUSIC are done in secondary markets.[148] Since there are no direct payments to Musicoin for MUSIC, it is difficult to say for certain whether purchasers paid money to a common enterprise under the *Howey* test. However, given how inclusive the Supreme Court has interpreted the *Howey* test to be,[149] it is possible that MUSIC would satisfy the first prong because Musicoin is still profiting from user transactions since its implementation of the UBI pool.[150]

MUSIC does meet the requirements of the *Howey* test's second prong because there is a return on the investment from the managerial efforts of others. While it does not pay a dividend, the fact that MUSIC's intrinsic value can increase means that investors are profiting.[151] Holders of MUSIC rely not only on Musicoin to set up the business model and promote its services, but also on the musicians utilizing the platform as well.[152] Musicians on Musicoin must inform their listeners that their art can be found on Musicoin in to be compensated with MUSIC.[153] In turn, the increased popularity of artists on Musicoin would drive the value of MUSIC up and thus allow the holders

147. *Id.*

148. *See id.* (stating that patrons could not purchase MUSIC at its launch because Musicoin did not host an ICO); MUSICOIN WHITE PAPER, *supra* note 143, at 16 (using a graphic representation to explain how MUSIC is produced and traded following the adoption of the UBI pool business model); *Secondary Market*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "secondary market" as a "market for goods or services that have previously been available for buying and selling; esp., the securities market in which previously issued securities are traded among investors").

149. *See* S.E.C. v. Edwards, 540 U.S. 389, 394 (2004) (expanding the term "profit" under the second prong of the *Howey* test to mean "dividends, other periodic payments, or the increased value of the investment"); Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel, 439 U.S. 551, 560 n.12 (1979) (explaining that the term "investment" under the first prong of the *Howey* test includes more than just cash); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (stating that "in searching for the meaning and scope of the word 'security' . . . form should be disregarded for substance and the emphasis should be on economic reality"); S.E.C. v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (stating "[an investment contract] embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits").

150. *See* MUSICOIN WHITE PAPER, *supra* note 143, at 16–17, 19 (explaining that Musicoin takes fees for itself out of the UBI pool).

151. *See id.* at 18–19 (explaining how MUSIC can be used by its holders); *see also* S.E.C. v. Edwards, 540 U.S. 389, 394 (2004) (holding that an investor's profits under the *Howey* test include the increase in value of the investment and not just payments).

152. *See* MUSICOIN WHITE PAPER, *supra* note 143, at 19 (stating that Musicoin is actively promoting their business model in order to partner with outside developers and enhance their services).

153. *See How It Works*, MUSICOIN, https://musicoin.org/how-it-works [https://perma.cc/H6S2-UBJF] (explaining that a musician gets paid MUSIC by having their songs streamed on Musicoin or by being tipped by the platform's listeners).

of the coin to profit.[154] Hence, MUSIC could be an investment contract under the *Howey* test and, by extension, a security.

Excluding the few exceptions like NEO, DASH, and MUSIC, cryptocurrency coins do not function like securities because they are only a medium of exchange.[155] Many cryptocurrency tokens, however, represent rights of their holders or tangible assets.[156] Thus, cryptocurrencies have incredible versatility in their uses and functions. Some may function like stock and provide voting rights.[157] Others are used to provide access to applications.[158] Others may serve no other purpose than to act as a substitute for fiat currency.[159] In spite of their novel nature, cryptocurrencies still bear a strong resemblance to traditional securities. Both cryptocurrencies and traditional securities are fungible and traded on secondary markets.[160] Both can represent the intangible rights of their holders.[161] Finally, and perhaps most importantly, both provide a way to finance the enterprises of their issuers.[162]

B. A Comparison of Cryptocurrencies with Commodity Contracts

While many similarities can be drawn between cryptocurrencies and securities, coins and tokens also share aspects with tradable commodity contracts, or "futures contracts." However, under the Commodity Exchange Act (CEA), commodity contracts are subject to CFTC oversight—rather than that of the SEC.[163] Congress began regulating commodity contracts to protect investors from the volatile price fluctuations affecting their value.[164] *Black's*

154. MUSICOIN WHITE PAPER, *supra* note 143, at 21 (explaining that the increased use of Musicoin will increase MUSIC's value).

155. *See* King, *supra* note 68 (explaining how coins function as typical currencies).

156. *See id.*; Zainuddin, *Altcoins*, *supra* note 17.

157. *See Understanding Dash Governance*, *supra* note 81 (explaining how certain node operators have voting and managerial rights in the Dash system).

158. *See* Garner, *supra* note 118 (explaining how STORJ acts as a form of payment to use the Storj cloud service).

159. *See* King, *supra* note 68 (explaining that BTC's only purpose is to act as a currency substitute).

160. *See* Yoav Vilner, *Cryptocurrency Exchanges Are Getting Better In User Experience And Liquidity*, FORBES (July 14, 2018, 2:03 AM), https://www.forbes.com/sites/yoavvilner/2018/07/14/cryptocurrency-exchanges-are-getting-better-in-user-experience-and-liquidity/#b7b325e37f38 [https://perma.cc/D5R8-WGPW] (discussing how cryptocurrencies are traded on exchanges).

161. *See Security*, BLACK'S LAW DICTIONARY (10th ed. 2014) (stating that the term security includes instruments that provide the holder with certain rights, such as stocks); King, *supra* note 68 (explaining that cryptocurrencies can provide rights to vote on managerial decisions and to use applications).

162. *See* Zainuddin, *Crypto ICO*, *supra* note 3 (explaining that the purpose of IPOs and ICOs is to raise money).

163. *See* Commodity Exchange Act, 7 U.S.C. § 6 (2012).

164. Ricci v. Chi. Mercantile Exch., 409 U.S. 289, 291 n.2 (1973) (citing Bd. of Trade of the City of Chi. v. Olsen, 262 U.S. 1 (1923)).

Law Dictionary defines a commodity as "[a]n article of trade or commerce" and includes "only tangible goods, such as products or merchandise, as distinguished from services."[165] Like the term security, the statutory definition of "commodity" is even broader than the dictionary's:

> The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13-1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and *all services, rights, and interests* (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.[166]

The Supreme Court has not developed a legal test for what falls under the definition of a commodity. However, the CFTC has jurisdiction over the foreign currency exchange markets (FOREX markets) in the United States of America that are not registered as securities exchanges with the SEC.[167] BTC functions like a foreign currency: its purpose is to be a medium of exchange, and it has an exchange rate with the U.S. Dollar (USD).[168] The CFTC has held that "virtual currencies" such as BTC fall under the definition of a commodity.[169] In reaching this decision, the CFTC stated that the statutory definition of commodities encompasses virtual currencies because it includes "all services, rights, and interests."[170] The Commission went even further and defined "virtual currency" as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction."[171] Ultimately, the U.S. District Court for the Eastern District of New York agreed with the CFTC and ruled that the Commission has concurrent jurisdiction over virtual currency trading along with other state and federal agencies until Congress clarifies

165. *Commodity*, BLACK'S LAW DICTIONARY (10th ed. 2014)
166. 7 U.S.C. § 1a(9) (2012) (emphasis added).
167. *Id.* § 2 (c)(2)(A)(iii).
168. *See Bitcoin Price (BTC)*, COINDESK, https://www.coindesk.com/price [https://perma.cc/XQ7Q-25YQ] (tracking the current and past exchange rates of BTC to USD); King, *supra* note 68.
169. *In re* Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736, at *2 (Sept. 17, 2015) [hereinafter CFTC Coinflip Order].
170. *Id.* (quoting 7 U.S.C. § 1a(9)).
171. *Id.* at *1 n.2.

otherwise.[172] Hence, the legal definition of commodity is not limited to tangible goods and includes coins that function simply as alternative mediums of exchange.

Unlike cryptocurrency coins, tokens can represent tangible and physical assets.[173] As such, tokens are also similar to commodity contracts.[174] WePower is a company that tokenizes renewable energy on the Ethereum blockchain.[175] Likewise, Digix is a cryptocurrency company that has tokenized gold on Ethereum's blockchain.[176] These tokens are examples of commodity tokens.[177]

WePower allows renewable energy producers to tokenize their green energy and sell it to buyers.[178] WePower has two types of tokens: energy tokens and WPR.[179] The energy tokens represent one kilowatt of electricity per unit.[180] WPR derives its value by entitling holders to a portion of energy tokens created through WePower.[181] WPR also gives holders priority access in the auction of energy tokens on the WePower platform.[182] The energy tokens are referred to as a "smart contract."[183] Each energy token denotes the type of energy it represents, when the energy will be produced and delivered, and its price.[184] Hence, the energy tokens function exactly like commodity contracts, with the nuance that they operate via a blockchain network.

Digix, like WePower, is a company that has tokenized another commodity, namely gold.[185] Each unit of its token, DGX, represents 1 gram of gold.[186] All of the gold backing DGX is physically stored in a vault in Singapore.[187] DGX is redeemable for gold bars of either 100 or 1,000 grams if a holder

172. CFTC v. McDonnell, 287 F. Supp. 3d 213, 217 (E.D.N.Y. 2018).
173. King, *supra* note 68; Zainuddin, *Altcoins*, *supra* note 17.
174. *See* 7 U.S.C. § 1a(9) (2012) (explaining how the term "commodity" encompasses physical goods).
175. WEPOWER WHITE PAPER 7–8, 30, https://wepower.network/media/WhitePaper-WePower_v_0.81-1.pdf [https://perma.cc/8N9N-TH35] (last updated Jan. 16, 2019) [hereinafter WEPOWER WHITE PAPER].
176. ANTHONY C. EUFEMIO, KAI C. CHNG & SHAUN DJIE, DIGIX'S WHITEPAPER: THE GOLD STANDARD IN CRYPTO-ASSETS 2 (Jan. 2016), https://digix.global/whitepaper.pdf [https://perma.cc/4BT4-AZFT].
177. *See supra* Part II.B (discussing the different kinds of tokens, including commodity tokens, which are tokens that can represent physical tangible assets).
178. WEPOWER WHITE PAPER, *supra* note 175, at 5.
179. *Id.* at 12–13.
180. *Id.* at 12.
181. *Id.* at 13–14.
182. *Id.* at 13.
183. *Id.* at 8.
184. *Id.*
185. Eufemio et al., *supra* note 176, at 2.
186. *Id.*
187. *Id.* at 8.

submits a request and travels to the vault for pick up.[188] The process of redemption is referred to as "recasting."[189] Holders have 30 days to appear at the vault from the time they submit a recasting request.[190] Hence, DGX functions like a commodity contract for the delivery of goods, except without a delivery date until the holder of the coin decides to initiate the recasting.[191]

Several similarities exist between traditional commodities and cryptocurrencies. Coins that serve no other purpose than to be used as fiat substitutes are similar to foreign currencies. Hence, a parallel can be drawn between markets dealing in the trade of fiat substitute coins and foreign currency markets, which can be subject to CFTC regulation.[192] Additionally, tokens can function as representations of physical assets, just like commodity contracts. The Commission has yet to specifically address the regulation of tokens, much less commodity tokens. However, given that commodity tokens function as contracts for the delivery of certain goods,[193] it is almost certain that they would fall under the jurisdiction of the CFTC.

C. *The Differences Between ICOs and the Formation of Commodity Contracts*

The CFTC purports that all virtual currencies are commodities.[194] Such a broad and sweeping categorization ignores the properties that cryptocurrencies also share with securities.[195] Given the numerous traits shared with both types of financial instruments,[196] regulating cryptocurrency trading exclusively under either classification is not an ideal permanent solution. However, the way in which ICOs are conducted could and should be regulated without regard for a coin or token's classification as a commodity contract or security. The SEC Director of Corporate Finance, William Hinman, appeared to agree

188. Digix Support, *What are the Steps to Redeem the Gold?*, DIGIX, https://digix.zendesk.com/hc/en-us/articles/360001811451-What-are-the-steps-to-redeem-the-gold [https://perma.cc/P6LD-DK7D].

189. *See id.*; Eufemio et al., *supra* note 176, at 6 (providing a flow chart of the recasting process).

190. Digix Support, *supra* note 188.

191. *See* CFTC v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492, 498 (D. Mass. 2018) (showing that there is a very low threshold test for the CFTC to find that a cryptocurrency is a commodity because agency argues that all virtual currencies are commodities).

192. 7 U.S.C. § 2(c)(2)(A)(iii) (2012) (noting that the CEA only applies to foreign exchange markets that are not registered as securities markets with the SEC under the Securities Exchange Act).

193. *See, e.g.*, Digix Support, *supra* note 188 (explaining how the DGX token is redeemable for gold); WEPOWER WHITE PAPER, *supra* note 175, at 8 (stating that the energy tokens have specific delivery dates for the use of the electricity they represent).

194. CFTC Coinflip Order, *supra* note 169, at *2.

195. *See supra* Part III.A.

196. *Compare supra* Part III.A (explaining the similarities between cryptocurrencies and securities), *with supra* Part III.B (comparing the nature of commodity contracts with cryptocurrencies).

with this line of reasoning when he stated, "*Putting aside the fundraising that accompanied the creation of Ether*, based on my understanding of the present state of Ether, *the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions*."[197]

One of the most striking differences between commodity contracts and cryptocurrencies is the way they are created. A purchaser creates a commodity contract by locking in a price of the desired commodity for future delivery date.[198] Therefore, commodity contracts are only created when there happens to be a demand for the underlying commodity at a specific price.[199] Additionally, there is no limited set supply of commodity contracts, since they are created by demand.[200] This is not the case for the sale and creation of cryptocurrencies in ICOs.[201] The ICO process is more similar to the IPO process.[202]

D. The Similarities Between ICOs and IPOs

Both ICOs and IPOs serve the same purpose: raising capital for a business endeavor.[203] Both also have an initial sale period where fungible cryptocurrency or stock is sold directly from the issuer before it becomes tradable on a secondary market.[204] Additionally, there is a fixed supply of both cryptocurrencies and shares set by the issuer of either instrument.[205] Entities seeking to initiate an ICO often release a "white paper."[206] White papers are documents published by issuers to the public.[207] They lay out the purpose of the ICO, the function of the cryptocurrency being issued, the mechanics of the sale itself, and any other information the issuer deems pertinent.[208] Likewise, corporations setting up IPOs issue a document called a "prospectus."[209] The

197. Graham Rapier, *Ethereum's Officially Not a Security — Here's Why it Matters for Other Coin Offerings*, BUS. INSIDER (June 15, 2018, 1:15 PM), https://markets.businessinsider.com/currencies/news/ethereum-not-a-security-what-it-means-for-ico-coin-offerings-cryptocurrencies-blockchain-bitcoin-2018-6-1027123435 [https://perma.cc/7T99-J66X] (emphasis added).

198. NerdWallet, *How to Get Started Trading Futures*, NERDWALLET (Mar. 12, 2019) https://www.nerdwallet.com/blog/investing/started-futures-trading/ [https://perma.cc/F8GD-FG4X].

199. *See id.*

200. *See id.*

201. *See* Rosic, *What is an ICO?*, *supra* note 22 (describing the ICO process); Zainuddin, *Crypto ICO*, *supra* note 3.

202. *See* Zainuddin, *Crypto ICO*, *supra* note 3 (comparing ICOs to IPOs).

203. *See id.*; Energy Premier, *supra* note 3; Smith, *supra* note 3.

204. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

205. *See* 15 U.S.C. § 77aa(11) (2012) (stating that the issuer in an IPO must disclose the total number of shares being sold); *Understanding Token Supply*, COINIST, https://www.coinist.io/understanding-token-supply/ (explaining the mechanics of token supply) [https://perma.cc/FKB3-SGG6].

206. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

207. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

208. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

209. *See* 15 U.S.C. § 77b(a)(10) (2012).

prospectus contains voluminous amounts of information about the issuing company's operations and financial track record.[210]

While many parallels can be drawn between the ICO and IPO processes, they still bear several contrasting characteristics. First, there is little regulatory oversight of the ICO process, unlike IPOs that require numerous disclosures and filings to the SEC.[211] Second, the duration of the ICO process is significantly shorter.[212] Third, ICOs are open to the general public, whereas shares are normally only issued to institutional investors during IPOs.[213] Finally, what is being sold in ICOs is not usually equity in the issuing company.[214]

The IPO process is heavily regulated and cumbersome for issuers.[215] Before an issuing company can sell its first stock, it must register the shares with the SEC.[216] The issuer does so by filing a registration statement.[217] The statement must contain comprehensive information about the issuer's business and the nature of the shares it is offering.[218] This information includes but is not limited to the issuer's principal place of business, who the officers and directors of the company are, who the underwriters are, how much commission the underwriters are due, the general character of the business engaged in by the issuer, the total number of shares being released, how many classes of stock are being sold, disclosures of the company's debt, estimated net proceeds from the IPO, estimated expenses from the IPO, a balance sheet, a profit and loss statement, copies of all contracts less than two years old, and any other information the SEC may require.[219] Nearly all of the information required in the registration statement is required in the prospectus as well.[220] Consequently, prospectuses are normally well over a hundred pages long and extremely thorough.[221]

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210. *See id.* §§ 77j, 77aa.

211. *See id.* (listing the specific information required in a prospectus); Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

212. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

213. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

214. *See* King, *supra* note 68 (stating that few companies have attempted ICOs with tokens representing equity in a company).

215. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3; *see also* 15 U.S.C. §§ 77a–aa (listing the various filing and registration requirements for the sale of securities).

216. 15 U.S.C. § 77f(a) (2012).

217. *Id.*

218. *Id.* §§ 77g, 77aa.

219. *Id.*

220. *See id.* § 77j (stating what information is required or omittable in a prospectus).

221. *See, e.g.*, *Cactus Inc. Preliminary Prospectus*, SEC (Jan. 12, 2018), https://www.sec.gov/Archives/edgar/data/1699136/000104746918000178/a2234259zs-1.htm#ca10505_prospectus_summary [https://perma.cc/S93B-MTA5]; *Facebook Prospectus*, SEC (May 17, 2012), https://www.sec.gov/Archives/edgar/data/1326801/000119312512240111/d287954d424b4.htm [https://perma.cc/E75P-JG7M];

By contrast, the ICO process is a much easier way for companies to raise capital due to the lack of regulatory oversight.[222] A company could theoretically launch an ICO without disclosing any information about its operations or business model, albeit such a strategy would be unwise if it wanted to attract investors.[223] Hence, issuers commonly release white papers to attract prospective investors even though they are not required to do so.[224] While prospectuses and white papers generally serve the same purpose of informing the public about the business and attracting investors,[225] they are exponentially different in form. Most notably, a white paper is completely optional for an ICO,[226] whereas a prospectus is mandatory for an IPO.[227] White papers are rarely over fifty pages and generally do not disclose any of the issuer's financial records.[228] In addition, while there are clear guidelines as to what must be disclosed in a prospectus, the author of a white paper can choose to withhold any information it deems superfluous.[229] Finally, securities issued in an IPO must be registered with the SEC.[230] Conversely, there are no registration requirements for cryptocurrencies issued in an ICO.[231] Thus, ICOs provide issuers with a novel way to raise funds without having to jump through numerous regulatory hoops.

In conjunction with less government oversight, ICOs provide quicker and cheaper access to capital than IPOs.[232] Corporations preparing for their IPOs must file numerous reports and hire accounting firms and investment

Google Prospectus, SEC (Aug. 18, 2004), https://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm [https://perma.cc/2XDH-HDRK].

222. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

223. *See* Energy Premier, *supra* note 3 ("ICOs are not limited with any legal document."); Smith, *supra* note 3 ("ICOs largely do not require adherence to regulatory protocols and are able to facilitate all processes without excessive oversight – for better or worse."); Zainuddin, *Crypto ICO*, *supra* note 3 ("ICOs are not bound by any legal requirements to issue any form of legal documentation.").

224. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

225. 15 U.S.C. § 77j; Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

226. *See* Zainuddin, *Crypto ICO*, *supra* note 3.

227. 15 U.S.C. § 77j.

228. *See, e.g.*, Eufemio et al., *supra* note 176; Jentzsch, *supra* note 120; MUSICOIN WHITE PAPER, *supra* note 143; WEPOWER WHITE PAPER, *supra* note 175; Wilkinson et al., *supra* note 123.

229. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

230. *See* 15 U.S.C. §§ 77f, 77g, 77aa (2012).

231. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

232. Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

banks to ensure they comply with government regulations and stock exchange listing requirements.[233] After filing, the corporation must then wait for approval from the SEC.[234] The entire procedure can take several months before a corporation releases its first stocks.[235] Additionally, the average out of pocket costs for setting up an IPO in compliance with regulations is $4.2 million as well as an underwriting fee that ranges from 4-7% of gross proceeds.[236] Thanks to the lack of regulations, the ICO process is exceptionally shorter[237] and cheaper.[238] An issuer can begin a sale as soon as the new cryptocurrency is set up on a blockchain network.[239] Since white papers are not a legal requisite, the only technical requirement for an ICO is that the cryptocurrency is generated and established on a blockchain.[240] In addition to the expedited set up process, an ICO crowd-sale itself commonly only lasts about a month.[241] Extremely popular ICOs can even conclude in mere seconds.[242]

The phrase "initial public offering" is somewhat misleading. IPOs are not usually open to the general public.[243] Instead, institutional investors, such as investment banks or investment funds, are the parties with the ability to

233. *See* 15 U.S.C. §§ 77g, 77aa (2012) (listing the information required for the registration of domestic securities); Smith, *supra* note 3 (discussing that "IPOs can last between four to six months thanks to a lengthy compliance process" and that "[t]ypically, auditing firms verify accounts, [and] investment banks serve as an underwriter for deals and further liaise with exchanges to ensure that companies wishing to go public are compliant to begin with"); Zainuddin, *Crypto ICO*, *supra* note 3 ("Traditional IPO issuance can be a lengthy process, due to the requirement of legal and compliance processes.").

234. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

235. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

236. *Considering an IPO to Fuel Your Company's Future?*, PWC, https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html [https://perma.cc/7G4L-G4RA].

237. *See* Energy Premier, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

238. *See* Alex Lielacher, *How Much Does It Really Cost to Launch an ICO?*, BITCOIN MKT. J. (Nov. 8, 2018 8:00 AM), https://www.bitcoinmarketjournal.com/launching-an-ico/ [https://perma.cc?EC98-MZUD] (stating that ICOs can cost between $100,000 and $500,000).

239. *See* Energy Premier, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

240. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

241. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

242. *See, e.g.*, Jonathan Keane, *$35 Million in 30 Seconds: Token Sale for Internet Browser Brave Sells Out*, COINDESK (May 31, 2017, 12:40 PM), https://www.coindesk.com/35-million-30-seconds-token-sale-internet-browser-brave-sells [https://perma.cc/Z6TZ-U7HG]; JD Alois, *Fastest ICO Ever? SingularityNet Raises $36 Million in 60 Seconds*, CROWDFUND INSIDER (Dec. 22, 2017, 7:28 PM), https://www.crowdfundinsider.com/2017/12/126315-fastest-ico-ever-singularitynet-raises-36-million-60-seconds [https://perma.cc/4BBD-A6LG].

243. *See* Energy Premier, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

purchase shares through primary markets.[244] ICOs, however, are open to anyone.[245] A potential roadblock for investors in ICOs is that some issuers require payment in another form of cryptocurrency, such as BTC or ETH, rather than fiat currency.[246] Hence, there are few limitations on who can participate in an ICO.

By definition, the financial instruments sold in an IPO are securities in the form of the issuing company's shares.[247] Only companies with a proven financial track record can facilitate an IPO.[248] Alternatively, ICO issuers can be individuals or startup companies with new business venture ideas as well as strongly established companies.[249] Depending on what characteristics the altcoin or token has, purchasers do not normally obtain any equity in the issuing enterprise.[250] Thus, unless the cryptocurrency specifically provides for management rights, which most do not,[251] investors in an ICO are voiceless on how the issuer should manage its cryptocurrency venture.[252]

Despite the differences between ICOs and IPOs, the processes are similar enough to regulate the same way until new legislation tailored to the ICO process is passed. The Supreme Court has held that, when determining whether security regulations are applicable, "form should be disregarded for substance and the emphasis should be on economic reality."[253] The economic

244. *See* Energy Premier, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3; *see also Primary Market*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "primary market" as "[t]he market for goods or services that are newly available for buying and selling; esp., the securities market in which new securities are issued by corporations to raise capital.").

245. *See* Energy Premier, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

246. Smith, *supra* note 3.

247. *See Initial Public Offering*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining an IPO as "[a] company's first public sale of stock; the first offering of an issuer's equity securities to the public through a registration statement"); *see also Fast Answers: Initial Public Offerings (IPO)*, U.S. SECS. & EXCHANGE COMMISSION, https://www.sec.gov/fast-answers/answersipohtm.html [https://perma.cc/HW2T-G3MG] (last updated May 31, 2013) ("An initial public offering, or IPO, refers to when a company first sells its shares to the public.").

248. *See* 15 U.S.C. § 77aa (2012) (mandating that a company disclose years of past financial history in its registration statement).

249. *See* Vikas Gupta, *Why Buy a Cryptocurrency When You Can Issue It?*, ECON. TIMES, https://economictimes.indiatimes.com/wealth/invest/why-buy-a-cryptocurrency-when-you-can-issue-it-heres-how/articleshow/62094457.cms [https://perma.cc/U9B3-WPP3] (last updated Dec. 18, 2017) (explaining that anyone with advanced coding skills can create a cryptocurrency).

250. *See* King, *supra* note 68 (explaining that equity tokens provide holders with shares in the issuing entity).

251. *See id.* (stating that there have been few attempts to create or sell equity tokens); *see also supra* Part III.A (using DASH and the DAO token as examples of cryptocurrencies with management rights).

252. *See* Zainuddin, *Crypto ICO*, *supra* note 3 (explaining that ICOs do not grant ownership in companies); *see generally* Energy Premier, *supra* note 3 (inferring that IPOs grant ownership in companies, but ICOs do not).

253. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (citing S.E.C. v. W. J. Howey Co., 328 U.S. 293, 298 (1946)).

reality of ICOs and IPOs is that both seek to raise capital for a business enterprise through the creation and sale of financial instruments to investors.[254] Hence, because IPOs and ICOs are significantly similar, their procedural differences should be disregarded, and their shared function as public sales of financial instruments should be given preference.

IV. IDENTIFYING THE ICO PROBLEMS

Cryptocurrencies and ICOs not only share numerous characteristics with securities and IPOs in function, they also pose similar risks to investors. Following the Stock Market Crash of 1929, Congress felt that financial markets needed to be regulated more closely to protect investors from economic risks.[255] As a result, the Securities Act of 1933 and the Securities Exchange Act of 1934 (the Securities Acts) were enacted.[256] Many of the problems with fraud that Congress sought to cure in the securities market can also be found in current ICOs.[257] Also, ICOs could potentially pose even more risk to investors because of the pseudonymous nature of cryptocurrencies.[258] Despite this, the SEC has yet to enforce regulations uniformly or clearly when dealing with ICOs.[259]

A. A Brief History of Securities Regulation

Before the passage of the Securities Acts, securities were mainly regulated by "blue sky" laws.[260] Blue sky laws are state statutes that regulate the sale and trade of securities.[261] States passed these laws as a response to securities fraud in the United States.[262] After the Stock Market Crash of 1929

254. *See* Energy Premier, *supra* note 3; Smith, *supra* note 3; Zainuddin, *Crypto ICO*, *supra* note 3.

255. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194–95 (1976).

256. *See id.* (stating the purpose of the Securities Act of 1933 was to protect investors from fraud); *see also Tcherepnin*, 389 U.S. at 335–36 (stating that the Securities Exchange Act of 1934 should be broadly construed to give effect to the purpose of the Securities Act of 1933).

257. *See* Shifflett & Jones, *supra* note 6 (describing various ICOs with signs of fraud).

258. *See* DAO REPORT, *supra* note 13, at 9–10 (describing how an unknown person stole 3.6 million ETH in the DAO ICO).

259. *See* King, *supra* note 68 (stating that companies are unsure what is considered legal when dealing with equity tokens); *see generally* DAO REPORT, *supra* note 13, at 17–18 (explaining that cryptocurrencies may be subject to securities law depending on the specific facts and circumstances of the transaction).

260. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348–49 (1991).

261. *Id.* at 348.

262. *See id.* at 396–97.

resulted in the Great Depression, the federal government decided to uniformly regulate securities by passing the Securities Acts.[263] The Securities Acts sought "to control the abuses [of the stock market that were] believed to have contributed to the Great Depression."[264] Congress adopted mandatory disclosures as its main weapon for combatting securities fraud and restoring investor confidence in financial markets.[265] As a result, financial markets bounced back with enormous success.[266]

With financial markets thriving once again, many soon forgot how essential the Securities Acts were for ensuring the protection of investors.[267] As a result, the new millennia brought with it the massive accounting and securities fraud scandals of Enron and WorldCom that contributed to the recession of the early 2000s.[268] Congress once again stepped in and created new legislation, the Sarbanes-Oxley Act (SOX), to further regulate how public companies must disclose their financial records.[269] Despite SOX, securities fraudfeasors persisted in taking advantage of investors, resulting in the Financial Crisis of 2008.[270] Companies like American International Group (AIG) and Lehman Brothers continued to perpetuate fraudulent activity.[271] AIG lied to its shareholders by claiming it was not losing money, when in fact, it was hemorrhaging millions of dollars.[272] Lehman Brothers released misleading financial statements to the public to hide losses.[273] In the aftermath of the Financial Crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which, among other things, established new mandatory disclosure rules to combat securities fraud.[274]

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263. Justin Tyler Hughes, Note, *Equity Compensation and Informant Bounties: How Tying the Latter to the Former May Finally Alleviate the Securities Fraud Predicament in America*, 82 S. CAL. L. REV. 1043, 1044 (2009).

264. Tabetha Martinez, Note, *Amending Rule 10B-5: Sac Capital and the Willfully Blind Financial Executive*, 37 T. JEFFERSON L. REV. 447, 453 (2015).

265. Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOY. U. CHI. L.J. 669, 680–82 (2014).

266. *See id.* at 683.

267. *See id.* at 686–89.

268. *See id.* at 700–04.

269. *See id.* at 704–05; *see also* 15 U.S.C. § 7266(a) (2012) ("The [Securities and Exchange] Commission shall review disclosures made by issuers . . . which have a class of securities listed on a national securities exchange . . . on a regular and systematic basis for the protection of investors . . . includ[ing] a review of the issuer's financial statement.").

270. *See* Ramirez, *supra* note 265, at 707–09 (using Countrywide Financial's predatory lending practices as an example of securities fraud).

271. *See id.* at 712–15.

272. *Id.* at 712–14.

273. *See id.* at 714–15.

274. 12 U.S.C. § 5532(a) (2012) ("The Bureau [of Consumer Financial Protection] may prescribe rules to ensure that the features of any consumer financial product or service . . . are fully, accurately, and effectively disclosed . . . in a manner that permits consumers to understand the costs,

Thus, securities fraud was a catalyst for the Great Depression, the recession of the early 2000s, and the Financial Crisis of 2008.[275] The American people are invariably the ones who suffer when companies are not forced to make honest disclosures about their business.[276] Congress and government regulators have consistently adopted disclosures throughout the past century to combat securities fraud.[277] If companies had been transparent about their activities, perhaps investors could have been spared, at least partially, of the crippling financial losses brought on by the Stock Market Crash of 1929 and the recessions of the early 2000s and 2008.

B. ICO Fraud

Just as ICOs provide companies and investors with new financial tools, they also provide criminals with new avenues to perpetrate their schemes. Cryptocurrency fraud is becoming an increasingly larger issue for investors as the popularity of ICOs grows.[278] In May 2018, the Wall Street Journal (Journal) published the results of an investigation into 1,450 ICOs.[279] The Journal found that 271 of the offerings showed hallmark signs of fraud.[280] In addition to dishonest cryptocurrency sales, ICOs also present new security risks for investors. The more nodes a blockchain has, the more secure its network is.[281] Hence, if the number of computers volunteering as nodes reduces, the system becomes more susceptible to cyber-attack.[282] Finally, victims of

benefits, and risks."); *See* David Huntington & Paul, Weiss, Rifkind, Wharton & Garrison LLP, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 7, 2010), https://corpgov.law.harvard.edu/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation [https://perma.cc/4C6D-TFU6] (explaining that "the [Dodd-Frank] Act requires enhanced reporting and disclosure by the issuer [of asset-backed securities] regarding the quality of the assets underlying the securities").

275. Ramirez, *supra* note 265, at 678–80, 703–04, 720–21.

276. *See id.* at 737 (stating that securities fraud is a "threat to the American economy as a whole," and that "fraudulent information fuels booms and busts").

277. *See id.* at 680–87, 700–20 (discussing how Congress passed the Securities Acts and SOX to combat securities fraud with disclosure requirements following the Great Depression and the securities frauds of the early 2000s respectively).

278. *See* Shifflett & Jones, *supra* note 6 (discussing how "bitcoin fever" has caused regulators to issue public warnings of fraud).

279. *Id.*

280. *Id.*

281. *See supra* Part II.A (discussing how blockchain systems require host computers, also known as "nodes," to facilitate their networks).

282. *See* Rosic, *Blockchain Technology*, *supra* note 18 (explaining that multiple nodes hosting blockchain ledger is more secure than a central server).

cryptocurrency crimes have few options to be made whole again.[283] Fraudfeasors and hackers are difficult to track down due to the pseudonymous nature of blockchains.[284]

The results of the Journal's investigation into ICO fraud shed new light on how cryptocurrency fraudfeasors are taking advantage of investors. Many of the questionable ICOs in the investigation touted their leaders as exceptional business professionals with exhaustive resumes and experience.[285] However, upon closer examination, some of the purported executives' pictures were merely stock images taken from other websites.[286] There is no evidence that many of the named executives even exist.[287] The Journal identified Denaro as one of the companies touting a fake executive.[288] Denaro purported to be a company setting up "an online-payment project."[289] It listed Jeremy Boker as its co-founder and claimed that he had "a 'respectable history of happy clients' in consulting before he launched Denaro."[290] In reality, the photo of Mr. Boker was a picture of Jenish Mirani, a Polish banker.[291] The Journal reported that "there is no evidence [Jeremy Boker] exists and the rest of his team appears to be fictional."[292]

Despite the omens of fraud, Denaro was allegedly able to swindle investors out of $8.7 million before the thieves behind the alleged cryptocurrency project cashed out and disappeared.[293] However, Pluto Coin, a new company seeking to create an ICO, soon emerged after Denaro went dark.[294] Pluto Coin created a "similar website" and published "an identical whitepaper" to Denaro's.[295] Half of the employees claimed by Denaro are now listed on Pluto Coin's website as part of its team.[296] Even worse, some of the ICO

283. *See* Lyla Armur, *CSI Crypto: Can Victims Recover Stolen Coin?*, BRAVE NEW COIN (Oct. 12, 2017, 12:06 PM), https://bravenewcoin.com/insights/csi-crypto-can-victims-recover-stolen-coin [https://perma.cc/738R-AL3B].

284. *See* Tyler Elliot Bettilyon, *Cryptocurrency's Criminal Revolution*, MEDIUM (July 12, 2018), https://medium.com/s/story/cryptocurrencys-criminal-revolution-6dae3cdf630f [https://perma.cc/W726-F9QG] (discussing how blockchain technology makes it difficult for law enforcement to catch or track cyber-criminals utilizing it).

285. *See* Shifflett & Jones, *supra* note 6.

286. *Id.*

287. *Id.*

288. *Id.*

289. *Id.*

290. *Id.*

291. *Id.*

292. *Id.*

293. *See* JP Buntix, *Denaro ICO Raises $8.7m and Goes up in Smoke*, LIVE BITCOIN NEWS (Mar. 23, 2018, 1:01 PM), https://www.livebitcoinnews.com/denaro-ico-raises-8-7m-and-goes-up-in-smoke [https://perma.cc/7DCB-2TWJ].

294. Shifflett & Jones, *supra* note 6.

295. *Id.*

296. *Id.*

companies the Journal investigated did not bother with creating fictitious executives and simply failed to name any employees whatsoever.[297]

The Journal also found that 111 of the ICO white papers evaluated contained portions that were copied verbatim from other white papers.[298] The copied sections included "descriptions of marketing plans, security issues and even distinct technical features such as how other programmers can interact with their database."[299] LoopX was one of the companies identified to have plagiarized other white papers.[300] After claiming to have raised $4.5 million, LoopX's website was shut down "and its Twitter account [now] features a single message linking to a news article alleging the founder or founders ran off with the money."[301] Additionally, the Journal found that over twenty-four of the companies analyzed "promised investors financial rewards without any risk—something the SEC prohibits."[302] PlexCorps, one of the companies making unrealistic investment guarantees, had its assets frozen by the SEC after it raised approximately $15 million.[303]

A significant number of the cryptocurrency fraud schemes could be prevented if SEC IPO regulations were applied to ICOs. Instead of the government vetting companies before they go public, investors are compelled to thoroughly investigate the legitimacy of ICOs.[304] ICO fraud could successfully be combatted by requiring companies to register with the SEC when they wish to facilitate their own ICOs.[305] However, fraud is not the only concern for ICO investors. Security breaches in ICOs have caused the public to reevaluate whether blockchain technology is as secure as previously theorized.[306]

C. *ICO Security Risks*

The global accounting firm Ernst & Young (EY) released a report on ICOs in December 2017.[307] It listed seven main types of cyber-attacks used

297. *Id.*
298. *Id.*
299. *Id.*
300. *See id.*
301. *Id.*
302. *Id.*
303. *See id.*
304. *See id.*
305. *See infra* Part V (discussing three possible solutions to mitigating the risks of ICO fraud).
306. *See* ERNST & YOUNG, EY RESEARCH: INITIAL COIN OFFERINGS (ICOS), at 2 (2017), https://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf [https://perma.cc/C7LT-YFM9] ("More than 10% of ICO proceeds are lost as a result of [cyber-]attacks.").
307. *Id.* at 1.

by ICO hackers.[308] According to the report, the most prevalent form of ICO cyber-attacks is "phishing."[309] Phishing is "a scam by which an Internet user is duped (as by a deceptive e-mail message) into revealing personal or confidential information which the scammer can use illicitly."[310] In the ICO context, phishing is accomplished by a hacker disabling the original ICO website and then creating a "clone" of it posing as the original.[311] Investors then sign in to what they believe is a legitimate website and send cryptocurrency to the hacker's address in an attempt to buy the altcoin or token.[312] According to EY, "[t]he likelihood of crypto funds being returned [to the investor] is close to zero."[313]

ICO phishing not only compromises funds that are used in cryptocurrency transactions, but also can compromise the private keys of investors.[314] With this information, criminals can access all the funds that investors have stored on an individual blockchain address.[315] Hence, ICO phishing could result in investors having all the cryptocurrency drained from their accounts. Phishing is not made possible by a design flaw in an ICO's security protocols, per se. It is merely the result of investors being tricked into handing over personal information.[316] However, other types of cyber-attacks can be directly attributed to flaws in an ICO's design.

Direct attacks on cryptocurrency trading platforms and ICO program coding are also concerns.[317] The exchanges on which cryptocurrencies are traded are also susceptible to cyber-attacks.[318] The average loss from a cyber-attack on a banks is approximately $1.5 million.[319] However, more often than not, the funds stolen in bank security breaches are insured.[320] On the other hand, cryptocurrency exchanges have lost $15 Billion due to hacking as of

308. *Id.* at 31 (listing phishing, distributed denial of service attacks, website and application hacks, attacks through employees, IT infrastructure attacks, attacks on investors, and the hacking of cryptocurrency exchanges and wallets as the types of cyber-attacks used by ICO hackers).

309. *Id.* at 32.

310. *Phishing*, MERIAM-WEBSTER ONLINE DICTIONARY (2018), https://www.merriam-webster.com/dictionary/phishing [https://perma.cc/9YKY-MURW].

311. *See* ERNST & YOUNG, *supra* note 306, at 32.

312. *See id.*

313. *Id.*

314. *See id.*

315. *See* Rosic, *Blockchain Technology*, *supra* note 18 (explaining how private keys function like passwords and give access to funds stored on blockchain public keys).

316. ERNST & YOUNG, *supra* note 306, at 32 (explaining how investors might unwittingly give their account information to hackers in ICO phishing schemes).

317. *See id.* at 31, 34 (listing the most common types of cyber-attacks on ICOs and using a timeline to demonstrate that hackers also target cryptocurrency exchanges).

318. *See id.* at 34.

319. *Id.* at 33.

320. *Id.*

2017 with few of them ever being recovered.[321] The anonymity, permanence of transactions, and rush and chaos of information associated with cryptocurrency exchanges also makes them more attractive targets than banks.[322] In addition to funds being stolen from traders on exchanges, investors also risk personal information being misused or stolen.[323] Large cryptocurrency exchanges require multiple forms of identification before one is permitted to trade the platform.[324] This information includes identification papers and credit card photocopies, phone numbers, and bank account information.[325] EY revealed that "[m]ost exchanges do not disclose policies and controls over personal data storage and use . . . . [A]nd chances of [the information's] misuse are high even without a breach."[326] Since 2012, the frequency of cryptocurrency exchange hacking has increased.[327] In some cases, the exchanges were shut down as a result and investors received little or no compensation for their stolen funds.[328]

The security benefits touted by blockchain advocates rely on the fact that numerous nodes are hosting the blockchain ledger.[329] Unlike miners, who are incentivized by monetary gain, many node operators are merely volunteers who donate their computing power to the blockchain.[330] Additionally, not all nodes are kept running 24 hours a day.[331] As a result, the number of active nodes is in constant flux.[332] Relying on volunteers who have no incentive to host the blockchain ledger may cause significant financial security issues moving forward if these node operators lose interest. Decommissioning or turning off a significant number of the nodes, even temporarily, could

321. Jim Finkle and Jeremy Wagstaff, *Hackers steal $64 million from cryptocurrency firm NiceHash*, REUTERS (Dec. 6, 2017), https://www.reuters.com/article/us-cyber-nicehash/hackers-steal-64-million-from-cryptocurrency-firm-nicehash-idUSKBN1E10AQ.

322. ERNST & YOUNG, *supra* note 306, at 33.

323. *See id.*

324. *Id.*

325. *Id.*

326. *Id.*

327. *Id.* at 34.

328. *Id.* (describing six major cryptocurrency exchange hacks between March 2012 and July 2017).

329. Florian Haffke, *Decreasing Number of Full Nodes in the Bitcoin Network*, TECHNICAL U. MUNICH (Mar. 28, 2017), https://www.blockchain.tum.de/index.php?id=95&tx_ttnews%5Btt_news-%5D=1&cHash=f31347bf636c0038f4652b42ffd4bc64&L=1 [https://perma.cc/CQW2-P92E].

330. *See* Jamie Redman, *Should Full Bitcoin Nodes Get Rewarded like Miners?*, BITCOIN.COM (Feb. 11, 2016), https://news.bitcoin.com/full-bitcoin-nodes-get-rewarded-like-miners [https://perma.cc/6JFL-2UMS] ("Bitcoin miners are offered an incentive to process transactions, which include freshly created digital coins as well as transaction fees. . . . Currently, there is no incentive to run a full node within the [Bitcoin] ecosystem.").

331. Cawrey, *supra* note 41 (discussing how a portion of Bitcoin nodes are only operating during the day).

332. *See Global Bitcoin Nodes Distribution*, BITNODES, https://bitnodes.earn.com/dashboard [https://perma.cc/C377-876S] (tracking the total number of active BTC nodes).

lead to catastrophic consequences by exposing the network to attacks.[333] Hence, there is no guarantee that a blockchain will be just as secure today as it was yesterday.

The code with which ICOs are set up can be compromised as well. A prime example of an ICO's coding being manipulated is the DAO hack.[334] The DAO token was constructed on the Ethereum blockchain network.[335] Slock.it, the company behind the DAO ICO, initiated an offering period for the DAO token from April 30, 2016 to May 28, 2016.[336] By the end of the period, the DAO had raised 12 million ETH, or $150 million.[337] In late May of 2016, Slock.it noticed that the DAO's code was vulnerable to manipulation.[338] One of the co-founders suggested a halt on all proposals for the DAO until the code was updated.[339] However, before Slock.it was able to fix the code, an unknown hacker siphoned about a third of the total ETH from the company's blockchain address, or $55 million.[340] Fortunately, the thief was barred from dispersing the funds from his or her address due to a failsafe parameter written into the DAO code.[341] The code barred anyone from pulling out their money from the DAO immediately.[342] Instead, investors wanting to pull out their funds had to wait 27 days from the initial withdrawal request, and then an additional seven days after that.[343] Within that time, Slock.it was able to work with Ethereum to change the blockchain coding to retrieve all funds raised from the DAO ICO into a new address.[344] From there, Slock.it allowed holders to trade in their DAO tokens for their original investment.[345] The identity of the DAO hacker is still unknown.[346]

333. *See* Shirley Siluk, *What Happens to Bitcoin if the Lights Go Out?*, COINDESK (May 30, 2013), https://www.coindesk.com/what-happens-to-bitcoin-if-the-lights-go-out [https://perma.cc/A8A7-U7BJ].

334. DAO REPORT, *supra* note 13, at 9 (describing the DAO cyber-attack of June 17, 2016).

335. *Id.* at 3 n.7.

336. *Id.* at 6.

337. *Id.* at 3.

338. *Id.* at 9.

339. *Id.*

340. Matthew Leising, *The Ether Thief*, BLOOMBERG (June 13, 2017), https://www.bloomberg.com/features/2017-the-ether-thief [https://perma.cc/8VQU-AX3L].

341. *Id.*

342. *Id.*

343. *Id.*

344. DAO REPORT, *supra* note 13, at 9.

345. *Id.* at 9-10.

346. *See* Leising, *supra* note 340 (describing that, even a year after the DAO hack, the only identifying information known about the hacker or hackers is the pseudonymous blockchain public keys used in the attack).

Had it not been for the failsafe protocol that restricted investment fund movements on the blockchain, the DAO could have been robbed of millions.[347] However, the DAO's happy ending of investors' funds being returned is the exception when blockchain cyber-attacks occur.[348] There are few avenues of recourse for victims of cryptocurrency crimes.[349] Victims can file complaints with the FBI's Cyber Criminal Unit.[350] Additionally, victims can also sue operators of exchanges and ICOs for negligence to be made whole again.[351] Unfortunately, both options require a great deal of time with no guarantee of restitution.[352]

Given the propensity for cyber-crime and the security risks in the issuance and trading of cryptocurrencies,[353] measures need to be taken to protect investors. Government agencies are slowly realizing how enormous a problem cryptocurrency crime can be.[354] Unfortunately, government authorities have not clearly defined what constitutes a security or commodity contract in the context of cryptocurrencies.

D. Unclear Government Regulation

The SEC and the CFTC have yet to agree which of them has authority over cryptocurrencies and, more specifically, ICOs. The CFTC argues that all digital currency falls under the definition of a commodity.[355] The SEC has taken a softer approach by stating that whether a cryptocurrency is a security

347. *See id.*

348. *See* Armur, *supra* note 283; Jenima Kelly et al., *Cryptocurrencies: How Hackers and Fraudsters are Causing Chaos in the World of Digital Financial Transactions*, INDEP. (Oct. 8, 2017, 12:31 PM), https://www.independent.co.uk/news/business/analysis-and-features/cryptocurrencies-hackers-fraudsters-digital-financial-transactions-bitcoin-virtual-currency-failures-a7982396.html [https://perma.cc/BC2Y-Y9HR] ("There have been at least three dozen heists of cryptocurrency exchanges since 2011. . . . More than 980,000 bitcoins have been stolen. . . . Few have been recovered.").

349. *See* Armur, *supra* note 283.

350. *Id.*

351. *Id.*

352. *See id.*

353. *See* Ana Alexandre, *New Study Says 80 Percent of ICOs Conducted in 2017 Were Scams*, COINTELEGRAPH (July 13, 2018), https://cointelegraph.com/news/new-study-says-80-percent-of-icos-conducted-in-2017-were-scams [https://perma.cc/SL9X-NU3G] ("A recent study . . . revealed that more than 80 percent of [ICOs] conducted in 2017 were identified as scams."); ERNST & YOUNG, *supra* note 306, at 33–34 (explaining that ICOs and cryptocurrency exchanges are susceptible to hacking).

354. *See* Armur, *supra* note 283.

355. *See* CFTC Coinflip Order, *supra* note 169, at *2 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.").

depends on the facts and circumstances surrounding it.[356] While the two government agencies appear to be in a pointless tug of war for regulatory power, white-collar criminals are taking advantage of the confusion created by it.[357]

The CFTC's characterization of cryptocurrencies, while extremely broad and inclusive, has the advantage of simplicity. The agency leaves no room for confusion over how cryptocurrencies should be treated. Its approach is that if a transaction involves cryptocurrency, the CFTC has total authority to regulate it.[358] To an extent, this approach helps ICO issuers and investors because cryptocurrency users would know which laws apply to their transactions without any ambiguity. Rather than trying to navigate inconsistent applications of bureaucratic regulations, issuers and traders would have a clear picture of how to properly operate within the bounds of the law.

The SEC's approach is not as simple, but it recognizes the novel nature of cryptocurrencies. By choosing to apply the *Howey* test on a case by case basis,[359] the SEC has indicated that, while many may be securities, not all cryptocurrencies necessarily fit under the definition. Even though this nuanced approach more accurately reflects the realities of cryptocurrency,[360] it leaves users in a cloud of uncertainty about when securities law disclosure and registration requirements are applicable. Reasonable minds could differ on the outcome of a *Howey* test analysis.[361] Without knowing whether securities law is applicable, innocent and honest issuers and investors could unwittingly expose themselves to criminal and civil legal action.

Both agencies' approaches have their weaknesses and strengths. A blanket application of either securities or commodities trading laws would provide clarity to a murky area of government regulation.[362] At the same time,

356. *See* DAO REPORT, *supra* 13, at 17 (stating that whether a cryptocurrency is a security "depend[s] on facts and circumstances").

357. *See supra* Part IV.B (discussing the fraud schemes and cyber-crimes that plague cryptocurrency markets).

358. CFTC Coinflip Order, *supra* note 169, at *2–3 (explaining that cryptocurrencies are commodities and that the CEA therefore applies to transactions involving them).

359. *See* DAO REPORT, *supra* 13, at 17 (stating that whether a cryptocurrency is a security "depend[s] on facts and circumstances"); *see also* United States v. Zaslavskiy, 2018 WL 4346339, at *4–7 (E.D.N.Y. Sept. 11, 2018) (applying the *Howey* test to the virtual currencies offered by the companies REcoin and Diamond Reserve Club).

360. *See supra* Part III (describing the similarities of cryptocurrencies with securities and commodity contracts).

361. *See, e.g.*, *supra* Part III.A (applying the *Howey* test to Musicoin and not being able to definitively determine whether MUSIC constitutes and investment contract).

362. *See* Benjamin Bain & Camila Russo, *U.S. Crypto Regulatory Fight Has Everything But Rules: QuickTake*, BLOOMBERG: QUICKTAKE (May 14, 2018, 1:12 PM), https://www.bloomberg.com/news/articles/2018-05-14/crypto-regulators-vs-lobbyists-is-dc-shirts-and-skins-quicktake [https://perma.cc/3KUS-ST9B] (discussing the lack of clarity from government regulators).

however, cryptocurrencies share many functional similarities with both securities and commodity contracts.[363] Since not all cryptocurrencies are created equal,[364] regulating them uniformly as one or the other would ignore their unique nature. Applying a case by case approach to each cryptocurrency would yield more accurate results in classifications, but this approach is not without its shortcomings. Depending on who applies the *Howey* test, it could yield different conclusions as to whether a specific cryptocurrency is a security. Hence, a middle ground approach to cryptocurrency regulation would better serve financial markets and protect investors.

V. THREE POTENTIAL SOLUTIONS TO ICO INVESTOR EXPOSURE

While there is no consensus for a solution to regulating ICOs, the current system must change and do so quickly to protect investors.[365] Regulators have several options for mitigating investor risks. First, the federal government could simply outlaw ICOs and the trading of cryptocurrencies, thus eliminating any risks completely. Second, regulators could choose to apply securities law uniformly to all coins and tokens. Third, the government could temporarily apply securities law until Congress passes new laws dealing with cryptocurrency regulation.

Outlawing ICOs altogether is a drastic approach. Nevertheless, China has chosen to adopt this solution.[366] However, the ban has proved less effective than Chinese regulators had hoped.[367] Cryptocurrency traders have continued to operate in defiance of the Chinese government through offshore networks.[368] Surprisingly, Chinese ICO activity increased since the regulations were instituted.[369] While many are fraudulent,[370] legitimate ICOs have proven to be a lucrative and useful method of crowdfunding various projects for tech companies.[371] Eliminating ICOs completely would be like using an

363. *See supra* Part III (identifying the similarities and differences of cryptocurrencies with securities and commodity contracts).

364. *See id.* (analyzing various examples of cryptocurrencies and explaining how each function differently).

365. *See supra* Part IV.B (explain the numerous fraud and security risks that cryptocurrency investors face).

366. Choudhury, *supra* note 15.

367. Kieran Smith, *China ICO Ban Proving Ineffective*, BRAVE NEWCOIN (May 9, 2018, 1:40 PM), https://bravenewcoin.com/insights/china-ico-ban-proving-ineffective [https://perma.cc/29SK-CFKU] [hereinafter Smith, *China ICO Ban*].

368. *Id.*

369. *Id.*

370. *See* Alexandre, *supra* note 353 (stating that a report found 80% of ICOs in 2017 were scams).

371. *See* Williams-Grut, *supra* note 5 (describing the 11 largest ICOs of 2017).

axe when a scalpel is required. As evidenced by China, companies and investors would continue to participate in ICOs even if they are deemed illegal. More stringent and tailored policing of ICOs would allow companies and investors to continue to reap the benefits of the cryptocurrency market while reducing the cyber-crime associated with it.

The ICO and IPO processes are similar enough that applying U.S. securities laws to ICOs would significantly reduce the propensity for fraud.[372] The remedial measures following the past financial crises reveal how effective disclosure and registration requirements are.[373] By forcing registration of companies wishing to facilitate an ICO, many of the current fraud schemes would fall apart. ICO fraudfeasors would no longer be able to hide behind a shroud of anonymity because they would be forced to disclose, among numerous other information, their purported companies' executives along with documentation to ensure its legitimacy.[374] The drawback of this solution is that it does not address the security issues associated with blockchain technology.[375] Additionally, applying IPO regulations to ICOs would prevent many of the companies that wish to have an ICO from doing so. Complying with registration under the Securities Acts is an extremely expensive and lengthy ordeal.[376] Hence, most small and young start-up companies, which frequently utilize ICOs, would likely be unable to afford the process.[377] The SEC also requires financial track records to be submitted, and many of the infant tech companies that benefit from ICOs would be too young to be able to provide strong financial histories.[378] This solution is not perfect because it would likely alienate companies benefitting from ICOs the most, but it would reduce the ease with which fraud can be perpetrated in the cryptocurrency markets.

372. *See supra* Part III.C (comparing the ICO and IPO processes).

373. *See supra* Part IV.A (discussing how the disclosure requirements instituted by the Securities Acts, SOX, and Dodd-Frank Act are effective when adhered to).

374. *See supra* Part III.C (discussing the numerous disclosure requirements for companies facilitating ICOs).

375. *See supra* Part IV.B (describing the investor security risks associated with cryptocurrencies).

376. *See Considering an IPO to Fuel Your Company's Future?*, *supra* note 236 (stating that the average cost of an IPO is $4.2 million with an additional underwriting fee that ranges from 4-7% of gross proceeds).

377. *See* Gilbert Darrell, *Why ICO's Will Be the Future of Startup Funding*, MEDIUM (July 22, 2018), https://medium.com/@artiedarrell/why-icos-can-be-the-future-of-startup-funding-1611cd54025b [https://perma.cc/UX2K-QM5C] (stating that an ICO "is the ability for a company usually (for now at least) a start-up or early-stage Enterprise, to raise capital from a global community to fund a future product or service").

378. *See id.* (explaining that ICOs are fundraising tools used by "start-up[s] or early-stage Enterprise[s]").

The best solution would be to temporarily apply the IPO regulations to ICOs until Congress passes legalization better equipped to encourage cryptocurrency market innovation while protecting investors. A report performed by the Statis Group, an ICO advisory firm, found that scams received only 11% of the total funds invested in all ICOs during 2017.[379] However, the report also revealed that over 80% of all 2017 ICOs were scams.[380] Hence, immediate regulatory action must be taken to combat ICO fraud. Applying the IPO regulations could temporarily stifle the ICO market, but the occurrence of ICO fraud is too frequent to let it go unchecked.

Ideally, the legislation would regulate all ICOs uniformly. Since ICOs and IPOs bear many similarities, the new regulations could be based on the existing securities registration laws. Mandatory reporting and disclosure requirements, plus a standard for white paper proposals, should be established. The submission process could be streamlined and accessible to more businesses than IPOs to allow younger companies with shorter financial track records to continue to participate. If Congress does not want to create a new agency to implement the ICO regulations, then a new division within an existing agency should be sufficient. Since the SEC is the entity that deals with IPOs, it would probably be the best equipped to oversee the ICO process.

The new regulations should allow companies to submit their white papers to regulating government entity (Government Regulator) whose purpose would be to determine whether the cryptocurrency project constitutes the trading of securities or commodities contracts in secondary markets. Again, this entity could even be a subdivision of the SEC or CFTC rather than an entirely new agency. The Government Regulator would determine whether the SEC or CFTC has jurisdiction to regulate the proposed cryptocurrency. All ICOs would be treated uniformly, but whether a cryptocurrency's trading on secondary markets will be treated as commodities or securities would depend on the Government Regulator's findings.

Finally, the proposed cryptocurrency laws should also require ICO issuers and cryptocurrency exchanges to have minimum cybersecurity standards. Currently, security is not prioritized in the ICO process as much as attracting investors.[381] Having minimum security standards would increase the cost of facilitating an ICO, but it is necessary, given how easily cryptocurrencies have been compromised historically.[382] The need for security is amplified by

379. SHERWIN DOWLAT, MICHAEL HODAPP & STATIS GROUP, CRYPTOASSET MARKET COVERAGE INITIATION: NETWORK CREATION 25 (2018), https://research.bloomberg.com/pub/res/d28giW28tf6G7T_Wr77aU0gDgFQ [https://perma.cc/E6ZZ-ZUGJ].

380. *Id.* at 1.

381. ERNST & YOUNG, *supra* note 306, at 30.

382. *See supra* Part IV.B (discussing the security issues associated with cryptocurrency trading).

the fact that crypto-criminals are hard to trace because of the pseudonymous nature of blockchain technology.[383]

Ultimately, the government must be uncharacteristically swift to act to protect investors. The magnitude of cryptocurrency-related cyber-crimes is alarming. Hence, investors need to be protected, but not at the cost of shutting down an entire arm of financial markets. If investors want to participate in ICOs, they will ultimately find a way.[384] At the same time, the government should not prevent young companies from utilizing ICOs by applying the burdensome requirements that are characteristic of IPOs. A balanced solution should be instituted and quickly.

VI. CONCLUSION

ICOs can be extremely useful financial tools, allowing investors to reap enormous benefits while providing young and old companies alike with a new avenue with which to raise capital. However, cybersecurity issues and fraudulent crowdfunding projects are extremely prevalent in ICOs. The pseudonymous nature and anonymity that coins and tokens provide arguably make financial fraud easier than ever. Eliminating ICOs, however, would not be prudent or effective. Many companies and individuals have already utilized ICOs and proved they can be lucrative for both issuers and investors absent fraud and security breaches. The SEC should, at the very least, make the IPO registration requirements of securities applicable to all ICOs. Ideally, this would only be a temporary solution until Congress drafts legislation tailored to the nature of cryptocurrencies that allows them to retain most of the characteristics which make ICOs so attractive to companies and investors alike. The government should encourage economic innovation, but it must quickly adapt to technological advances in financial markets to protect investors.

383. *See* Bettilyon, *supra* note 284 (describing how blockchain technology makes tracking cryptocurrency crime difficult).

384. *See* Smith, *China ICO Ban*, *supra* note 367 (describing how ICO participation in China has increased even after the government outlawed them).

OVERDOSED: ANALYZING THE CAUSES AND POTENTIAL SOLUTIONS FOR HIGH PRESCRIPTION DRUG PRICES IN THE UNITED STATES

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I. INTRODUCTION

The problem of rising drug prices has long plagued the United States.[1] With an aging population, and continued political disagreement about what can be done, a legal analysis of the current state of legislation surrounding drug prices is in order. This Comment will help aid the important conversations that are to follow by giving a thorough background of the problem, and some potential solutions to solve it.

Part I will first analyze the drug system in the United States, noting some foundations which I will build on throughout this Comment. This Section will include the problems that the drug prices pose on a vulnerable population, and normal citizens. Part II will address why and how drugs have become so expensive, including the detailed concerns with the Federal Drug Administration (FDA) waiting period that legalizes a monopoly. This section will analyze both the benefits and the arguments against the FDA waiting period as analyzed by Congress and others. Part III will address the parties that are currently in charge of drug price regulation, and some problems they may be facing. Part IV addresses current proposals aimed at helping some of these problems. Finally, Part V describes some additional laws and policies that could be of further help in fixing this epidemic. Ultimately, until legislation is enacted that directly combats the price of drugs or that gives regulatory agencies more power to monitor price increases and effectively enable more

1. *See* Jay Hancock, *Everyone Wants to Reduce Drug Prices. So Why Can't We Do It?*, N.Y. TIMES (Sept. 23, 2017), https://www.nytimes.com/2017/09/23/sunday-review/prescription-drugs-prices.html [https://perma.cc/F5Q3-MGHX]; Jessica Wapner, *How Prescription Drugs Get Their Prices, Explained*, NEWSWEEK MAG. (Mar. 17, 2017, 8:00 AM), http://www.newsweek.com/prescription-drug-pricing-569444 [https://perma.cc/Z6VN-N7JF]; Sam Kaplan, *Why Prescription Drugs Cost So Much*, AARP BULL. (May 1, 2017), https://www.aarp.org/health/drugs-supplements/info-2017/rx-prescription-drug-pricing.html [https://perma.cc/E79N-J6XG]; Ginger Skinner, *Americans Say They Are Suffering as Drug Costs Continue to Rise*, CONSUMER REPS. (Dec. 14, 2017), https://news.yahoo.com/americans-suffering-drug-costs-continue-210754196.html [https://perma.cc/E2DQ-HMZU].

direct and substantive competition between drug manufacturers, there is no reason to believe that drug prices will fall.

Likely the entire United States population, at some point in their life, relies on prescription drugs to help bounce back from sickness, or to actively fight against various debilitating illnesses. Despite their targeted purpose, prescription drugs are often billed as "miracle drugs," giving those desperate for a solution to their health problem what appears to be a silver bullet to good health.[2] Indeed, this unrealistic expectation of what prescription drugs can do is perpetuated by Hollywood, in movies like *Lucy* or *Limitless*.[3] The real injury, though, are to those that have no choice but to rely on prescription drugs to combat debilitating health crises, such as cancer or dialysis. While some of the high costs of combating these illnesses are covered by insurance, "the federal government reported that Americans" spent "$41 billion in out-of-pocket expenses" to pay for these prescription drugs.[4] Indeed, a large number of bankruptcies are often caused by medical-related debt, where debtors purchase their prescription drugs with credit cards, which they are subsequently unable to pay off.[5]

Cancer treatment costs are one example of how impactful drug prices are on the 15 million Americans living with a cancer history today.[6] According to the American Cancer Society, "[i]n 2014, cancer patients paid nearly $4 billion out-of-pocket for cancer treatments."[7] Roughly 12% of the $87.8 billion dedicated to fighting cancer was spent on prescription drugs.[8] There is no question that "[a]ccess to quality health insurance is essential to making cancer care affordable for patients and survivors," but lowering costs of prescription drugs is also essential to lessening the out-of-pocket burden on cancer patients.[9]

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2. *See* Martha Rosenberg, *6 'Miracle' Drugs Big Pharma Now Regrets*, ALTERNET (Oct. 27, 2016), https://www.alternet.org/personal-health/6-miracle-drugs-big-pharma-now-regrets [https://perma.cc/6UG5-TWM7].

3. *See, e.g.*, LIMITLESS (Relativity Media 2011); LUCY (EuropaCorp 2014).

4. Dan Mangan, *Medication Costs Fuel Painful Medical Debt, Bankruptcies*, CNBC, https://www.cnbc.com/2014/05/28/costs-fuel-painful-medical-debt-bankruptcies.html [https://perma.cc/9CHE-CAUW] (last updated May 29, 2014, 12:51 PM).

5. *Id.*

6. JENNIFER SINGLETERRY, THE COSTS OF CANCER, AM. CANCER SOC'Y CANCER ACTION NETWORK 2 (April 2017), https://www.acscan.org/sites/default/files/Costs%20of%20Cancer%20-%20Final%20Web.pdf [https://perma.cc/QXD9-WZ3R].

7. *Id.*

8. *Id.*

9. *Id.* at 3.

Like cancer patients, dialysis patients face staggering healthcare costs.[10] Dialysis is a lifesaving treatment for those with severe medical disease.[11] The medical costs for chronic kidney disease are so expensive that it accounts for 7% of the Medicare budget, even though those afflicted by the disease are only 1% of the Medicare population.[12] Those needing dialysis—likely hemodialysis, which 90% of all dialysis patients require—costs $89,000 per patient, amounting to roughly $42 billion a year.[13] While a majority of this cost is absorbed through some type of insurance—i.e., Medicare, Medicaid, or private insurance—at least some portion of this cost may be paid by the patient as an out-of-pocket expense.[14] Regardless of the percentage that the patient is required to pay, it is clear that reducing the price of drugs that are critically needed will help lower health insurance costs for the government, private insurance companies, and the out-of-pocket responsibility of the patient.

The United States, far and away, spends the most on prescription drugs than any other high-income country on the planet.[15] Compared to nine other high-income countries—namely: Switzerland, Germany, Canada, France, United Kingdom, Australia, the Netherlands, Norway, and Sweden—our per capita spending on prescription drugs is between 30% and 190% higher.[16] Despite the per capita spending on prescription drugs, the percent of total health spending on prescription drugs is well in line with the average of other countries, suggesting that, in addition to paying more per person than high-income countries for prescriptions, we are also paying more than other high-income countries for other aspects of our health spending.[17]

While it is staggering to note that we pay such high prices for prescription drugs, the most alarming trend associated with prescription prices is the rate at which prices have risen in the United States compared to other high-income countries.[18] Through the 1980's and well in to the 1990's, the United

10. *See* NAT'L INST. OF DIABETES & DIGESTIVE & KIDNEY DISEASES, U.S. RENAL DATA SYS., USRDS ANNUAL DATA REPORT: ATLAS OF END-STAGE RENAL DISEASE IN THE UNITED STATES, vol. 2, 325, 328, 332 (2013), https://www.usrds.org/2013/pdf/v2_ch11_13.pdf [https://perma.cc/3JR5-LT92]; Statistics for *The Kidney Project*, U. CAL. S.F., https://pharm.ucsf.edu/kidney/need/statistics [https://perma.cc/ZKP5-EZEK].

11. *See When Do I Need Dialysis?*, WEBMD, https://www.webmd.com/a-to-z-guides/kidney-dialysis#1 [https://perma.cc/A6CJ-DLXQ].

12. Statistics for *The Kidney Project*, *supra* note 10.

13. *Id.*

14. *Id.*

15. Dana O. Sarnak et al., *Paying for Prescription Drugs Around the World: Why Is the U.S. an Outlier?*, THE COMMONWEALTH FUND (Oct. 5, 2017), http://www.commonwealthfund.org/publications/issue-briefs/2017/oct/prescription-drug-costs-us-outlier [https://perma.cc/3J9N-BUL4].

16. *Id.*

17. *Id.*

18. *See id.*

States' per capita spending on pharmaceuticals was well within the range of our high-income peers.[19] However, since 1998, while other countries have seen increases in prescription spending per capita, the United States' spending per capita has increased significantly by roughly 215% percent.[20] It is important to note that the price spike is not only associated with brand name drugs, but recently in generics as well.[21]

Despite drug utilization being similar between the United States and the other countries, "the prices at which [the same] drugs are sold in the U. S. are substantially higher."[22] Comparing the prices of six "blockbuster" drugs—Crestor, Lantus, Advair, Januvia, Humira, and Sovaldi—with other high-income countries highlights this discrepancy.[23] Examining the United States' prices, without discounts given to consumers, against the next highest price paid by a high-income country: Crestor is 113% more expensive in the United States; Lantus is 178% more expensive; Advair is 109% higher; Januvia is 148% more; Humira is 43% more expensive; and Sovaldi is 4% more expensive.[24] These high prices, in addition to the dramatic increase in prices in recent years, has only solidified the view of pharmaceutical companies and their chief executives as villains in the eyes of the public.[25]

A. Effects on the Government

These high costs effect more than just those who directly purchase them—they directly impact the government through Medicaid and Medicare spending, and those who have private insurance. First, the impact on government through Medicaid is easy to identify. Medicaid is a government program that "provides health coverage to millions of Americans, including eligible low-income adults, children, pregnant women, elderly adults and

19. *Id.*

20. *Id.* (citing to embedded Exhibit 1, https://infogram.com/paying-for-prescription-drugs-around-the-world-why-is-the-us-an-outlier-exhibit-1-1g8e207n3rnqmod [https://perma.cc/T3JJ-GP4V] with data gathered from Organisation for Economic Co-operation and Development, 2017; Data for Australia and Canada from 2014).

21. Peter Jaret, *Prices Spike for Some Generic Drugs*, AARP BULL. (July/August 2015), http://www.aarp.org/health/drugs-supplements/info-2015/prices-spike-for-generic-drugs.html [https://perma.cc/JV8X-T3W8].

22. Sarnak et al., *supra* note 15.

23. *See id.*

24. *See id.* (citing to data gathered from Robert Langreth et al., *The U.S. Pays a Lot More for Top Drugs Than Other Countries*, BLOOMBERG (Dec. 18, 2015), https://www.bloomberg.com/graphics/2015-drug-prices [https://perma.cc/Q974-8T35]).

25. *See* Madeleine Sheehan Perkins, *The Life of 'Pharma bro' Martin Shkreli, Who Was Convicted of Securities Fraud and Faces Up To 20 Years in Prison*, BUS. INSIDER (Aug. 4, 2017 11:15 PM), http://www.businessinsider.com/pharma-bro-who-is-he-martin-shkreli-convicted-2017-8 [https://perma.cc/NY8R-H9VM].

people with disabilities. Medicaid is administered by states, according to federal requirements. The program is funded jointly by states and the federal government[,]"[26] and, as of the June 2019 enrollment report, there are currently 65.6 million people covered by the program.[27] Including the Childhood Health Insurance Program (CHIP), the number of persons covered jumps to over 72 million.[28] Since the government provides the insurance to the covered persons, they are responsible for covering a vast majority of the prescription drug prices when prescriptions are filled. Thus, it is clear that a vast sum of the high price paid by those who purchase prescription drugs rests with the government, which covers a large portion of this cost for nearly a fifth of all Americans.[29]

The government feels a similar, if not more pronounced, impact on those prescriptions it covers through those people on Medicare. Medicare is a government program similar to Medicaid, but almost exclusively covers those who are near the retirement age of 65.[30] There are several types of Medicare, including Part A and Part B, and Part B acts more like traditional insurance, covering outpatient services, medical supplies, and preventative services.[31] The monthly premium for this Medicare Part B is a fixed $135.50, which helps offset some of the government costs associated with the program.[32] However, since prescription drug prices are so high, and those over 65 are much more likely to need prescription drugs, Medicare requires a separate prescription plan to cover these costs.[33] Again, while this may help offset some of the high costs, the majority of the prescription drug price is paid by the government, which acts as an insurance provider through Medicare to a

26. MEDICAID, https://www.medicaid.gov/medicaid/index.html [https://perma.cc/TQH3-SCKK].

27. *Id.*

28. *June 2019 Medicaid and CHIP Enrollment Data Highlights*, MEDICAID, https://www.medicaid.gov/medicaid/program-information/medicaid-and-chip-enrollment-data/report-highlights/index.html [https://perma.cc/VLL2-5XVH].

29. Ashley Kirzinger et al., *KFF Health Tracking Poll – February 2019: Prescription Drugs*, KAISER FAM. FOUND. (March 1, 2019), https://www.kff.org/health-costs/poll-finding/kff-health-tracking-poll-february-2019-prescription-drugs [https://perma.cc/W86G-5VPX]; Robin Rudowitz et al., *10 Things to Know about Medicaid: Setting the Facts Straight*, KAISER FAM. FOUND. (March 6, 2019), https://www.kff.org/medicaid/issue-brief/10-things-to-know-about-medicaid-setting-the-facts-straight [https://perma.cc/KR9W-D48S].

30. *See Getting Started with Medicare*, MEDICARE, https://www.medicare.gov/people-like-me/new-to-medicare/getting-started-with-medicare.html [https://perma.cc/84KS-QCCS].

31. *See What Part B Covers*, MEDICARE, https://www.medicare.gov/what-medicare-covers/what-part-b-covers [https://perma.cc/4MS8-8EUW].

32. *See Part B Costs*, MEDICARE, https://www.medicare.gov/your-medicare-costs/part-b-costs [https://perma.cc/NG6Q-SL4V].

33. *See generally Copayment/Coinsurance in Drug Plans*, MEDICARE, https://www.medicare.gov/drug-coverage-part-d/costs-for-medicare-drug-coverage/copaymentcoinsurance-in-drug-plans [https://perma.cc/NS4H-Z4BX] (explaining copayment and coinsurance relating to prescription drug costs).

high number of Americans. As the population grows and more of the next generation meets retirement age, the skyrocketing costs of prescription drugs will only further add financial stress to the government.

B. *Effects on Americans*

Many Americans also pay for prescriptions through private insurance plans they acquire from their employer. As prescription drugs continue to increase in price, so will the costs of insurance needed to cover them. In 2017, roughly 56% of Americans relied on private insurance purchased through their employer or through the private insurance market.[34] As a function of simple business economics, the higher it costs to provide a service, the higher the price consumers must pay to receive it. This means that as prescription drug prices continue to balloon, insurance companies will have to raise their prices to cover their costs. Thus, the higher drug prices go, the higher the price that will be paid by those with private insurance.[35]

Finally, there is a societal price being paid because of pharmaceutical drugs, and their use. The most pronounced in today's society are expenses associated with the opioid crisis.[36] Opioids are a class of drugs that come from the opium or poppy plant and include the illegal drug of heroin, and legal prescription drugs such as oxycodone, hydrocodone, codeine, morphine, among others.[37] Opioids were responsible for nearly 33,000 overdose deaths in 2015, which is nearly quadruple the number of deaths from 2000, and higher than any year on record.[38]

In addition to the devastating impact these drugs have on the families of those fighting abuse, the estimated lost productivity for people in the United States suffering from opioid abuse totaled $20.4 billion in 2013, a year which saw even less opioid consumption than we face today.[39] As a whole, in 2013,

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34. *See* Data from 2017, *Health Insurance Coverage of the Total Population*, KAISER FAM. FOUND., https://www.kff.org/other/state-indicator/total-population [https://perma.cc/R7D4-2FKA] (representing percentage of Americans who either received coverage from their employer (49%) or from a non-group private insurance provider (7%)).

35. One bill proposed by Senators Bernie Sanders and Al Franken intended to use the immense purchasing power of these programs to help drive down the overall price of prescription drugs. *See* Prescription Drug Affordability Act of 2015, S. 2023, 114th Cong., §101(a) (2015). Although this bill was read twice in the Senate, it was ultimately referred to the Senate Committee on Finance, where it has remained since September 10, 2015.

36. *See New Business Pulse Focuses on CDC's Efforts to Protect the Public from Opioid Overdoses,* CDC FOUND. (Mar. 15, 2017), https://www.cdcfoundation.org/pr/2017/new-business-pulse-focuses-on-CDCs-efforts-to-protect-the-public-from-opioid-overdose [https://perma.cc/NRX6-VLAR] [hereinafter *Opioid Overdoses*].

37. *Opioids*, NAT'L INST. ON DRUG ABUSE, https://www.drugabuse.gov/drugs-abuse/opioids [https://perma.cc/Q39D-Y4F4].

38. *Opioid Overdoses*, *supra* note 36.

39. *Id.*

prescription opioid dependence, abuse, and overdose cost the United States $78.5 billion, with about a third of that cost being due to increased health care and substance abuse treatment costs.[40] While there is no doubt that opioids have legitimate medical purposes to help those recovering from painful injuries and surgeries, it is also clear that these drugs should be viewed as financially impacting Americans in ways that do not show up on pharmacy bills.

II. WHY ARE PRESCRIPTION DRUGS SO EXPENSIVE?

There is no single reason why prescription drugs in America have become so expensive. The complexity of the development of a drug and the length of the FDA approval process, litigation costs, monopolistic rewards for meeting the stringent FDA requirements, and rebates and other cost measures that limit the list price of drugs, all contribute to the problem of high prices for the consumer.

A. Length of Food and Drug Administration Approval Process

At the outset, it is important to lay a basic framework for the different types of drugs that exist in the market. Generally, there are two broad categories of drugs: those that require a prescription from a doctor (i.e., prescription drugs), and those that are received over the counter (i.e., OTC drugs). While both drugs target the symptoms of a particular sickness and require FDA approval, OTC drugs have to follow the FDA OTC drug monographs.[41] OTC drug monographs are more akin to a "recipe book," which allow OTC drugs to be marketed without specific FDA approval if they maintain certain levels of threshold ingredients.[42] If a new OTC drug does not follow the drug monograph, a lengthier process is required before the drugs can be sold, where the FDA must approve of the new combination of ingredients through the "New Drug Approval System."[43]

In contrast to OTC drugs, all prescription drugs must go through the FDA's New Drug Application (NDA) process.[44] This is a formal process where a drug sponsor asks the FDA to approve a new drug for marketing in the United States.[45] As a part of the NDA process, the sponsor must include

40. *Id.*
41. *Prescription Drugs and Over-the-Counter (OTC) Drugs: Questions and Answers*, FDA, https://www.fda.gov/drugs/questions-answers/prescription-drugs-and-over-counter-otc-drugs-questions-and-answers [https://perma.cc/6UYP-M67B] (last updated Nov. 13, 2017).
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*

all human and animal data, an analysis of the data, how the drug interacts in the body, and how it is manufactured.[46]

According to the FDA, there are twelve steps a drug must take before it is allowed to be marketed in the United States: (1) animal testing; (2) submission of an Investigational New Drug application; (3) the first of three phases of human testing, where twenty to eighty healthy volunteers test the drug; (4) the second phase of human testing, where hundreds of patients are either given placebos or the drug to evaluate effectiveness and safety; (5) the final phase of human testing, where thousands of patients take the drug, and data of the effectiveness and safety are further analyzed; (6) a review meeting, where the FDA meets with the drug sponsor; (7) the NDA application described above; (8–9) the FDA decides whether to file the NDA and, if filed, the drug is passed on to the FDA Review Team; (10) drug labeling approval; (11) manufacturing facility inspection; and (12) FDA drug approval.[47] This process often takes several years, with the longest part of the approval process being the human testing in steps three through five.[48]

There also is a way for drugs to be approved faster, via the Accelerated Approval and the Fast Track programs.[49] The Accelerated Approval program looks at "surrogate endpoints" rather than waiting for clinical trials to be completed, and the Fast Track program accepts application information on a rolling basis where the proposed drug is intended to treat an urgent medical need. Once a drug is approved, its molecular make up is produced in the "Orange Book,"[50] allowing for the FDA to monitor the chemical contents of the drug, and the status of the patents and exclusivity codes associated with it.[51] Similar to the Orange Book, the "'Purple Book' [is] a list of approved or 'licensed' biological products, including all biosimilar and interchangeable biological products[,]" aimed to be "the biological equivalent to the 'Orange Book.'"[52]

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46. *Id.*

47. *Drug Approval Process Infographic,* FDA 1–2, https://www.fda.gov/downloads/Drugs/ResourcesForYou/Consumers/UCM284393.pdf [https://perma.cc/QUF2-4R3G].

48. *The FDA's Drug Review Process: Ensuring Drugs Are Safe and Effective*, FDA, https://www.fda.gov/Drugs/ResourcesForYou/Consumers/ucm143534.htm [https://perma.cc/NEW3-8JFZ] (last updated Nov. 27, 2017).

49. *Drug Approval Process Infographic*, *supra* note 47, at 2.

50. Renu Lal, *Patents and Exclusivity*, FDA, CTR. FOR DRUG EVALUATION & RES. SMALL BUS. & INDUSTRY ASSISTANCE 1 (May 19, 2015), https://www.fda.gov/downloads/drugs/developmentapprovalprocess/smallbusinessassistance/ucm447307.pdf [https://perma.cc/6ACA-CVX4].

51. *See id.* For a more detailed discussion about patents and exclusivity, see *infra* Section II.D.

52. *See* Evert Uy Tu & Jeffrey A. Wolfson, *FDA Throws the (Purple) Book at Biosimilars—Purple v. Orange*, HAYNES & BOONE 1 (2014), http://www.haynesboone.com/-/media/files/alert-

There is no doubt that this meticulous process before a prescription drug can be marketed has at least some influence on the high price of prescription drugs. According to the Tufts Center for the Study of Drug Development, a pharmaceutical company will pay roughly $2.6 billion for the development of a drug before it gets marketing approval.[53] This cost, not surprisingly, has increased by 145% since Tufts last conducted the report in 2003.[54] Once a drug has been approved, drug manufacturers spend an additional $312 million in post-approval development, which refine the formulations, dosages, and potential side effects of the drug once it is on the market.[55]

Are there any steps in the process that could be eliminated to reduce the length and expenses associated with developing a drug, while ensuring the drug is safe for human consumption? This question will be addressed further in a subsequent section.[56]

B. Litigation Costs

In addition to the costs associated with developing drugs in accordance with FDA regulations, drug manufacturers must allocate for any potential litigation costs associated with the drug. Medicine is an art, as well as a science, and the same formula that helps one person could produce devastating results for another. One way to avoid these potential injuries is to provide adequate warnings to patients so that they understand the effects of what they are taking. Even if a patient is given a warning, there is no guarantee the warning will be adequate.[57] Additionally, even those drugs that are prescribed by doctors for a specific illness, when they produce an unintended harmful effect, the drug manufacturer can still be held liable.[58] While many of these lawsuits

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pdfs/fdapurplebookvorange-book.ashx?la=en&hash=EB36CA715635DBB6FC539201629EC493FD07A3DC [https://perma.cc/2YUA-YQ6Z].

53. Press Release, Tufts Ctr. for the Study of Drug Dev., Cost to Develop and Win Marketing Approval for a New Drug is $2.6 Billion (Nov. 18, 2014), https://static1.squarespace.com/static/5a9eb0c8e2ccd1158288d8dc/t/5ac66adc758d46b001a996d6/1522952924498/pr-coststudy.pdf [https://perma.cc/BRX6-SDAS].

54. *Id.* The amount previously estimated in 2003 was adjusted to account for inflation. *Id.*

55. *Id.* Data gathered from previous years was adjusted to account for inflation. *Id.*

56. *See infra* Section III.

57. *See, e.g.*, Armantrout v. Bristol-Myers Squibb (*In re* Plavix Mktg., Sales Practices & Prods. Liab. Litig), No. 13-4521, 2017 WL 3531684, at *7 (D.N.J. Aug. 17, 2017); Motus v. Pfizer, Inc., 196 F. Supp. 2d 984, 989 (C.D. Cal. 2001); Carlin v. Superior Court, 920 P.2d 1347, 1351 (Cal. 1996).

58. These types of injuries are most frequently pursued as products liability actions, but also can be brought under the traditional torts doctrine of negligence. *See, e.g.*, Williams v. Ciba-Geigy Corp., 686 F. Supp. 573, 574, 580 (W.D. La. 1988) (offering the same alleged drug injury and pursuing recovery under several different causes of action).

are ultimately dismissed,[59] frequent litigation against large drug manufacturing companies produces incredibly varied results, which correlatively adds to the cost of producing prescription drugs.[60]

It is not just personal injury cases pursued by consumers that could potentially cost drug manufacturers. In addition, the government often pursues criminal and civil penalties for failing to follow the FDA's strict procedures. Indeed, a pharmaceutical drug manufacturer's worst nightmare likely looks like Pfizer's experience in 2009.[61] In 2009, Pfizer agreed to pay $2.3 billion to the Department of Justice, which, at the time, was the largest health care fraud settlement in United States history.[62] This settlement resolved criminal and civil liability stemming from the illegal promotion of certain pharmaceutical products.[63] Even bigger still, in 2012, the Department of Justice again received a healthy $3 billion settlement from British pharmaceutical giant GlaxoSmithKline to resolve its criminal and civil liability arising from the company's unlawful promotion of certain drugs, its failure to report safety data, and false price reporting practices.[64] Based on the litigation costs from consumers and from regulators, drug prices have yet another high built-in cost for their production.

While the sticker shock on the Pfizer and GlaxoSmithKline penalties may seem like an outlier, regulators have consistently pursued civil and criminal penalties against drug companies for a variety of offenses. Since 2000, the total amount of penalties paid by pharmaceutical companies was $33,123,998,360 as of September 2019.[65] Excluding the record-breaking

59. *See, e.g.*, Gonzalez v. Bayer Healthcare Pharm., Inc., 930 F. Supp. 2d 808, 820–21 (S.D. Tex. 2013); Frazier v. Mylan Inc., 911 F. Supp. 2d 1285, 1303 (N.D. Ga. 2012).

60. See successful litigation and settlements against large opioid manufacturers Purdue and Johnson & Johnson which resulted in large settlements and awards, respectively, for the plaintiff states. *See* Jan Hoffman, *Johnson & Johnson Ordered to Pay $572 Million in Landmark Opioid Trial*, N.Y. TIMES (Aug. 26, 2019), http://www.nytimes.com/2019/08/26/health/oklahoma-opioids-johnson-and-johnson.html [https://perma.cc/L6ZW-NU2K]; Brian Mann, *Purdue Pharma Reaches Tentative Deal To Settle Thousands of Opioid Lawsuits*, NPR (Sept. 11, 2019), https://www.npr.org/2019/09/11/759967610/purdue-pharma-reaches-tentative-deal-to-settle-thousands-of-opioid-lawsuits [https://perma.cc/PVK2-KG63].

61. *Justice Department Announces Largest Health Care Fraud Settlement in its History*, U.S. DEP'T OF JUST. (Sept. 2, 2009), https://www.justice.gov/sites/default/files/usao-ma/legacy/2012/10/09/Pfizer%20-%20PR%20%28Final%29.pdf [https://perma.cc/E9DJ-FLLW].

62. *Id.*

63. *Id.*

64. *See GlaxoSmithKline to Plead Guilty and Pay $3 Billion to Resolve Fraud Allegations and Failure to Report Safety Data*, U.S. DEP'T OF JUST. (July 2, 2012), https://www.justice.gov/opa/pr/glaxosmithkline-plead-guilty-and-pay-3-billion-resolve-fraud-allegations-and-failure-report [https://perma.cc/X4WT-A5JS].

65. *Violation Tracker Industry Summary Page*, GOOD JOBS FIRST, https://violationtracker.goodjobsfirst.org/industry/pharmaceuticals [https://perma.cc/8EDS-8CQQ] (describing total amounts and types of violations by pharmaceutical companies). The total amount of penalties is adjusted to account for "agency records and settlement announcements for the same case." *Id.*

penalties levied against Pfizer in 2009 and GlaxoSmithKline in 2012 still leaves more than $27 billion in fines over the last 20 years. The penalties range from off-label or unapproved promotion of medical products pursued by the FDA, consumer protection penalties by the Federal Trade Commission (FTC), violations of the False Claims Act[66] pursued by the Department of Justice and by the United States Attorney's Office, and kickbacks and bribery violations pursued by the Department of Justice.[67] Consistent enforcement by regulators resulting in industry penalties of more than $1.5 billion a year also adds to the high prices of drugs in the United States.

C. *Rebates and Credits Require "High List" Prices*

Prices paid by consumers and insurance companies are often much lower than the high list price on drugs. Similar to other industries—like automakers and electronics companies—pharmaceutical manufacturers often issue rebates to consumers and purchasers further down the supply chain.[68] Rebates are a "return of part of the purchase price by the seller to the buyer," and are frequently used to offset the higher cost of brand-name prescription prices to more competitive levels with generics.[69] In 2016, rebates and similar discounts reduced the invoice price of drugs by an estimated 28%,[70] cutting into the list price that manufacturers demand.

The higher brand name drug prices get, the larger the rebate needed to offset the cost to a more competitive level. Similarly, if a rebate is based on a percentage of the total price of the drug, drug manufacturers have an incentive to have a higher list price on the drug they are discounting. As an example, assume Crestor is discounted with a 25% rebate. If the list price in 2017 is $100, the total amount paid by the purchaser would stand at $75. Without increasing the rebate, the manufacturer could raise the list price to $110 in

66. False Claims Act, 31 U.S.C. §§ 3729–3733 (2012). This act is also known as "the Lincoln Law." *False Claims Act*, BERGER MONTAGUE, https://bergermontague.com/federal-false-claims-act [https://perma.cc/P4CA-GJVB]. It "was enacted in 1863 by a Congress concerned that suppliers of goods to the Union Army during the Civil War were defrauding the Army." *The False Claims Act: A Primer*, U.S. DEP'T OF JUST., https://www.justice.gov/sites/default/files/civil/legacy/2011/04/22/C-FRAUDS_FCA_Primer.pdf [https://perma.cc/68UX-FJFT].

67. *Violation Tracker Industry Summary Page*, *supra* note 65.

68. GABRIELA DIEGUEZ, MAGGIE ALSTON & SAMANTHA TOMICKI, MILLIMAN WHITE PAPER, A PRIMER ON PRESCRIPTION DRUG REBATES: INSIGHTS INTO WHY REBATES ARE A TARGET FOR REDUCING PRICES 1–2 (May 2018), http://www.milliman.com/uploadedFiles/insight/2018/Prescription-drug-rebates.pdf [https://perma.cc/B783-7ZKD].

69. *Id.* at 1.

70. IQVIA INST. FOR HUMAN DATA SCI., MEDICINES USE AND SPENDING IN THE U.S.: A REVIEW OF 2016 AND OUTLOOK TO 2021 (May 2017), https://www.iqvia.com/institute/reports/medicines-use-and-spending-in-the-us-a-review-of-2016 [https://perma.cc/LYJ2-L5KU].

2018, justified by inflation, increased demand, and other reasons. Now, instead of paying $75, the purchaser would be paying $82.50, $7.50 more than the previous year, for the exact same drug with the exact same rebate. In short, while drug companies could be aggressive in their rebate percentages, they also can charge a higher list price to be discounted, ensuring that the price paid by the purchaser is still at a high level to pad their profits.

Even if name-brand drug manufacturers offered higher rebates to remain competitive, those rebates would not have to increase significantly due to the increased price of generic drugs. If generic prices increase in amounts similar to brand name drug prices year over year, the rebate percentage could increase but the amount paid would be similar to a previous year.

Rebates provide a way of discounting prices to more aggressive levels, but as drug prices increase and rebate percentages stay the same, their effect of decreasing the amount paid by the purchaser will diminish.

D. Monopolistic Effects and Rewards for Meeting the Stringent FDA Requirements

Despite all of the procedures the FDA imposes and the possible costs of litigation, the FDA incentivizes drug companies to continue to produce desperately needed drugs with patents and marketing exclusivity.[71] A patent allows for an inventor, and drug manufacturer, "to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention [or drug] into the United States."[72] If a drug manufacturer goes through the necessary steps and is granted a patent at any point in the FDA's drug approval process, for the life of the patent, the FDA will not publish the drug's active ingredients, product or composition patents, or other information the drug manufacturer supplies on the new drug application form in the Orange Book.[73]

The FDA also allows protection for drug manufacturers through exclusivity of market rights, independent of patent rights. This exclusivity "prevents the submission or effective approval" of drugs similar to drugs already marketed, in an effort to "promote a balance between new drug innovation and generic drug competition."[74] There are five general types of exclusivity, governed by different laws allowing for drug manufacturers to exclusively market their drugs in a monopolistic fashion: (1) "Orphan Drug Exclusivity," which runs for seven years where a drug is meant to treat diseases effecting

71. *See* Lal, *supra* note 50, at 1.
72. *Id.*
73. *Id.*; *see also supra* text accompanying note 50.
74. Lal, *supra* note 50, at 1.

a small number of Americans;[75] (2) "New Chemical Entity Exclusivity," which runs for five years;[76] (3) "Other Exclusivity," three years for a modification (if certain criteria are met);[77] (4) "Pediatric Exclusivity," which extends patents and other exclusivity timelines by six months when the sponsor conducts certain pediatric studies;[78] and (5) "180-Day Exclusivity,"[79] which governs the amount of time a company may exclusively market a generic version of a patented drug.[80] The FDA operates an "Exclusivity Board" through its subdivision, the Center for Drug Evaluation and Research (CDER), which provides oversight and recommendations regarding exclusivity.[81]

While these laws and extended timelines give an incentive for drug companies to recoup their high costs in developing a drug, the monopolies that are established by these prolonged periods are hard to break down. Take, for example, the 180-day exclusivity period. The 180-day exclusivity allows one drug company to market a generic version of a drug when a brand name version of the drug has been marketed exclusively for a number of years. In essence another drug manufacturer is able to exclusively offer a generic version of the drug to compete against the name-brand at whatever price it sees fit.[82] Only after the 180 days expire will other, rival company be allowed to enter the marketplace and challenge pricing, and until then, prices can remain high.[83]

III. WHO CAN CURRENTLY COMBAT THE HIGH DRUG PRICES?

Outside of Congress, there are several different governmental agencies and private parties that can directly impact high drug prices. Among them, the FDA, the FTC (more specifically, its Health Care Division), doctors, and insurance companies. While the FDA may have the most meaningful power to enact sustained changes of drug prices, all of these stakeholders could, at

75. Orphan Drug Act of 1983, 21 U.S.C. § 360cc (2012); 21 C.F.R. § 316.31(a) (2019); Lal, *supra* note 50, at 2.

76. 21 C.F.R. § 314.108(b)(2) (2019); Lal, *supra* note 50, at 2.

77. 21 C.F.R. § 314.108(b)(4)–(5) (2019); Lal, *supra* note 50, at 2.

78. Best Pharmaceuticals for Children Act of 2002, 21 U.S.C. § 355a(c)(1) (2012); Lal, *supra* note 50, at 2.

79. Drug Price Competition and Patent Term Restoration Act of 1984, 21 U.S.C. § 355(j)(5)(B)(iv) (2012); Lal, *supra* note 50, at 2.

80. Lal, *supra* note 50, at 3.

81. *Id.*

82. *See* FDA, GUIDANCE FOR INDUSTRY, 180-DAY EXCLUSIVITY: QUESTIONS AND ANSWERS 2–4 (Jan. 2017), https://www.fda.gov/downloads/Drugs/GuidanceComplianceRegulatoryInformation/Guidances/UCM536725.pdf [https://perma.cc/ZXY9-VVH2].

83. *See* Jaret, *supra* note 21.

least slightly, contribute to lower prices for consumers if legislative changes enable them.

A. *The FDA*

Some may argue that the FDA, as the government agency with direct oversight of prescription drug approval, has a duty to help reduce prices. However, according to the FDA's mission statement, they are in no way entrusted with protecting the financial market for the prescription drugs they approve:

> The Food and Drug Administration is responsible for protecting the public health by ensuring the safety, efficacy, and security of human and veterinary drugs, biological products, and medical devices; and by ensuring the safety of our nation's food supply, cosmetics, and products that emit radiation.
>
> [The] FDA also has responsibility for regulating the manufacturing, marketing, and distribution of tobacco products to protect the public health and to reduce tobacco use by minors.
>
> [The] FDA is responsible for advancing the public health by helping to speed innovations that make medical products more effective, safer, and more affordable and by helping the public get the accurate, science-based information they need to use medical products and foods to maintain and improve their health.
>
> [The] FDA also plays a significant role in the Nation's counterterrorism capability. [The] FDA fulfills this responsibility by ensuring the security of the food supply and by fostering development of medical products to respond to deliberate and naturally emerging public health threats.[84]

Despite this limited mission statement, the FDA has succumbed to the pressure to try and do something to combat high prescription drug pricing.[85] Indeed, Dr. Scott Gottlieb, the 23rd Commissioner of the FDA, discussed the speed of approval in an October 2017 blog post as a way of reducing complex and generic drug costs, and, in turn, drug prices for consumers.[86] While Dr. Gottlieb recognized that "[the] FDA doesn't control drug pricing," he also recognized the policies that the FDA requires for approval "impact both the

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84. *What We Do*, FDA, https://www.fda.gov/AboutFDA/WhatWeDo [https://perma.cc/MVK6-HZFC].

85. *See* Nathaniel Weixel, *FDA Chief Says Agency Will Take Action to Lower Drug Prices*, THE HILL (Oct. 2, 2017, 6:59 PM), http://thehill.com/policy/healthcare/medical-devices-and-prescription-drug-policy/353538-fda-chief-says-agency-will [https://perma.cc/5G6J-V5TR].

86. Scott Gottlieb, *Reducing the Hurdles for Complex Generic Drug Development*, FDA (Oct. 2, 2017), https://www.fda.gov/news-events/fda-voices-perspectives-fda-leadership-and-experts/reducing-hurdles-complex-generic-drug-development [https://perma.cc/4DW9-JNQW].

direct and indirect costs of drug development."[87] The FDA, given its current scope authorized by federal law, can continue to make the drug approval process quicker, and more efficient, which will help offset some of the high costs associated with developing prescription drugs.[88]

B. The Federal Trade Commission and Its Health Care Division

The FTC, along with the Department of Justice, are the two regulatory agencies tasked with combatting American antitrust abuses. The FTC is an independent administrative agency charged by Congress with protecting consumers by enforcing competition and consumer protection laws.[89] Despite being one of two agencies entrusted with combating antitrust abuses, the FTC is the agency with primary responsibility for the pharmaceutical industry.[90] To underscore its expertise in this area, the FTC collaborated with the FDA in 2017 on two events: "one examining regulatory barriers in pharmaceutical markets; and the other on the role of intermediaries in the distribution of pharmaceuticals."[91]

Within the FTC, the Health Care Division of the Bureau of Competition (Health Care Division)[92] is responsible for non-merger issues within the pharmaceutical industry, among other things.[93] While the Health Care Division does not have the power to stop mergers among pharmaceutical companies,[94] they can control false or repeated filings with the FDA that could result in

87. *Id.*

88. See *supra* Part II.A for a discussion of the high costs associated with the current lengthy drug approval process.

89. 15 U.S.C. §§ 41–58 (2012); *see also* STATEMENT OF THE FEDERAL TRADE COMMISSION TO THE DEPARTMENT OF HEALTH AND HUMAN SERVICES REGARDING THE HHS BLUEPRINT TO LOWER DRUG PRICES AND REDUCE OUT-OF-POCKET COSTS 2 (July 16, 2018), https://www.ftc.gov/system/files/documents/advocacy_documents/statement-federal-trade-commission-department-health-human-services-regarding-hhs-blueprint-lower/v180008_commission_comment_to_hhs_re_blueprint_for_lower_drug_prices_and_costs.pdf [https://perma.cc/LW72-7XA9] [hereinafter FTC STATEMENT].

90. *See, e.g.*, FED. TRADE COMM'N & U.S. DEP'T OF JUST., IMPROVING HEALTH CARE: A DOSE OF COMPETITION (2004), https://www.ftc.gov/sites/default/files/documents/reports/improving-health-care-dose-competition-report-federal-trade-commission-and-department-justice/040723healthcarerpt.pdf [https://perma.cc/5RV2-T7U6].

91. *See* FTC STATEMENT, *supra* note 89, at 2–3 & nn.10, 11.

92. *See* MARKUS H. MEIER ET AL., OVERVIEW OF FTC ACTIONS IN PHARMACEUTICAL PRODUCTS AND DISTRIBUTION, HEALTHCARE DIVISION, FTC 1–2 (June. 2019), https://www.ftc.gov/system/files/attachments/competition-policy-guidance/overview_pharma_june_2019.pdf [https://perma.cc/HD79-SZGQ].

93. *Id.*

94. *See id.* This responsibility falls squarely within the jurisdiction of the Mergers I Division of the FTC. *Id.*

illegal monopolies.[95] Additionally, the Health Care Division protects increased prices by challenging certain conduct within the pharmaceutical distribution industry,[96] mergers of pharmaceutical products,[97] and mergers involving pharmaceutical distributors.[98] Finally, the Health Care Division files numerous *amicus* briefs that directly support similar anticompetitive conduct pursued by states, and private litigants.[99]

While there is no doubt that these actions by the Health Care Division have helped to abate increases in drug prices, this team of highly talented attorneys could be given the authority to further protect consumers. If Congress enhanced the scope of the Health Care Division's responsibility outside of its current limited scope to include regulation of increased drug pricing, it would give a well-equipped, highly experienced organization the ability to directly combat price abuses by drug manufacturers. Absent explicit, congressional authorization, the Health Care Division's hands are essentially tied—limiting their investigations and actions only to the areas described above. The Health Care Division's current scope does assist in combatting antitrust violations—which, in turn, is aimed at benefitting consumers—but those within the Health Care Division likely look forward to a more direct, and consistent, challenge, benefitting those suffering because of high drug prices.

C. Doctors

Consumers need a doctor's prescription to obtain prescription drugs. While doctors cannot do much to reduce the costs of creating a drug, they are often at the heart of the drug manufacturer's plan to market name-brand drugs that produce the highest profit margin, which are often the drugs that cost patients the most.[100] Drug representatives actively target doctors, in an effort to persuade them to provide samples of the drug, or talk about the advantages that their drug might have over similar drugs on the market. While many of these tactics are likely efforts to increase a particular drug representative's

95. *See id.* at 3–14 (detailing cases where the Health Care Division has stepped in to enforce policies that could be harmful to consumers).

96. *See id.* at 19–26 (detailing cases where the Health Care Division has enforced pharmaceutical distribution arrangements that could violate antitrust law).

97. *See id.* at 26–68 (detailing cases where the Health Care Division has stopped pharmaceutical product mergers that violate antitrust law).

98. *See id.* at 70–75 (detailing cases where the Health Care Division has enforced pharmaceutical distribution arrangements that could violate antitrust law).

99. *See id.* at 77–88 (detailing cases where the Health Care Division has filed amicus briefs).

100. *See* G. Michael Allan et al., *Physician Awareness of Drug Cost: A Systematic Review*, 4 PLOS MED. 1486, 1486–87 (2007), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC1989748 [https://perma.cc/SZJ5-LEVL].

sales, their persuasion can have real impacts on the drugs that a doctor prescribes to patients. Many doctors have no idea how much drugs cost, or even that there are cheaper, equally effective alternatives on the market.[101] In one study evaluating doctors' estimated prices of drugs, doctors come within only 25% of the true cost of a prescription drug less than one-third of the time.[102] This suggests that doctors buy into the sales tactics deployed by drug companies at the cost of the patients' needs. While doctors do not need to exclusively take into account the cost of the drugs in their treatment plans, taking advantage of those drugs that do the same thing for less should at least partially incentivize drug companies to reduce the pricing on some of their more expensive drugs.

D. Insurance Companies

Using healthcare insurance is one of the most common ways consumers acquire prescription drugs. Through a healthcare plan, consumers can pay only a portion of the actual price of prescription drugs through a variety of cost saving mechanisms, including tier pricing, deductibles, and coinsurance.[103] Tier pricing allows different types of drugs to be placed on different tiers, which have a set copay for drugs on that tier.[104] As an example, tier-one drugs could include the brand name drug, with a copay of $50, and tier-two drugs could include the generic versions of those drugs with a copay of $10. The tier pricing program allows insurance companies to effectively incentivize consumers to purchase more cost-effective prescriptions by placing them on a lower-priced tier. Expanding the number and rotating the types of drugs on each tier could allow consumers to purchase more drugs for more competitive prices.

Another way that insurance companies can decrease the amount consumers pay for prescription drugs is to expand the number of plans that count prescription drug purchases towards a consumer's deductible. UnitedHealthcare, one of the largest insurance providers in the country, only allows *some* plans to count prescription drug purchases towards deductible amounts.[105] Once the deductible is met, an insurance company would then cover a higher percentage of healthcare related expenses incurred by a consumer. If insurance companies allow all prescription drug purchases made

101. *Id.* at 1496.
102. *Id.* at 1486, 1496.
103. *See Prescription Drug Coverage*, UNITED HEALTHCARE, https://www.uhone.com/insurance/health/prescription-drug-coverage [https://perma.cc/6NB2-2MA].
104. *Id.*
105. *See id.*

under all plans to count toward the deductible, once it is met, patients would have to pay less for the prescription drugs they purchase.

Coinsurance is a means for insurance companies and consumers to share different percentages of the prescription drug prices purchased.[106] A consumer that pays higher premiums would pay a lower percentage of the total price of a prescription drug, and a consumer that chooses an insurance plan with lower premiums would pay a higher percentage of the drug prices. One way insurance companies could utilize this type of insurance program to lower prices for consumers is to contribute a higher percentage to more cost-effective drugs. Even if a consumer would have a high premium plan, an insurance company contributing to a higher percentage of the cost of a lower-priced generic drug would likely cause consumers to choose that drug over the higher-priced brand-name drug.

Further, insurance companies could use the purchasing power they wield to negotiate higher rebates and lower costs on frequently used drugs.[107] Larger insurance companies, at least partially, pay for billions of prescription drugs every year, and they could directly discuss the prices they pay with drug manufacturers in an effort to lower prices. The lower the prices they acquire for prescription drugs—even under coinsurance type programs—will immediately lower the amount a consumer pays for their prescriptions at the pharmacy window.

Because so many Americans utilize insurance plans to offset the high price of prescription drugs, insurance companies are in a unique position to be able to combat the high drug prices paid by consumers.

IV. CURRENT PROPOSALS AIMED AT CURBING HIGH PRICES

A. President Trump's Blueprint in "American Patients First"

One current proposal aimed at curbing high drug prices is President Donald Trump's "American Patients First" plan (the Plan).[108] Fixing high drug prices is one of the President's "greatest priorities."[109] According to the Department of Health and Human Services (HHS), the Plan is "a historic plan for bringing down the high price of drugs and reducing out-of-pocket costs

106. *See id.*

107. *See supra* Part II.C (describing rebates and credits and how they are used to partially offset prescription drug prices); *see also infra* Part IV.A.2 (describing President Donald Trump's Blueprint and the Government using its purchasing power to negotiate for lower prescription drug prices).

108. *American Patients First: The Trump Administration Blueprint to Lower Drug Prices and Reduce Out-of-Pocket Costs*, DEP'T OF HEALTH & HUM. SERVS. 1 (May 2018), https://www.hhs.gov/sites/default/files/AmericanPatientsFirst.pdf [https://perma.cc/9P8T-P8WP] [hereinafter *American Patients First*].

109. *Id.* at 3 (quoting President Donald Trump).

for the American consumer."[110] Described as a "blueprint,"[111] the Plan describes four main strategies for lowering drug prices: (1) improving competition; (2) better negotiation; (3) incentivizing for lower list prices; and (4) lowering out-of-pocket costs.[112] The blueprint is broken down into two phases: (1) actions the President may direct HHS to take immediately; and (2) actions HHS is considering.[113]

It is important to note two things. First, a "blueprint" is defined as "a detailed plan or program of action."[114] Yet, the Plan jostles back and forth between addressing future actions to be taken and touting accomplishments of the Trump administration. As an example, the highlights of the Plan describe current actions the President *may* direct HHS to take,[115] but when detailing these potential actions that the Plan proposes, they are then described as "Trump Administration Accomplishments on Drug Pricing."[116] While it is difficult to determine if the Plan is addressing future actions—like the definition of blueprint suggests—or actions already taken, the Plan does address critical ways HHS could actively work to lower prescription drug prices. The analysis below will approach the Plan's proposals as if they are future proposals to try and combat the high prices of prescription drugs.[117]

Second, the Plan's overarching goal is to lower costs for the "American consumer" and to "bring immediate relief to American patients,"[118] but a majority of the policy proposals only address Medicare and Medicaid actions to be taken, not actions that would affect every American consumer. The most generally applicable section of the Plan is the "Increase Competition" portion, described below. The fact that the Plan mostly describes Medicare and Medicaid actions underscores the difficulty the government has in directly combatting this problem for all consumers. By focusing on purchases the government makes, the Plan enables negotiations and policies as a large-scale purchaser of prescription drugs but little else.

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110. *Id.* at 5.

111. *Id.*

112. *Id.* at 9.

113. *Id.*

114. *Blueprint*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/blueprint#other-words [https://perma.cc/JCM6-FCNV].

115. *See American Patients First*, *supra* note 108, at 9–11.

116. *Id.* at 18.

117. In addition to the proposed actions HHS may take, the Plan also describes "Further Actions Under Review and Opportunities for Feedback." *Id.* at 26–38. These are "even bolder actions to bring down prices for patients and taxpayers" being considered by HHS on which it is seeking feedback and public comment. *Id.* at 26. Because these further actions are even more removed from the actual actions described in the "blueprint" portion of the Plan, it will not be analyzed in this Comment.

118. *Id.* at 5.

1. Increase Competition

The first portion of the Plan describes efforts to increase competition as a means of decreasing prescription drug prices through several strategies.[119] The Plan has several different proposals, but some blend into broader policy ideas rather than specific actions to be taken. First, the Plan proposes accelerating the FDA approval of generic drugs to create direct competitors for name-brand drugs.[120] As described in Part III.A, this proposal will likely decrease the total cost of a drug, reducing the price passed on to the consumer. Also rolled into this proposal, the Plan suggests the FDA publish the names of drugs that have no competitors to spur new entrants.[121]

Second—but similar to the first proposal—the Plan describes the Drug Competition Action Plan (DCAP) which focuses the FDA's efforts to improve the efficiency of generic drug approval by "maximizing scientific and regulatory clarity with respect to complex generic drugs," and "closing loopholes" that allow drug companies to stall generic competition.[122] Indeed, a PowerPoint presentation describing the DCAP mirrors several of the same proposals analyzed above.[123]

Third, the Plan suggests facilitated opportunities for information sharing between drug manufacturers, doctors, and patients to improve patient access to medical products.[124] This proposal could serve two key functions. First, it would increase patient access to information about the drugs themselves. This increased information—outside of just the price—could allow a patient to consider similar drugs that might be priced more competitively. Second, it could make patients aware of alternative means of solving their health problems, outside of utilizing high-priced prescription drugs. Both of these functions would help a patient choose what medicine to take and if they want to utilize prescriptions, which in turn, would help consumers spend less at the pharmacy counter.

Finally, the last proposal of this part of the Plan is to create a system of codes that will highlight Medicare Part D billings and payments to biosimilar medications, including those at more aggressive price points.[125] This portion

119. *See id.* at 18–19.
120. *See id.* at 18.
121. *Id.*
122. *American Patients First*, *supra* note 108, at 18.
123. *See generally* Maryll W. Toufanian, *FDA's Drug Competition Action Plan*, FDA (Sept. 7, 2018), https://www.accessiblemeds.org/sites/default/files/2018-09/Maryll_Toufanian.pdf [https://perma.cc/W9XP-XKNR] (describing a three-prong action plan that commits to streamlining drug application review processes, enhancing development and review of complex drug applications, and reducing "gaming" that may extend brand monopoly for drug manufacturers).
124. *American Patients First*, *supra* note 108, at 19.
125. *Id.*

of the Plan could help the government and consumers who make prescription drug purchases under Medicare Part D, but would only serve as a non-binding example of how private insurance companies could reduce patient costs.

While the overarching policy of increasing competition is a winning strategy to combat high drug prices, the American Patients First plan falls short of naming specific policy ideas that would immediately and effectively accomplish this goal.

2. *Improve Government Negotiation Tools*

The second point of President Trump's Plan is to utilize massive government spending to directly negotiate better prices and provide higher drug price transparency.[126] Unlike the previous section of the Plan, this portion directly references actions that would make a difference in the amount spent on prescription drugs—albeit only for those in Medicare and Medicaid programs.[127]

The first step includes finalizing changes to Medicare Parts C and D to allow faster mid-year substitutions of generic drugs into prescription drug purchases.[128] This step appears to be aimed at increasing competition between a wider variety of generic drugs with less regulations, yet it is included in the "Better Negotiation" portion of the Plan.

The second—and likely most successful—step of this portion of the Plan describes a 5-part program to modernize Medicare Part D, including reducing the requirement of drugs per category or class from two to one.[129] While this may seem to contradict the "competition is the best friend of high prices" approach described in the "Increasing Competition" portion of the Plan, reducing the drugs per class from two to one will achieve an important function: it would consolidate the government's purchasing power, leading to an ability to better negotiate prices for particular drugs. Similar to a "volume discount,"[130] this idea of negotiating allows manufacturers to secure a large volume of future orders it can rely on, and it allows the purchaser to shop different manufacturers to secure a lower price. Reducing the number of drugs per class to one allows *all* purchases in that class to be made on that drug, rather than two, thus increasing the total amount spent and the discount to be acquired.

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126. *See id.* at 19–20.
127. *See id.*
128. *Id.* at 19.
129. *Id.* at 20.
130. *See generally* Rafi Mohammed, *When It's Wise to Offer Volume Discounts*, HARV. BUS. REV. (Oct. 25, 2013), https://hbr.org/2013/10/when-it-is-wise-to-offer-volume-discounts [https://perma.cc/JZY2-QAEE] (explaining four reasons to offer volume discounts).

The remaining portions of this step of the Plan mostly address pricing structures paid to Medicare and Medicaid, including: "establishing an inflation limit for reimbursement,"[131] testing Medicaid's purchasing approaches to match "private sector best practices,"[132] and leveraging Medicare Part D's negotiation power for certain drugs covered under Part B.[133] The final step looks to address price disparities in the international market through historical studies,[134] but this likely would have limited impact on the government's negotiating power. Given the differences between the international prescription drug markets and the United States' market,[135] even with a larger amount of information about what foreigners pay—it will likely have limited utility for a United States focused negotiation.

3. Create Incentives for Lower List Prices

The remaining two portions of the Plan are both short and scant with details. First, the "Lowering List Prices" section "[c]all[s] on the FDA to evaluate the inclusion of list prices in direct-to-consumer advertising."[136] But, list price is not always an effective measure of the price the medication actually costs.[137] Thus, this requirement will likely do no more than provide sticker shock to consumers already concerned about paying a high price for their medications.

Next, HHS may direct Centers for Medicare and Medicaid Services (CMS) to develop a drug pricing dashboard tool that will provide key features like when price increases occur, why they occur, and highlight drugs that have not taken a price increase, among other things.[138] While this could help CMS acquire better purchasing prices based on stronger negotiating power, it is, again, unclear how this action would lower the list prices of a drug.

Finally, the Plan makes note to develop proposals related to the Affordable Care Act's Maximum Rebate Amount provision, which would limit manufacturer rebates on brand and generic drugs in the Medicaid program to 100% of the Average Manufacturer Price (AMP).[139] This portion will directly lower prices—both for the consumer and the government—if it takes effect across all the different types of drugs. Currently, this discount is capped at 23.1% for "Innovator Drugs," 17.1% for "Blood Clotting Factors," 17.1% for

131. *American Patients First*, *supra* note 108, at 20.
132. *Id.* at 20–21.
133. *Id.* at 21.
134. *Id.*
135. *See supra* notes 12–24 and accompanying text.
136. *American Patients First*, *supra* note 108, at 25.
137. *See* discussion *supra* Part II.D.
138. *American Patients First*, *supra* note 108, at 25.
139. *Id.*

"Drugs Approved by the FDA Exclusively for Pediatric Implications," and 13% for "Non-innovator Drugs."[140]

4. *Bring Down Out-of-Pocket Costs for American Consumers*

The last portion of the Plan aims to reduce patient out-of-pocket spending. First, it seeks to accomplish this goal by prohibiting the "pharmacy gag clauses" in Medicare Part D contracts.[141] These clauses are portions of contracts that prevent pharmacists from telling patients when they could pay less out-of-pocket by not purchasing their medications through their insurance policies.[142] On its face, this appears to be a straightforward means of accomplishing the goal of bringing down out-of-pocket spending for the average consumer, but it would only apply to those who have a Medicare Part D plan.

Finally, the Plan would "[r]equire Part D Plan sponsors to provide additional information about drug price increases and lower-cost alternatives in the Explanation of Benefits they currently provide their members."[143] Similar to other portions of the Plan, while this aims to lower consumer cost by providing them with more information about other drugs, it appears to be more aimed at accomplishing that goal through information about competitive alternatives than directly bringing down a consumer's out-of-pocket costs.

B. *The Federal Trade Commission's Statement Regarding the Plan*

Part of the Plan also asks for outside agencies to propose additional policies and public comment on its proposals. The FTC, as an enforcement agency and advocate in promoting competition in drug markets, took that opportunity to provide a statement specifically addressing the abuse of Risk Evaluation and Mitigation Strategies (REMS) and spurring biologics competition.[144]

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140. *Medicaid Drug Rebate Program*, MEDICAID, https://www.medicaid.gov/medicaid/prescription-drugs/medicaid-drug-rebate-program/index.html [https://perma.cc/HHL6-B7DT] (last updated Nov. 13, 2018). With the exception of the non-innovator drugs, the actual rebate on each of the drugs is the greater of the AMP or the difference between the AMP and the best price per unit and adjusted by the Consumer Price Index-Urban (CPI-U) based on launch date and current quarter AMP. *Id.* The CPI-U is used as "an integral part of computation of the unit rebate amounts for innovator drugs" and is available through the Bureau of Labor Statistics. *Id.*

141. *American Patients First*, *supra* note 108, at 25.

142. *Id.*

143. *Id.*

144. FTC STATEMENT, *supra* note 89, at 1–2.

"REMS are strategies intended to manage the known or potential safety risks associated with the use or distribution of certain pharmaceutical products[,]" but are often used to thwart generic competitors.[145] REMS abuse can occur in two ways: (1) for products subject to REMS with restricted distribution systems, branded manufacturers can invoke REMS requirements to refuse to offer samples to other manufacturers attempting to obtain FDA approval of generic or biosimilar products;[146] and (2) once a competitor applies for a generic, biosimilar, or interchangeable product with the FDA, the branded manufacturers may deny access to the necessary REMS system, leaving the FDA unable to approve the competitor's application.[147]

In "support[ing] the FDA's efforts to clarify the circumstances under which it will grant waivers of the shared REMS requirement[,]" the FTC also recognizes that "[u]nder current law, it seems unlikely that the prospect of antitrust liability alone will create the proper incentives for branded and generic firms to reach agreement on a shared REMS program."[148] The FTC then called for a legislative solution to the REMS problem that "could avoid the uncertainty of litigation and, unlike a lengthy antitrust case, provide an immediate solution to this challenging problem."[149]

To help create more biosimilar competition, the FTC specifically recommended the FDA: "(1) continue to create a pathway for expedited approval of interchangeable biologics; (2) reconsider the current naming guidance for biologics in light of the [Plan]; and (3) improve the Purple Book."[150]

V. ADDITIONAL LAWS AND POLICIES THAT COULD COMBAT HIGH PRICES?

While this Comment only specifically addressed the Plan and its impact on drug prices, there are a number of additional policies that could impact drug pricing, if Congress were to enact them: eliminating or significantly reducing the exclusivity periods, price gouging as a means of curbing price increases, forcing fixed margins, increasing imports, and government development of generic drugs. Some will likely never be considered by Congress because of their economic nature—i.e., forcing fixed margins—but others can be altered to have an immediate and lasting impact on drug pricing in the United States.

145. *Id.* at 3–4.
146. *Id.* at 4 & n.14.
147. *Id.* at 4.
148. *Id.* at 7.
149. *Id.*
150. *Id.* at 9.

A. *Eliminating or Significantly Reducing the Exclusivity Periods*

The framework for exclusivity only drives drug prices up and harms those who need the drugs.[151] First, there is no incentive for the drug manufacturer to produce a generic version while the brand name drug is still covered by exclusivity.[152] If a monopolist can use its market power to assert price control over the consumers, there is no reason to expect that they would introduce a product that would reduce their profit margin.[153] Thus, for the entire exclusivity period, it is essentially guaranteed that no generic drug will be produced, allowing for the higher-priced name-brand to be the only drug on the market.[154]

Second, the exclusivity period drives no innovation of the drug, meaning once the chemical combination is locked in, there is no incentive to change the drug to be more effective based on a similar drug challenging its market share. One of the key issues with a monopoly is that is stifles innovation—and the exclusivity period for prescription drugs is no different.

Finally, because there is only one drug on the market, potential shortcomings in availability could be detrimental to those that rely on it. Without alternative drugs, any delay in the production of an exclusive drug could have serious, life changing effects to the patients taking it. All of these reasons, along with the high prices that exclusivity guarantees, support eliminating the exclusivity period, or at least severely reducing it. This is one option Congress could take to help curb price increases.

B. *Price Gouging Laws as Means of Curbing Price Increases*

In a free market economy, the main goal is to drive down prices of goods through competition. Thus, by eliminating competition, it also eliminates the very means by which our market is designed to correct high pricing. The only way, then, that the drug pricing can be corrected is through legislative measure. Indeed, several states have attempted to take on this free market problem by imposing significant penalties on manufacturers for price increases over a

151. *See* Erika King Lietzan, *A Brief History of 180-Day Exclusivity Under the Hatch-Waxman Amendments to the Federal Food, Drug, and Cosmetic Act*, 59 FOOD & DRUG L.J. 287, 303 (2004).

152. *See* Press Release, Tufts Ctr. for the Study of Drug Dev., *supra* note 53.

153. *See* Brooke Grp. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 211 (1993) (detailing how a cigarette company with brand-name market power used this control to further gain control in the generic market).

154. *See* Aaron S. Kesselheim et al., *Determinants of Market Exclusivity for Prescription Drugs in the United States*, JAMA INTERNAL MED. (Sept. 11, 2017), http://www.commonwealthfund.org/publications/in-the-literature/2017/sep/determinants-market-exclusivity-prescription-drugs [https://perma.cc/F8J6-YCTW].

specified period of time.[155] Twelve states—Colorado, Illinois, Louisiana, Maryland, Minnesota, Mississippi, New Hampshire, New Jersey, Rhode Island, Virginia, Washington, and Wisconsin—have attempted to pass price gouging legislation,[156] however, if eventually enacted, these laws could face significant constitutional challenges without federal action.[157]

In a recent opinion published by the Fourth Circuit, the court held Maryland's first-of-its-kind drug price gouging statute unconstitutional as a violation of the dormant Commerce Clause.[158] Maryland's legislature enacted HB 631, "An Act concerning Public Health—Essential Off-Patent or Generic Drugs—Price Gouging—Prohibition" (the Act) without its governor's signature in 2017.[159] While the Act only targeted the pricing of "off-patent or generic drug[s]," the Act's intention overall was to deter unconscionable increases in prescription drug prices.[160] The Act defined unconscionable increase as "excessive and not justified by the cost of producing the drug or the cost of appropriate expansion of access to the drug to promote public health."[161] Additionally, the Act targeted the negative side effects of the current drug pricing system, which "'[r]esults in consumers . . . having no meaningful choice about whether to purchase the drug at an excessive price' due to the drug's 'importance . . . to their health' and '[i]nsufficient competition in the market.'"[162] The Act imposed civil penalties of $10,000 per violation, and also retained the ability to enjoin the sale of the medication at the increased, unconscionable price.[163] The Act also provided the Maryland Medical Assistance program the ability to identify violations, by notifying the Attorney General when "'an increase of 50% or more in the wholesale acquisition cost of the drug within the preceding 1-year period' or when a 30-day supply of the drug 'would cost more than $80 at the drug's wholesale acquisition cost.'"[164]

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155. *See State Legislative Action to Lower Pharmaceutical Costs*, NAT'L ACAD. FOR ST. HEALTH POL'Y, https://nashp.org/rx-legislative-tracker-2019 [https://perma.cc/CP4K-YMR7] (last updated Sept. 26, 2019) (displaying interactive U.S. map to show status of state legislation to address prescription drug costs).

156. *Id.*

157. *See* Brian Witte, *Federal Appeals Court Strikes Down Drug Price-Gouging Law*, NBC WASH., https://www.nbcwashington.com/news/local/Federal-Appeals-Court-Strikes-Down-Drug-Price-Gouging-Law-479665303.html [https://perma.cc/8V3L-HV3F] (last updated Apr. 14, 2018, 11:30 PM) (discussing a Maryland price-gouging law that was struck down by the U.S. Court of Appeals for the Fourth Circuit).

158. Ass'n for Accessible Meds. v. Frosh, 887 F.3d 664, 674 (4th Cir. 2018).

159. *Id.* at 666.

160. *Id.* (quoting MD. CODE ANN. HEALTH-GEN. § 2-802(a) (West 2017)).

161. *Id.* (quoting HEALTH-GEN. § 2-801(f)).

162. *Id.* (alterations in original).

163. *Id.* (citing HEALTH-GEN. § 2-803(d)).

164. *Id.* at 666–67 (quoting HEALTH-GEN. § 2-803(a)).

The Association for Accessible Medicines (AAM) sued the Attorney General in district court, arguing that the statute should be enjoined because it is unconstitutionally vague, and that it violated the dormant Commerce Clause.[165] The district court dismissed AAM's claim, and it appealed.[166] In a 2–1 ruling, the Fourth Circuit held that the Act violated the dormant Commerce Clause of the Constitution, namely that the Act controlled prices included in transactions occurring outside of Maryland.[167] Unlike the cigarette sales in *Star Scientific Incorporated v. Beales*,[168] which strictly applied to wholesale drug sale operations contained wholly within Virginia, the Fourth Circuit found that the "made available for sale"[169] language found within the Act did not specifically target only operations within Maryland.[170] Additionally, the court held that the Act, like the acts enacted by other states, would impose a significant burden on interstate commerce.[171] Because "the Act attempt[ed] to dictate the price that may be charged elsewhere for a good[,]" namely, other states where elements of the drug manufacturer's pricing structure take effect, the court struck it down.[172] Ultimately, while the court "sympathize[d] with the consumers affected by the prescription drug manufacturers' conduct and with Maryland's efforts to curtail drug price gouging," it made clear that the state legislature could not combat drug price gouging in a way that would contravene the Constitution.[173] Indeed, the court seemed only to prohibit Maryland's efforts to combat prescription drug price gouging "*in the manner utilized by the Act*," leaving the door open to similar acts by Maryland—and other states—that comply with the dormant Commerce Clause of the Constitution.[174]

Association for Accessible Medicines underscores the necessity for congressional action, and how a federal law similar to the Act could effectively prevent the drug price spikes sweeping through America. While the dormant Commerce Clause limits a state's ability to enact certain legislation that effects commerce outside the state's boundaries,[175] the Commerce Clause grants the federal government the power to regulate interstate commerce

165. *Id.* at 667.
166. *Id.*
167. *Id.* at 670.
168. Star Sci., Inc. v. Beales, 278 F.3d 339, 346 (4th Cir. 2002).
169. HEALTH-GEN. § 2-801(b)(1)(iv).
170. Ass'n for Accessible Meds. v. Frosh, 887 F.3d 664, 670 (4th Cir. 2018).
171. *Id.*
172. *Id.* at 672–73.
173. *Id.* at 674.
174. *Id.*
175. *Id.* at 672.

among the several states.[176] So, one of the very best ways that the drug price problem could be addressed is by enacting a price gouging statute similar to the Act, but applying it across the entire country.

While there currently are price gouging laws enacted across thirty-four states and the District of Columbia,[177] many of these laws only target price gouging when it is related to a disaster, or state of emergency.[178] Because there is no federal law on point—indeed, the closest may be the Federal Price Gouging Prevention Act of 2013,[179] whose last action was taken in May of 2013—a price gouging law could be enacted without the disaster, or state of emergency language. Even if Congress found it necessary to combat prices only in an event of an emergency, it is clear that the current price escalation—especially given the upcoming demand for drugs from baby boomers—qualifies as an emergency under any definition of the word.

C. *Forcing Mixed Margins*

Another option to help combat high drug prices could be to enact mandatory, fixed margins that drug manufacturers could charge for prescription drugs. While this effort would go against some of the free market ideas our country is founded on, it is not entirely unprecedented. Indeed, nineteen other developed countries in the period from 1992 to 2004 enacted policies that expressly limited the revenues pharmaceutical companies could receive.[180] While these legislations can lead to less markets for generic drugs, the delay of new drugs, and limit the availability of new drugs, they did have a positive effect on reducing drug prices, and on reducing the revenues that drug companies demand from consumers.[181] Even those countries that could still be considered developing, like India, have found success in profit margin caps.[182] While this is and should be considered an extreme option, it is still nonetheless an opportunity to correct prices and margins that could continue

176. *See, e.g.*, United States v. Lopez, 514 U.S. 549, 553 (1995); Gibbons v. Ogden, 22 U.S. 1, 199–200 (1824).

177. *See Price Gouging Laws by State*, FINDLAW, https://consumer.findlaw.com/consumer-transactions/price-gouging-laws-by-state.html [https://perma.cc/A7NA-MVNC].

178. *See id.* Varying versions of the laws have been enacted in thirty-four states including Arkansas, Connecticut, Delaware, and Florida, to name a few. *Id.*

179. Federal Price Gouging Prevention Act of 2013, 113th Cong., H.R. 2070 (2013).

180. *See* Neeraj Sood et al., *The Effect of Regulation on Pharmaceutical Revenues: Experience in Nineteen Countries*, 28 HEALTH AFF. 125, 125–29 (Dec. 2008), https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3829766 [https://perma.cc/W6MF-QGRL].

181. *Id.* at 129–36.

182. Prabha Raghavan, *Now, Government Plans to Cap Margins of Medical Devices to Bring Down Prices*, ECON. TIMES, https://economictimes.indiatimes.com/industry/healthcare/biotech/pharmaceuticals/govt-plans-to-cap-margins-for-medical-devices-to-provide-relief-to-industry/articleshow/61137881.cms [https://perma.cc/UZ3M-L7D9] (last updated Oct. 19, 2017, 11:57 AM).

to escalate, eventually pricing some patients out of the ability to purchase drugs all together.

D. Increasing Imports

As described in Part I, the same prescription drugs sold around the world are significantly more expensive in the United States than in other high-income countries.[183] One way to lower the costs for Americans is to purchase these drugs from abroad, at the lower costs, and import them into the United States for domestic consumption. This would serve "to stimulate price competition among biologics and certain small molecule generics."[184]

While there are concerns with the safety of importing prescription drugs from other countries, today's biopharmaceutical industry and its standards are global.[185] Further, as one recent FDA Commissioner described, 40% of all finished prescription drug products sold in the United States were manufactured *outside* of the United States, and 80% of key pharmaceutical ingredients utilized in the manufacturing of drugs in the United States were sourced from other countries.[186]

Some states, like Vermont and Utah, have already begun state-administered wholesale importation of drugs to offset the high burden on its state's residents.[187] Other states—like Colorado, Connecticut, Florida, Illinois, Indiana, Massachusetts, Maine, Minnesota, Missouri, New Mexico, Oklahoma, and Oregon—have considered similar actions with varied support from state legislators.[188] However, the imported drugs for these states are almost exclusively from Canada, because, under existing federal law,[189] only the federal government can import from more competitive markets like the EU or Japan.[190]

While states who utilize importation of lower-priced drugs from Canada will at least partially lower drug prices for consumers in their state, amending

183. *See supra* notes 12–24 and accompanying text.

184. *See* Jane Horvath, *Prescription Drug Importation: New Federal Initiatives and the Case for State Action*, HEALTH AFF. (Nov. 14, 2018), https://www.healthaffairs.org/do/10.1377/hblog20181113.552343/full [https://perma.cc/2WLJ-NCMJ].

185. *Id.*

186. *Id.*

187. *See id.*

188. *Id.*; *see also State Legislative Action to Lower Pharmaceutical Costs*, *supra* note 155 (detailing action and its progress on importation statutes in varying states).

189. *See* Horvath, *supra* note 184 (describing case law, dormant Commerce Clause case law, Medicaid rules, and other federal government restrictions on importations).

190. *See generally* Cécile Rémuzat et al., *Overview of External Reference Pricing Systems in Europe*, 3 J. MKT. ACCESS & HEALTH POL'Y 1, 1–2 (2015), https://doi.org/10.3402/jmahp.v3.27675 (describing pricing structures and how several European countries maintain low prices across different boarders through external reference pricing).

the FDA rules to allow for importation from a wider variety of more competitive countries will likely lower costs even more.

E. Government Development of Generic Drugs

One option to lower costs of prescription drugs is to allow the government to enter into the business of researching and developing generic drugs. While many will argue that the government is not in the business of healthcare—let alone prescription drug manufacturing—many of the steps required in the research and development of a new drug are already done by the FDA in the evaluation of drug effectiveness. Indeed, the overlap not only in the science behind the drug, but the marketing of the drug once it is completed. These areas of expertise would make the government's development of the prescription drugs easier than an entirely new prescription drug manufacturer.

Further, the government would be in a unique position to bypass many of the critical choke points of drug development, like waiting for certain approvals for the FDA before proceeding. If the FDA was responsible for reviewing its own application, information could be shared in a more informal and consistent setting as the drug moves through the approval process. This would help speed up applications by allowing approval by step, instead of by drug.

Finally, the government—as a drug manufacturer—would be able to directly negotiate with the government—as a purchaser of prescription medicine—in at cost or cost-plus agreements. This ultimate level of transparency would effectively eliminate the high margins of even generic drugs that private drug manufacturers exact.

VI. CONCLUSION

Some argue the case against more government regulation in the prescription drug market,[191] but there is no doubt that something needs to be done. It seems the only way that prescription drug prices can be curbed is through federal action, specifically modifying the drug marketing structure, the exclusivity or patent period, price gouging efforts, or margins drug manufacturers receive. Some of these options may seem drastic to Congress, but when examining the serious plight facing Americans, these are reasonable alternatives compared to the inability to purchase drugs at all.

191. ELIZABETH L. WRIGHT, CITIZENS AGAINST GOV'T WASTE, PHARMACEUTICAL PRICE CONTROLS: A PRESCRIPTION FOR DISASTER 11 (Oct. 2016), https://www.cagw.org/reporting/pharmaceutical-price-controls [https://perma.cc/DJ3V-DCTL].

Without additional action taken by Congress or other government agencies, many of the solutions proposed in this Comment will remain ideas instead of actions taken to reduce the burden on consumers. While actions need to be enacted to immediately and directly combat the high drug prices, additional policies need to be discussed and proposed to spur future ideas. By continuing to have informed policy makers—at both the federal and state levels—discussions can continue to be robust and fresh ideas generated. The rhetoric battle against prescription drug prices and the manufacturers of those drugs will be an easy fight. But, what will not be so easy, is a continued and concerted effort to make lasting impacts for *all* Americans on something as meaningful as their health and finances.

IS THE SKY REALLY FALLING? A CLOSER LOOK AT THE CURRENT PENSION "CRISIS" AND THE CONSTITUTIONALITY OF RETROACTIVE PENSION REFORM

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I. INTRODUCTION

Public pensions have been around for more than a century in the United States.[1] Though originally seen as a mere "gratuity," they eventually became recognized as a significant part of an employee's compensation package.[2] For decades now, defined-benefit pensions have played a key role in providing state and local governments with a stable workforce of trained and experienced personnel.[3] But times are rapidly changing. Since the 2008 recession, warnings of a "crisis" have spread across the country by groups claiming that public pensions are "running dry," that they are grossly "underfunded and cannot be sustained."[4] But is this true? Recent studies suggest that the "crisis"

1. TYLER BOND, NAT'L PUB. PENSION COAL., WHY PENSIONS MATTER 1 (Mar. 2017), https://protectpensions.org/wp-content/uploads/2017/03/NPPC-Why-Pensions-Matter-FINAL.pdf [https://perma.cc/4MYT-UUES] ("The first public pension plan in the United States was established in New York City in 1857.").

2. *See* Allied Chem. & Alkali Workers, Local Union No. 1 v. Pittsburgh Plate Glass Co., 404 U.S. 157, 180, (1971) ("To be sure, the future retirement benefits of active workers are part and parcel of their overall compensation and hence a well-established statutory subject of bargaining.").

3. *See* Eric M. Madiar, *Is Welching on Public Pension Promises an Option for Illinois? An Analysis of Article XIII, Section 5 of the Illinois Constitution*, 48 J. MARSHALL L. REV. 167, 176 (2014). Madiar writes:

> These plans also allow employers to attract better employees, reduce turnover, facilitate orderly retirement of older employees, and make it possible to retain valuable employees who might otherwise seek more gainful employment. In addition, retirement plans are especially important for public employers because the "government cannot compete with private industry salary levels, and must rely heavily upon the equalizing factor of an attractive and liberal retirement plan."

Id. (quoting Rubin G. Cohn, *Public Employee Retirement Plans- The Nature of the Employees' Rights*, 1968 U. ILL. L.F. 32, 40 (1968)).

4. NAT'L CONFERENCE ON PUB. EMP. RET. SYS., DON'T DISMANTLE PUBLIC PENSIONS BECAUSE THEY AREN'T 100 PERCENT FUNDED 1 (Nov. 2017), http://www.ncpers.org/files/NCPERS%20Research%20Series_Don't%20Dismantle%20Public%20Pensions%20Because%20They%20Arent%20100%20Percent%20Funded_Web.pdf [https://perma.cc/V3UR-KMN3] [hereinafter NCPERS, DON'T DISMANTLE PUBLIC PENSIONS].

narrative might have arisen from a general misunderstanding about what funding ratios truly tell us about the financial stability of public sector pensions.[5] Perhaps even more concerning aspect of the so-called "crisis" is the way the states have responded to it. A recent survey reported that at least 74% of the states have already passed legislation which had the effect of either retroactively reducing earned retirement benefits or reducing retirement benefits for new employees. Those reductions were not just made to the *future* benefits of current employees; many retirees saw their paychecks reduced as well.[6] But were such actions even lawful?

Many states have their own statutory and constitutional barriers protecting public pension benefits. When those remedies are unavailable or fall short, employees must look to the federal system for relief. Article I, Section 10 of the United States Constitution, known as the Contracts Clause provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts."[7] Madison described the Clause as a "bulwark in favor of . . . private rights" against improper legislation generally.[8] Indeed, during the first century of its existence, the Contracts Clause was invoked by courts "more than any other [constitutional] provision to invalidate state legislation."[9] Though a severe departure from the original approach by the U.S. Supreme Court rendered the Clause dormant for most of the twentieth century, some of its power was restored in 1977 when the Court decided *United States Trust Company of New York v. New Jersey*.[10] While still too lenient on states, the Clause may nonetheless provide a meaningful check on retroactive pension reform under the current situation.

The goal of this writing is to make two main points. First, the Comment challenges the current notion that a true nationwide "crisis" even exists because low or decreasing funding levels say very little about a public pension

5. TOM SGOUROS, HAAS INST. FOR A FAIR & INCLUSIVE SOC'Y, FUNDING PUBLIC PENSIONS: IS FULL PENSION FUNDING A MISGUIDED GOAL? 6 (Wendy Ake & Stephen Menendian eds., 2017).

6. *See* Jean-Pierre Aubry & Caroline V. Crawford, *State and Local Pension Reform Since the Financial Crisis*, 54 CTR. FOR RET. RESEARCH. AT B.C. 1, 2 (Jan. 2017); *see also* Eric M. Madiar, *Public Pension Benefits Under Siege: Does State Law Facilitate or Block Recent Efforts to Cut the Pension Benefits of Public Servants?*, 27 A.B.A. J. LAB. & EMP. L. 179, 180 (2012) (explaining that by 2012, at least 41 of the 50 states had already enacted significant changes to state pension plans).

7. U.S. CONST. art. I, § 10.

8. THE FEDERALIST NO. 44, at 319 (James Madison) (The Belknap Press of Harvard Univ. Press ed., 1961).

9. Stephen A. Simon, *Inherent Sovereign Powers: The Influential Yet Curiously Uncontroversial Flip Side of Natural Rights*, 4 ALA. C.R. & C.L. L. REV. 133, 145–46 (2013).

10. *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1 (1977); *see also* Douglas W. Kmiec & John O. McGinnis, *The Contract Clause: A Return to the Original Understanding*, 14 HASTINGS CONST. L.Q. 525, 525–26 (1987) (explaining the recent partial restoring of the Clause to its original understanding).

fund's long-term stability. To the extent there is a credible risk, nothing about the current data seems to warrant the conclusion that *retroactive* modifications are the only viable solution. And if having public pensions 100% funded is an appropriate goal,[11] states and municipalities need not bankrupt themselves trying to accomplish this overnight. Second, this Comment establishes that if no crisis exists, then a large amount of recent "pension reform" legislation might be subject to attack under the current Contracts Clause analysis. To further illustrate these concepts, this Comment will occasionally refer to a recent bill passed by the Texas Legislature in July 2017 involving the Houston Firefighters Relief and Retirement Fund (HFRRF).[12]

Part I of this Comment attempts to shed some new light on the "pension crisis" based on recent studies and explains why some analysts are calling the crisis a "myth." Part II briefly examines the original purpose and scope of the Contracts Clause, and how the Framers intended it to operate even in times of severe economic hardships. Part III traces the historical development of the Clause's application through three distinct periods of U. S. Supreme Court jurisprudence. Part IV includes an analysis of the current law as it relates to recent pension reform measures and explains how some measures might fail the three-part test announced in *United States Trust Company of New York v. New Jersey*.[13] Part V concludes with a summary of main points and some closing thoughts.

II. IS THERE A TRUE "CRISIS?"

At the heart of the pension reform movement is the notion that cutbacks are unavoidable due to the widening gap between current pension assets and *future* liabilities. Advocates of reform point to the changes in the funding gap as evidence that pensions do not have the assets needed to cover all the retirement benefits employers promised to pay their employees in the future. To further capture the dismal nature of the situation, reform advocates often point to states like Illinois, where state-sponsored pension plans in 2016 were

11. Some scholars consider fully-funded pensions in the public sector to be a waste. *See infra* note 20 and accompanying text.

12. Firefighters Relief and Retirement Fund, TEX. REV. CIV. STAT. ANN. art. 6243e.2(1); SYLVESTER TURNER, CITY OF HOUS., CITY OF HOUSTON LEGISLATIVE REPORT (2017), http://www.houstontx.gov/txlege/sb-2190-pension-reform [https://perma.cc/V4RF-W737].

13. *See U.S. Trust*, 431 U.S. at 17–25.

the lowest-funded in the country at roughly 46%,[14] and Detroit, where pensions were largely to blame for its bankruptcy in 2013.[15] These and other similar examples were used to generate a widespread sense of urgency among U.S. taxpayers to find ways to close the enormous "trillion dollar gap" that was crippling the economy.[16] But do these examples really mean that a bona fide *crisis* is at hand—one that calls for retroactive reductions and possibly dismantling public pensions altogether? The fact that Illinois' pensions have operated at or near their current funding levels since the early 1970s is telling.[17]

An overemphasis on Illinois, Kentucky, New Jersey, and Connecticut presents at best a distorted view of the pension landscape as a whole because these were the only four of the fifty states with less than fifty percent funding in 2016, while the broader picture shows an average funding ratio across the board of between 72.6% and 77.6%."[18] The HFRRF was 86.12% funded in July 2017 when the Texas Legislature passed SB 2190 and reduced benefits.[19]

Unsurprisingly, not every analyst believes the sky is falling—and for reasons that appear far too reasonable to dismiss. One analyst for the Haas Institute recently observed that full funding of public pensions is not only a misguided goal but also a waste of taxpayer money,[20] and to a large extent,

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14. *See, e.g.*, NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 5 tbl.2 (showing Illinois's liabilities of $247.6 billion and assets of $114 billion were the lowest in the country); Robert Reed, *Proposed $107 Billion Bond Isn't the Cure for Illinois Public Pension Crisis*, CHI. TRIB. (Jan. 30, 2018), http://www.chicagotribune.com/business/columnists/reed/ct-biz-illinois-pension-bond-blowout-robert-reed-0131-story.html [https://perma.cc/UL8S-NEWR].

15. Saqib Bhatti, *Why Chicago Won't Go Bankrupt—And Detroit Didn't Have To*, IN THESE TIMES (June 22, 2015), http://inthesetimes.com/article/18096/a_scam_in_two_cities [https://perma.cc/Y8NF-ANFK] ("All of this uproar rested on a basic falsehood in the dominant public narrative around Detroit: that pensions played a key role in driving the city bankrupt.").

16. *See generally* THE PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROAD TO REFORM (Feb. 2010), https://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2010/TrillionDollarGapUnderfundedStateRetirementSystemsandtheRoadstoReformpdf.pdf [https://perma.cc/984Q-FLCD] (discussing the "trillion-dollar gap" as of 2010).

17. *See* Madiar, *supra* note 3, at 186–87 (explaining that the funding levels of Illinois' pension systems in 1970 were roughly the same as today).

18. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 7.

19. HOUS. FIREFIGHTERS' RELIEF & RET. FUND, FISCAL YEAR 2018 COMPREHENSIVE ANNUAL FINANCIAL REPORT, 42 (2018), https://www.hfrrf.org/resources/73a316c6-ed20-4eae-9474-414adfb9eaa3/hfrrf%20comprehensive%20annual%20financial%20report%20fy18.pdf?trackid=hfrrf%20comprehensive%20annual%20financial%20report%20fy18.pdf [https://perma.cc/D2YG-L85P].

20. *See* SGOUROS, *supra* note 5, at 5; *see also* John J. McTighe et al., *Why Full Funding of Pensions is a Waste of Money*, SAN DIEGO UNION TRIB. (Sept. 14, 2017), http://www.sandiegouniontribune.com/opinion/commentary/sd-utbg-public-pensions-funding-20170914-story.html [https://perma.cc/CD4R-LU56] ("Both the city and county of San Diego pensions systems are quite

"the crisis is the result of the accounting rules governing both these plans and the governments that sponsor them."[21] After a closer look at the 2013 Detroit bankruptcy, the analyst concluded that it "had far more to do with the politics of Michigan's suburbs . . . than it did with the mathematical reality of the city finances."[22] The National Conference on Public Employee Retirement Systems (NCPERS) recently performed a study analyzing 2016 data from 299 state-sponsored pension plans from all fifty states.[23] They determined that "funding status has little correlation with a pension fund's ability to pay the promised benefits."[24] The report concludes with the following:

> If left intact, public pension plans are sustainable, as they have been for decades. Our analysis of data from more than 6,000 state and local pension plans over the last quarter century shows that pension funds are resilient. They weathered the Great Recession and several other economic downturns during the study period. Their assets now are higher than ever before.[25]

One law professor explained that "the notion of 'unfunded liabilities' is merely an ominous new catchphrase coined during debates over massive spending programs such as Social Security and Medicare that is rooted in financial fallacy."[26] Indeed, some have even gone as far as calling the pension crisis a "myth."[27]

How do members of the general public view pensions? A 2015 report from the National Institute on Retirement Security (NIRS) revealed that

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stable at a 70–80 percent funding ratio. Wouldn't the tax dollars required to get them to 100 percent funding be better spent on other needs—like police, parks and libraries?").

21. SGOUROS, *supra* note 5, at 4.

22. *Id.* at 5.

23. *See* NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 5 tbl.2.

24. *Id.* at 1. The report also suggests that public pensions by themselves "impose little or no burden on taxpayers." *Id.* It reads:

> In fact, public pensions are revenue-neutral or revenue-positive. [They] contribute to state and local revenues in two ways. First, when retirees spend their pension checks in local economies, it creates economic activity that generates revenues. Second, pension funds invest $3.7 trillion in the economy. This investment, traced down to individual localities, also boosts economic activity, which in turn generates state and local revenues. Our analysis shows that total state and local revenues generated by retiree spending and pension fund investments are equal to or greater than the taxpayer contribution to pensions.

Id.

25. *Id.* at 11.

26. Jan Dennis, *'Unfunded Liabilities' a Financial Myth, Expert Says*, ILL. NEWS BUREAU (Apr. 1, 2009, 9:00 AM), https://news.illinois.edu/view /6367/205985 [https://perma.cc/D8NJ-MBXN].

27. Tyler Bond, *The "Pension Crisis" is a Myth, Part One*, NAT'L PUB. PENSION COAL. (July 13, 2017), https://protectpensions.org/2017/07/13/pension-crisis-myth-part-one/ [https://perma.cc/34ZV-GMAW]. The author further suggests that those who promote the dismantling of public pensions may either have a general hostility towards public employees, or a financial interest in converting defined benefit plans into 401ks. *Id.*

while "[s]ome 86 percent of Americans agree that the nation faces a [retirement] crisis,"[28] there appeared to be a "high and growing" percentage of Americans who say that pensions are "worth having because [they] provide[] steady income that will not run out."[29] The report attributed this to a large number of Baby Boomers (about ten thousand a day) entering retirement "without pensions, with lower Social Security benefits, inadequate individual account balances and skyrocketing healthcare costs."[30]

A. Pensions Continue to be Financially Stable Despite Funding Ratios

Even if funding ratios were a reliable benchmark for measuring a pension fund's overall financial health, states like Illinois, Kentucky, and New Jersey do not represent public pensions in general. As noted, states overall had an average funding level of 77.6% based on quarterly earnings data from 2016.[31] The more extreme examples of low funding are isolated and can largely be attributed to those states' persistent failures to make their annual employer contributions.[32] Illinois, for instance, has not once made a full contribution over the last seventy-eight years.[33]

Public pensions have withstood and recovered from every economic downturn over the last two decades, including the 2001 and 2008 recessions.[34] The NCPERS study looked at data from the U.S. Census Bureau from 1993 to 2016 to measure and compare the ability to pay pension benefits across all fifty states. During that twenty-four-year period, there were only four years (2002, 2008, 2009, and 2012) in which state pension funds had negative cash flows.[35] The positive cash flows during the remaining twenty years enabled them to build up enough assets in reserve "to weather the 2001 recession, the Great Recession of 2008, and other economic downturns."[36] Data provided by the Houston Firefighters' Relief and Retirement Fund from

28. DIANE OAKLEY & KELLY KENNEALLY, NAT'L INST. ON RET. SEC., RETIREMENT SECURITY 2015: A ROADMAP FOR POLICY MAKERS, AMERICANS' VIEWS OF THE RETIREMENT CRISIS 6 (2015).

29. *Id.* at 2. The report provides that "67 percent of Americans indicate they would be willing to take less in pay increases in exchange for guaranteed income in retirement." *Id.*

30. *Id.* at 1. The report further comments, "It doesn't take an actuary to see that the numbers for many just don't add up." *Id.*

31. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 7.

32. *See* GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSION PLANS: CURRENT STRUCTURE AND FUNDED STATUS 22–24 (July 2008), http://www.gao.gov/assets/130/120599.pdf [https://perma.cc/GD62-4UQW] [hereinafter GAO].

33. *See* Tyler Bond, *The "Pension Crisis" is a Myth, Part Three*, NAT'L PUB. PENSION COAL. (Aug. 1, 2017), https://protectpensions.org/2017/08/01/pension-crisis-myth-part-three/ [https://perma.cc/GU5X-2LPB].

34. *See* NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 8, 10.

35. *See id.* at 3.

36. *Id.*

that same twenty-four-year period reflected growth in fund assets from less than $900 million in 1993 to just under $4 billion in 2016.[37]

B. How Changes in Accounting Standards Contributed to the Crisis

The accounting and reporting guidelines for state and local pension systems are established by the Governmental Accounting Standards Board (GASB).[38] The rules govern how state and local governments must report their pension fund's financial information, and though states are not required to *fund* pensions according to the metrics and assumptions prescribed, it is believed that deviating could have a negative effect on bond ratings.[39] The GASB recently changed the way state and local pension systems calculate and report future liabilities by changing the "discount rate," or the returns a plan expects to earn on investments over a period of years.[40] The discount rate also affects how much a government must contribute to a pension fund.[41] Prior to the changes, states and municipalities were assuming future returns of about 7.6% based on their fund's actual past performance.[42] Under the new rules, pension systems that are not fully-funded must now apply a blended discount rate that uses both a long-term expected rate of return and a "risk-free" rate of return,[43] which is roughly equivalent to U.S. treasury bond rates at about 2–3%.[44] Applying a lower discount rate of return means that the present value of future pension liabilities is "assumed" to be lower, thus making the liabilities seem higher. Thus, changes in how pension systems calculate and reflect their unfunded liabilities were primarily responsible for the dramatic increase in the funding gap from an estimated $900 billion in 2014 to

37. Graph of *Houston Firefighters' Relief & Retirement Fund, Net Plan Asset Growth Since 1937*, HOUS. FIREFIGHTERS' RELIEF & RET. FUND, https://www.hfrrf.org/Resources/04af43c5-d259-4f1d-b674-d7d5a5a034e8/Fund%20Growth%20Chart%20-%20June%2030,%202018.pdf [https://perma.cc/U6YN-KHQX] [hereinafter HFRRF Graph].

38. SGOUROS, *supra* note 5, at 7.

39. *See id.* at 28.

40. *Id.* at 14.

41. Robert Pozen & Theresa Hamacher, *A Realistic Discount Rate for Pensions*, FIN. TIMES (Aug. 19, 2012), https://www.ft.com/content/b5e7a3bc-e133-11e1-9c72-00144feab49a [https://perma.cc/LT4K-UWAV]. A lower expected return causes the "present value" of future liabilities to go up, thus, more contributions are needed today to "fund" those liabilities. *Id.*

42. JOSHUA D. RAUH, HOOVER INST., HIDDEN DEBT, HIDDEN DEFICITS: 2017 EDITION 1 (2017), https://www.hoover.org/research/hidden-debt-hidden-deficits-2017-edition [https://perma.cc/WJB4-LJB2].

43. SGOUROS, *supra* note 5, at 14.

44. Craig Foltin et al., *State and Local Government Pensions at the Crossroads: Updating Accounting Standards Highlight the Challenges*, CPA J. (May 2017) https://www.cpajournal.com/2017/05/08/state-local-government-pensions-crossroads/ [https://perma.cc/S8KL-LBKK]. ("[T]he 10-year U.S. Treasury rate has hovered in the 2–3% range for the last five years . . . .").

as high as $3.41 trillion in 2017.[45] But that was only on paper. The new accounting standards have zero effect on the $3.26 trillion in *real* money owned by the funds—money which continues to increase.[46]

The new accounting standards were supposed to bring clarity by creating a uniform system of accounting and by "closing some reporting loopholes" to make it easier to answer important questions about the financial condition of pension plans.[47] But some commentators think the rules do just the opposite and raise far more questions than they answer. This is because they see a critical flaw with the ultimate question actuaries must ask when making their annual report—If the pension fund closed tomorrow, how much would be needed to pay out all the promised benefits until the last member dies?[48] Knowing the answer to such a question is extremely important when it comes to private-sector pensions where there is a real risk of permanent closure. But a government entity is not like a commercial enterprise; its revenue stream is not voluntary but rather compulsory in nature.[49] Indeed, the power to lay and collect taxes is perhaps the most stable and predictable method of revenue generation the world has ever known. As research and data analyst Tom Sgouros put it: "[T]he GASB rules do a good job of answering, 'How much money will this plan need to pay off its debts if it is closed tomorrow?' But most plans are not going to be closed tomorrow, so this is usually not very useful information."[50]

If the goal of a funding policy is "to provide for all benefits expected to be paid to members and their beneficiaries when due,"[51] accounting guidelines should be structured in a way that measures real progress towards that goal. Not only do the GASB standards fail to do this by "exaggerat[ing] the problems facing pension funds," they steer legislatures towards misguided

45. *Id.*

46. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 7.

47. SGOUROS, *supra* note 5, at 27.

48. *See id.* at 27–28.

49. *See id.*

50. *Id.* at 28; *see also* GAO, *supra* note 32, at 19 ("[I]t is unlikely that public entities will go out of business or cease operations as can happen with private sector employers . . . ."); ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOS. COLL., WHY HAVE DEFINED BENEFIT PLANS SURVIVED IN THE PUBLIC SECTOR? 6 (Dec. 2007), https://crr.bc.edu/wp-content/uploads/2007/12/slp_2.pdf [https://perma.cc/T5DH-9ECT] (explaining that public employers face "fewer market pressures" than private-sector employers).

51. PAUL ANGELO & TOM LOWMAN, CONFERENCE OF CONSULTING ACTUARIES PUB. PLANS CMTY. (CCA PPC), ACTUARIAL FUNDING POLICIES AND PRACTICES FOR PUBLIC PENSION PLANS 9 (Oct. 2014), https://www.ccactuaries.org/Portals/0/pdf/CCA_PPC_White_Paper_on_Public_Pension_Funding_Policy.pdf [https://perma.cc/J6PU-XJSG].

"solutions" that may cost taxpayers and the economy far more in the long run than they purport to save.[52] As Sgouros further observed:

> [T]he clarity provided by the GASB rules comes at the expense of making the situation seem much more dire than necessary. By ignoring, if not actually undermining, the value of the collective strength of a pension plan, the rules do a deep disservice to those who have contributed loyally to the plans for decades. The new rules will also require governments to add a deficit of billions of dollars to their governments' bottom line, something few political leaders have the will to ignore.[53]

It is well-recognized that low funding ratios "do not necessarily indicate that benefits for current plan members are at risk."[54] As long as income from investments and employer-employee contributions meet or exceed benefit payments, public pension systems could theoretically operate forever.[55] Because most of a pension fund's annual income is derived from investment earnings, it seems a better accounting method might be one that focuses on the ability to weather economic downturns like the 2001 and 2008 financial recessions.

C. *Are Pensions Too Costly to Sustain?*

Another argument advanced by reform advocates is that public pensions are too costly to maintain. Recall that pensions took most of the blame for Detroit's bankruptcy in 2013, yet not even 20% of the city's $18 billion debt was attributable to pension debts.[56] In fact, one analyst determined that "[t]he cost of running the city's pension systems had actually declined in the previous two years."[57]

In another study done by NCPERS, it was found that funding public pensions only cost taxpayers an average of "about [twenty] cents on the dollar,"[58] while the remaining eighty percent "comes from investment earnings

52. SGOUROS, *supra* note 5, at 6, 17 ("A good accounting system is supposed to provide an accurate picture of an organization's financial health and a useful guide to action. In these cases, the accounting system guides its users to destructive and inappropriate action.").

53. *Id.* at 28.

54. *See* GAO, *supra* note 32, at 21.

55. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 11. A 2008 report issued by the Congressional Government Accountability Office (GAO) revealed the following: "Currently, most state and local government pension plans have enough invested resources set aside to pay for the benefits they are scheduled to pay over the next several decades" and further added that "it is unlikely that public entities will go out of business or cease operations as can happen with private sector employers." GAO, *supra* note 32, at 18–19.

56. SGOUROS, *supra* note 5, at 6.

57. *Id.*

58. NAT'L CONFERENCE ON PUB. EMP. RET. SYS., PUBLIC PENSIONS ARE A GOOD DEAL FOR TAXPAYERS 2 (Aug. 2017), http://www.ncpers.org/files/NCPERS%20Re-

and employee contributions."[59] The report further reads that "[i]f we take into account tax revenue generated as a result of pension spending and investment, the [twenty]-cents-on-the-dollar tax burden is wiped out. Thus, pension funds pose little, if any, burden on taxpayers . . . ."[60]

While it is undoubtedly true that the cost of pensions has increased somewhat because of longer life expectancies and the so-called "baby-boomer" spikes, the perceived "spiraling costs" are likely a result of the new accounting rules. The GASB has specifically stated that the standards only dictate how pensions are *reported*, not how they are funded.[61] Nevertheless, the perception among lawmakers, the media, and taxpayers appears to be that pensions less than 100% funded are at risk.[62]

The recent obsession with fully-funding state and local pensions has made them far more costly than they need to be. Many governments have sought to pay down their liabilities by amortizing them on a fixed schedule, usually thirty years.[63] This rarely succeeds, however, as the way pensions are structured makes this approach highly impractical.[64] Recall that pensions receive most of their income from investments.[65] History has shown that over a thirty-year period, there will be several years when low or negative investment earnings will cause a negative cash flow for that year, in which case the fund's own assets will be used to make up the difference.[66] Under a fixed amortization schedule, the balance of unfunded liabilities would be unaffected in those years because any extra payments would be absorbed by the shortfall—and there would be one less year remaining to pay down the debt.[67] Thus, the schedule eventually becomes unworkable due to the "snowball effect" caused by adding the swallowed payments to subsequent years.[68]

To the extent that governments can benefit by paying extra towards the narrowing of funding gaps, there appears very little reason to suggest they

search%20Series_2017%20Public%20Pensions%20Are%20A%20Good%20Deal%20for%20Taxpayers_Web.pdf [https://perma.cc/2JX9-C2ZB] [hereinafter NCPERS, PENSIONS ARE A GOOD DEAL].

59. *Id.* at 3. The report comments that "[t]his is a good deal for taxpayers. They get quality public service from dedicated nurses, firefighter[s], teachers, and police officers by paying only about [twenty] cents on the dollar for the retirement portion of earnings." *Id.*

60. *Id.*

61. *See* SGOUROS, *supra* note 5, at 9.

62. *Id.*

63. *See id.* at 26–27.

64. *See id.*

65. *See supra* note 59 and accompanying text.

66. *See* SGOUROS, *supra* note 5, at 26–27.

67. *See id.*

68. *Id.* Sgouros suggests that "[a] better way to amortize shortfalls due to volatility is to amortize them on the same time scale as the system amortization. If a shortfall occurs in year 20 of a 30-year schedule, that shortfall is amortized over 30 years rather than the remaining 10." *Id.* at 27.

pay the entire balance immediately. Though employees begin creating pension liabilities from their first day on the job, those liabilities will not become due for decades—if ever.[69] As noted earlier, under the right conditions, these pensions can operate in perpetuity despite the size of their funding gaps. Absent a genuine liquidity concern, the rush to close the funding gaps and the methods used by governments to achieve this appear unreasonable. Critics might claim that such an approach is an irresponsible form of "kicking the can down the road." Perhaps. But this assumes first, that there is even a can that needs kicking, and second, that "can-kicking" can never be done responsibly. This is especially important when the alternatives require breaking contractual promises and potentially exposing state and local governments to years of costly litigation.

D. How Pensions Benefit the Economy

There are several ways in which public pensions provide a substantial benefit to the economy. First, taxpayers directly benefit from the services provided by emergency response personnel, teachers, and other services public employees provide, while paying only twenty cents on the dollar towards their pension.[70] Second, the local economy also benefits when retirees spend their pension checks on goods and services.[71] Third, on a larger scale, the national economy benefits from the more than $4 trillion in assets pension funds inject into the economy in various ways.[72] A recent study by the National Institute on Retirement Security (NIRS) revealed that "[e]ach dollar paid out in pension benefits supported $2.21 in total economic output nationally."[73]

As we will see in Part II, concerns over the way states were responding to a financial "crisis" shortly after the American Revolution are what became the primary motivator for the drafters to insert the Contracts Clause into the Constitution.

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69. Many employees may never become eligible to receive benefits due to early termination for various reasons such as disability or death.

70. *See* NCPERS, PENSIONS ARE A GOOD DEAL, *supra* note 58, at 1.

71. *Id.*

72. *Id.*; *see also Public Pension Assets: Quarterly Update (Q1 2019)*, NAT'L ASS'N. OF ST. RET. ADMINS., https://www.nasra.org/content.asp?admin=Y&contentid=200 [https://perma.cc/URC3-H2C9] ("As of the first quarter of 2019 (March 31), public pension assets were a record $4.50 trillion, an increase of approximately 9.8 percent, from $4.10 trillion as reported for the prior quarter . . . .").

73. JENNIFER ERIN BROWN, NAT'L INST. ON RET. SEC., PENSIONOMICS 2016: MEASURING THE ECONOMIC IMPACT OF DB PENSION EXPENDITURES 1 (Sept. 2016), https://www.nirsonline.org/wp-content/uploads/2017/06/pensionomics2016_final.pdf [https://perma.cc/3JAC-Z2G5].

III. ORIGINAL PURPOSE AND SIGNIFICANCE OF THE CONTRACTS CLAUSE

In drafting the Constitution, the Framers sought to avoid two extremes: a "dictatorship on the one hand and tyranny by majorities on the other."[74] Madison expressed another concern in *The Federalist No. 10* regarding the tendency of governments to "fall easy prey" to special interest groups or "factions" that would try to use their majority power to control the government and effect a redistribution of wealth.[75] Specifically, Madison warned of a "rage for paper money, for an *abolition of debts*, for an equal division of property, or for any other improper or wicked project."[76] Madison felt that states were too small in population to maintain a healthy dispersion of views that would protect the minority from oppression.[77] A large republic would likely do a better job of "controlling the effects of faction[s]" by having a greater variety of interests.[78] In *The Federalist No. 44*, Madison reiterated the theme of factionalism while discussing the prohibition on bills of attainder, ex post facto laws, and laws impairing the obligation of contracts, viewing each as "contrary to . . . every principle of sound legislation."[79] Madison continued:

> The sober people of America are weary of the fluctuating policy which has directed the public councils. They have seen with regret and with indignation, that sudden changes, and legislative interferences, in cases affecting personal rights, become jobs in the hands of enterprising and influential speculators; and snares to the more industrious and less informed part of the community. They have seen, too, that one legislative interference is but the first link of a long chain of repetitions . . . . They very rightly infer . . . that some thorough reform is wanting, which will

74. Richard A. Epstein, *Toward a Revitalization of the Contracts Clause*, 51 U. CHI. L. REV. 703, 710 (1984).

75. *See id.* at 711 (citing THE FEDERALIST NO. 10, at 78 (James Madison) (Clinton Rossiter ed., 1961)). Professor Epstein further observed that the "great danger is that, once in office, legislators need no longer rely upon naked aggression to exact private gain, but can instead enlist the force of the state by passing laws that work to advance their own interests at the expense of the public or some part of it." *Id.* at 712. Madison defined "factions" as "a number of citizens . . . who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community." THE FEDERALIST NO. 10, at 44 (James Madison) (Hallowell ed., 1837).

76. THE FEDERALIST NO. 10, at 49 (James Madison) (Hallowell ed., 1837) (emphasis added).

77. Kmiec & McGinnis, *supra* note 10, at 528. It is interesting to note that the bulk of debate on the Clause at the Convention was over its "antimajoritarian nature." *See id.* at 532–33.

78. *See* THE FEDERALIST NO. 10, at 48 (James Madison) (Hallowell ed., 1837).

79. THE FEDERALIST NO. 44, at 212 (James Madison) (Hallowell ed., 1837).

> banish speculations on public measures, inspire a general prudence and industry, and give a regular course to the business of society.[80]

According to some commentators, one might argue that the pension crisis narrative is a modern example of precisely the kind of factionalism Madison envisioned.[81]

A. The Framers on the Importance of Protecting Contractual Stability

Naturally, anyone obligated to perform under a contract stands to benefit by avoiding those obligations. The Framers understood that protecting the integrity of contractual agreements was essential to maintain a thriving and stable economy. Like other constitutional restrictions on state autonomy, the Contracts Clause was "aimed at the particular abuses with which [the Framers] were familiar."[82] In an effort to address the widespread financial difficulty that arose after the Revolution, many states enacted debt relief laws, also known as insolvency statutes, which allowed debtors to discharge their obligations "by tendering worthless property instead of money, or depreciated paper money instead of coin."[83] In *Ogden v. Saunders*, Chief Justice John Marshall observed that the insolvency statutes had become so excessive "as to break in upon the ordinary intercourse of society, and destroy all confidence between man and man."[84] Chief Justice Marshall continued:

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80. *Id.* at 213.

81. *See, e.g.*, DAVID SIROTA, INST. FOR AM.'S FUTURE, THE PLOT AGAINST PENSIONS: THE PEW-ARNOLD CAMPAIGN TO UNDERMINE AMERICA'S RETIREMENT SECURITY –AND LEAVE TAXPAYERS WITH THE BILL 6 (2013), https://ourfuture.org/wp-content/uploads/2013/09/Plot-Against-Pensions-final.pdf [https://perma.cc/9HP6-CJSE] ("In each of these states and many others now debating pension 'reform,' [the] Pew [Foundation] and Arnold [Foundation] have colluded to shape a narrative that suggests cutting public pension benefits is the only viable path forward."); Matt Taibbi, *Looting the Pension Funds: All Across America, Wall Street is Grabbing Money Meant for Public Workers*, ROLLING STONE (Sept. 26, 2013 11:00 AM), https://www.rollingstone.com/politics/news/looting-the-pension-funds-20130926 [https://perma.cc/33XR-7YHQ] (describing instances of political influence by large financial groups seeking to dismantle public pensions).

82. Robert L. Hale, *The Supreme Court and the Contract Clause*, 57 HARV. L. REV., 512, 512 (1944).

83. *Id.* at 512–13; *see also* Kmiec & McGinnis, *supra* note 10, at 528; Janet Irene Levine, *The Contract Clause: A Constitutional Basis for Invalidating State Legislation*, 12 LOY. L.A. L. REV. 927, 928 (1979) (discussing economic hardships post-Revolution). Regarding debt-relief legislation statutes, Levine writes:

> These legislative schemes undermined confidence in the economy and made prosperous trade impossible. Business persons were unwilling to enter any transaction that involved credit because of the propensity of state legislatures to abrogate later these credit agreements by legislative fiat. The Framers sought to ensure stability for the debtor-creditor relationship by adopting the contract clause, which would prevent future state interference with debtor-creditor relationships.

Id.

84. Ogden v. Saunders, 25 U.S. 213, 355 (1827) (Marshall, C.J., dissenting).

> The mischief had become so great, so alarming, as not only to impair commercial intercourse, and threaten the existence of credit, but to sap the morals of the people, and destroy the sanctity of private faith. To guard against the continuance of the evil was an object of deep interest with all the truly wise, as well as the virtuous, of this great community, and was one of the important benefits expected from a reform of the government.[85]

B. *At the Ratifying Convention*

The Contracts Clause was introduced during the Constitutional Convention of August 28, 1787, when Rufus King proposed a clause that would prohibit the impairment of contracts to the language against bills of attainder and ex post facto laws.[86] King suggested language that mirrored a provision in the Articles known as the Northwest Ordinance,[87] which provided:

> [I]n the just preservation of rights and property, it is understood and declared, that no law ought ever to be made or have force in the said territory, that shall, in any manner whatever, interfere with or affect private contracts, or engagements, *bona fide*, and without fraud previously formed.[88]

The Clause drew little resistance at the Convention, although its approval was not totally unanimous.[89] King's proposal drew an immediate objection by the governor of Pennsylvania because of the Clause's anti-majoritarian nature.[90] Madison responded that any "inconvenience" caused by the "frustration of the majority will" would be outweighed by the Clause's utility.[91] Scholars generally agree that the proliferation of insolvency statutes, as described above, posed a threat to contractual stability and were the kind of abuses the Contracts Clause aimed to prevent.[92] However, not everyone at the Convention appeared to supported that notion. Colonel Mason of Virginia expressed

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85. *Id.*

86. Kmiec & McGinnis, *supra* note 10, at 529.

87. *Id.* at 530.

88. An Ordinance for the Government of the Territory of the United States northwest of the river Ohio, art. II (July 13, 1787), *reprinted in* 1 Stat. 51 n.(a), 1 Cong. ch. 8 (1789).

89. *See* Kmiec & McGinnis, *supra* note 10, at 530.

90. *Id.*

91. *Id.* (quoting 2 JAMES MADISON, THE RECORDS OF THE FEDERAL CONVENTION 440 (Max Farrand ed., 1911)).

92. *Compare* Kmiec & McGinnis, *supra* note 10, at 530–33 ("[T]here is little doubt that such legislation was one of the major evils that the Clause was designed to eradicate."), *with* Note, *Rediscovering the Contract Clause*, 97 HARV. L. REV. 1414, 1422 (1984) ("The framers apparently directed the contract clause exclusively against the states because it was the state legislatures that had passed the array of debtor-relief legislation that prompted the framers' concern with contractual stability.").

concerns that unforeseen circumstances would arise making contractual impairments necessary, to which James Wilson of Pennsylvania responded that the Clause was aimed only at retroactive, not prospective laws.[93] Luther Martin argued that the Clause might prevent states from taking necessary action in times of economic crisis.[94] The fact that the Contracts Clause was inserted over these objections is evidence that the Framers did not intend economic difficulties to provide justification for states to retroactively impair contractual obligations.[95]

C. *Original Significance*

The Framers undoubtedly expected the Contracts Clause to be of great significance. Madison spoke of the Clause as being a "bulwark in favour of . . . private rights" against improper legislation generally.[96] Indeed, the Clause was one of the few direct prohibitions on the states included in the main body of the Constitution. Its scope is unmistakably clear and absolute: "*No State shall . . . pass any . . . Law* impairing the Obligation of Contracts."[97] In *Sturges v. Crowninshield*, Chief Justice John Marshall wrote that the Contracts Clause was "incapable of being misunderstood."[98] In terms of the Clause's subject matter, the word "obligation" was given its ordinary meaning: that a person who made a promise was legally bound "to perform his undertaking."[99] As for the term "impair," Chief Justice Marshall wrote that "[a]ny law which releases a part of this obligation, must, in the literal sense of the word, impair it."[100] As we will see, the Supreme Court adhered to Chief Justice Marshall's interpretation throughout the first century of its existence. As a result, the Contracts Clause remained a fierce check on legislative overreaching.

D. *State-Created Contracts*

Though not specifically expressed in the language, the Clause's applicability to contracts to which the state itself was a party became apparent from very early on. In *Fletcher v. Peck*, the first Supreme Court case interpreting

93. Kmiec & McGinnis, *supra* note 10, at 531 (quoting 2 MADISON, *supra* note 91).

94. *Id.* at 533. Martin further argued that the Clause was oppressive to debtors because it provided no way for them to "extricate themselves" from the brink of financial ruin. *Id.* at 533 n.34.

95. *See id.* at 530–31, 537.

96. THE FEDERALIST NO. 44, at 301 (James Madison) (Cooke ed., 1961).

97. U.S. CONST. art. I, § 10, cl. 1 (emphasis added).

98. Sturges v. Crowninshield, 17 U.S. 122, 197–98 (1819) ("It would seem difficult to substitute words which are more intelligible, or less liable to misconstruction, than those which are to be explained.").

99. *Id.* at 197.

100. *Id.*

the Clause, the Court struck down a Georgia legislature's attempt to rescind a prior legislature's land grant to a private party.[101] Relying primarily on the Clause's general and absolute language, the Marshall Court held that the grant created a contractual right which fell within the scope of the Contracts Clause.[102] Perhaps even more interesting about the opinion was Chief Justice Marshall's view that the grant not only created a fully "executed" contract, it also created "an implied *executory* contract [ ] that the grantee shall continue to enjoy the thing granted according to the terms of the grant."[103]

Nothing in the Clause's language or the congressional record suggests that it was meant to be limited to private contracts.[104] It would have been altogether uncharacteristic for the Framers to presume that a natural human being could become immune to self-serving tendencies simply by being elected to public office. As Justice Blackmun more recently observed: "A governmental can always find a use for extra money."[105] Arguably, the Framers were even more sensitive of the need to restrain governments from avoiding their own contractual obligations than they were of those between private parties.

E. The Concept of Prospectiveness

Much like the constitutional restrictions on ex-post facto laws and bills of attainder, the Contracts Clause was meant to preserve a fundamental belief under the rule of law that laws should operate prospectively and not retrospectively.[106] As noted earlier, Madison wrote that the Clause was intended to "inspire a general prudence and industry, and give a regular course to the business of society."[107] The Framers understood that people needed the reasonable assurance that their promissory agreements would be enforced as bargained and in accordance with the laws that were in effect at the time they were made. As one scholar observed:

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101. *See* Fletcher v. Peck, 10 U.S. 87 (1810).

102. *See id.* at 123.

103. *Id.* at 123; *see also* Kmiec & McGinnis, *supra* note 10, at 535.

104. *See* Epstein, *supra* note 74, at 708; Kmiec & McGinnis, *supra* note 10, at 539 n.67.

105. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 22, 25–26 (1977). Professor Richard Epstein observed that "[s]elf-interest and abuse of power are themes that resonate in all social life. One cannot assume that the virtuous will obtain public office, or that, if they do, they will retain their virtue in the face of pressure and temptation." Epstein, *supra* note 74, at 712. He continued:

> Indeed it is the essence of legislation to take private property, to merge it into a common pool, and then to distribute it in ways determined by collective political decision making. The lurking danger is that legislators will ignore the terms of their trust, coalesce into factions, and dispose of the beneficial interests of others for their own personal gain.

Id. at 712–13.

106. *See* Kmiec & McGinnis, *supra* note 10, at 527–29.

107. THE FEDERALIST NO. 44, *supra* note 79, at 213.

> No man would yield his liberty to civil society if an arbitrary will could apply laws retrospectively to conduct that conformed to the law at the time it was undertaken. The task of the Framers was to translate this basic postulate of just government into rules of practical application by which governing power could be restrained from departing from "settled standing Laws" and injuring interests which were created in reliance on such laws.[108]

It would be practically impossible for people to plan their financial affairs, especially for the long-term, if the government could easily change the rules governing their transactions and commitments before the benefits were received.

IV. THREE PERIODS OF CONTRACTS CLAUSE JURISPRUDENCE

Contracts Clause jurisprudence in the U.S. Supreme Court can be divided into three distinct periods. The first period began under Chief Justice John Marshall shortly after the turn of the nineteenth century and lasted until about the 1930s; however, signs of departure from Chief Justice Marshall's approach began the 1870s when the police powers and substantive due process doctrines were gaining traction. The beginning of the second period was marked by the famous *Home Building & Loan Association v. Blaisdell* decision in 1934.[109] From that point until the beginning of the third (and current) period, the Contracts Clause laid dormant due to the highly-deferential approach established in *Blaisdell*.[110] Finally, the Court restored some of the Clause's potential in 1977 with *United States Trust Co. of New York v. New Jersey*, which still applies.[111]

A. The Early Years and the Marshall Approach

In this author's opinion, the century following the Convention was the one most faithful to the Clause's original meaning. Under Chief Justice John Marshall, the Supreme Court applied the Clause more broadly than any Court

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108. Kmiec & McGinnis, *supra* note 10, at 527. *Ogden v. Saunders* is the first case recognizing that a contract should be governed by the laws existing at the time the contract was made. *See Ogden*, 25 U.S. at 303 ("The most obvious and natural application . . . is to laws having a retrospective operation upon existing contracts . . . ."). Much later, in *City of El Paso v. Simmons*, Justice Hugo Black wrote in his dissent:

> The Contract Clause . . . reflect[s] the strong belief of the Framers of the Constitution that men should not have to act at their peril, fearing always that the State might change its mind and alter the legal consequences of their past acts so as to take away their lives, their liberty or their property.

City of El Paso v. Simmons, 379 U.S. 497, 591 (1965) (Black, J., dissenting).

109. *See generally* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).

110. *See* Kmiec & McGinnis, *supra* note 10, at 534, 541–44.

111. *See id.* at 545–46 (discussing U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1 (1977)).

thereafter.[112] The Marshall Court applied the Contracts Clause more than any other constitutional provision to protect individual rights from oppressive economic legislation.[113] As a contemporary of the Framers, Chief Justice Marshall would have been most familiar with the problems the Framers were confronted with, one of them being the pervasiveness of debtor-relief laws.[114] Recall that in *Ogden v. Saunders*, Chief Justice Marshall observed that the problem had become so excessive "as to break in upon the ordinary intercourse of society, and destroy all confidence between man and man."[115] The earliest decisions reflected this sentiment.

1. Fletcher v. Peck

In *Fletcher v. Peck*, the Marshall Court established two notable aspects of the Clause's application.[116] First, the Clause's protection was extended to contracts to which the state itself was a party.[117] Second, the prohibition on contractual impairments was practically absolute.[118] The ultimate question before the Court was whether the Georgia Legislature could revoke a land grant made by a previous legislature.[119] To reach that issue, the Court first had to determine whether a land grant was a contract, and if so, whether state-created contracts fell within the Clause's scope.[120] To that end, Chief Justice Marshall wrote that the words of the Contracts Clause "are general, and are

112. *See id.* at 526 ("The early period of contract clause jurisprudence was largely faithful to this original understanding of the Clause. Since then, the Clause has fallen into desuetude.").

113. *See* Levine, *supra* note 83, at 930 (explaining that the clause was used to invalidate legislation in seventy-five decisions rendered prior to 1889, representing nearly half of all cases during that period where the Supreme Court declared a legislation unconstitutional); *see also* Comment, *The Constitutionality of the New York Municipal Wage Freeze and Debt Moratorium: Resurrection of the Contract Clause*, 125 U. PA. L. REV. 167, 176 (1976) ("Almost half of all decisions before 1889 in which state legislation was declared invalid by the Court were based on the contract clause."). Compare that with the period after *Blaisdell*, where the Court denied every Contracts Clause claim presented to it between 1941 and 1977. *See* Note, *Rediscovering the Contract Clause*, 97 HARV. L. REV. 1414, 1414 n.2 (1984).

114. *See supra* text accompanying notes 84–87.

115. *Ogden v. Saunders*, 25 U.S. 213, 354–55 (1827) (Marshall, C.J., dissenting). Chief Justice Marshall further described the practice as one that "sap[s] the morals of the people, and destroy[s] the sanctity of private faith." *Id.* at 355.

116. *See* Fletcher v. Peck, 10 U.S. 87 (1810).

117. Levine, *supra* note 83, at 929 (citing *Fletcher*, 10 U.S. at 137). Levine also noted how the Marshall Court applied the Contracts Clause from a "natural law" perspective, viewing certain rights, especially property rights, as "essential to the continued existence of government" that "predat[ed] the government." *Id.* at 929 n.12.

118. *See Fletcher*, 10 U.S. at 137 ("The words themselves contain no such distinction. They are general[] and are applicable to contracts of every description.").

119. *Id.* at 137–38.

120. *Id.* at 136 ("In considering this very interesting question, we immediately ask ourselves what is a contract? Is a grant a contract?").

applicable to contracts of every description."[121] He went on to explain that because the word "contract" was used in a general sense, it must be construed to cover not just fully *executed*, but *executory* contracts as well.[122]

To address the Clause's absoluteness, Chief Justice Marshall invoked the doctrine of *noscitur a sociis*, a rule of construction that says the meaning of a term can be "known from its associates."[123] Turning to the prohibitions on bills of attainder and ex-post facto laws, Chief Justice Marshall observed that "[a] bill of attainder may affect the life of an individual, or may confiscate his property, or may do both."[124] Chief Justice Marshall further explained:

> In this form the power of the legislature over the lives and fortunes of individuals is expressly restrained. What motive, then, for implying . . . an exception [favoring] the right to impair the obligation of those contracts into which the state may enter?
>
> The state legislatures can pass no *ex post facto* law. An *ex post facto* law is one which renders an act punishable [though] it was not punishable when it was committed. . . . Why, then, should violence be done to the natural meaning of words [to give] the legislature the power of seizing, for public use, the estate of an individual [by] a law annulling the title by which he holds that estate? . . . This cannot be effected [sic] in the form of an *ex post facto* law, or bill of attainder; why, then, is it allowable in the form of a law annulling the original grant? [125]

2. Sturges v. Crowninshield

Another significant statement by the Marshall Court came a few years after *Fletcher* in a case called *Sturges v. Crowninshield*. In *Sturges*, the Court invalidated a New York bankruptcy law discharging a financial obligation made before the law was passed.[126] The Marshall Court reaffirmed the notion that the Clause's language was unequivocal and its prohibition absolute.[127]

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121. *Id.* at 137.

122. *Id.* Chief Justice Marshall continued:

> Since, then, in fact, a grant is a contract executed, the obligation of which still continues, and since the [C]onstitution uses the general term contract, without distinguishing between those which are executory and those which are executed, it must be construed to comprehend the latter as well as the former . . . . It would be strange if a contract to convey was secured by the [C]onstitution, while an absolute conveyance remained unprotected.

Id.

123. *See id.*

124. *Id.* at 138.

125. *Id.* at 138–39.

126. Sturges v. Crowninshield, 17 U.S. 122, 134–35 (1819).

127. *See id.* at 133 ("The prohibition is plain and unequivocal—needs no comment, and is susceptible of no misinterpretation.").

The Court also rejected the argument that the Clause only prohibited laws that allowed debtors to pay their balances in installments.[128] Chief Justice Marshall reasoned that "[n]o men would use terms embracing a whole class of laws, for the purpose of designating a single individual of that class. No court can be justified in restricting such comprehensive words to a particular mischief, to which no allusion is made."[129] The *Sturges* Court also rejected an argument that would have created an exception for laws that furthered a legitimate state interest, even if that purpose was debt relief for the insolvent.[130]

3. Trustees of Dartmouth College v. Woodward

In *Trustees of Dartmouth College v. Woodward*, the Court struck down a New Hampshire law that amended the charter of Dartmouth College.[131] The charter amendment increased the number of members on the College's Board of Trustees from twelve to twenty-one and gave the governor a great deal of control over the new board positions.[132] New Hampshire argued that no constitutional impairment existed because while the amendment added new terms to the charter, it did not alter the original terms.[133] In rejecting this argument, Chief Justice Marshall explained that the charter contained a provision that expressly stated that "the number of trustees should forever consist of twelve, and no more," and thus, any "violent alteration in its essential terms" would have been an impairment.[134] The Court held that in the absence of an express reservation by the state of the power to modify, a future legislature could not do so without violating the Contracts Clause.[135]

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128. *See id.* at 205–06.

129. *Id.* at 205.

130. *See id.* at 156–58. Attorney for the debtor argued that the states had the "natural, inherent, and indispensable power, of discharging . . . payment." *Id.* at 156.

131. *See* Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 654 (1819).

132. *See id.* at 539–42.

133. *See id.* at 652.

134. *Id.* at 651.

135. *Id.* at 675. The Court held that:

> Unless a power be reserved for this purpose, the crown cannot, in virtue of its prerogative, without the consent of the corporation, alter or amend the charter, or divest the corporation of any of its franchises, or add to them, or add to, or diminish, the number of the trustees, or remove any of the members, or change or control the administration of the charity, or compel the corporation to receive a new charter. This is the uniform language of the authorities, and forms one of the most stubborn, and well settled doctrines of the common law.

Id.

4. Ogden v. Saunders

Ogden v. Saunders established the first real limitation to the scope of the Contracts Clause during the Marshall era. Specifically, it did not prohibit states from enacting laws that *prospectively* impaired contractual obligations.[136] From a natural law standpoint, however, Chief Justice Marshall viewed the right to contract as a natural right. Therefore, because the Contracts Clause protected the right to contract, argued Chief Justice Marshall, any law that interfered with it was unconstitutional regardless of whether it was prospective or retrospective.[137] Nevertheless, the remaining Justices disagreed, and the Court correctly held that the Clause only prohibited retroactive impairments.[138] As some scholars have noted, Chief Justice Marshall's expansion of the Clause to prospective impairments based on a natural rights approach "might have ushered in substantive due process years before the *Lochner* era."[139] After Chief Justice Marshall's death, the Supreme Court used the Contracts Clause to invalidate legislation in at least fifty-seven more cases from 1848 to 1900.[140]

5. Stone v. Mississippi

The Clause was further weakened by the Court in *Stone v. Mississippi*.[141] In *Stone*, "the Court held that [Mississippi] could amend a corporate charter to forbid the corporation from selling lottery tickets, despite the fact that the charter had previously granted the corporation the right to conduct lotteries."[142] It reasoned that lotteries were an issue of public morality to which the

136. *See* Ogden v. Saunders, 25 U.S. 213, 262 (1827).

137. *Id.* at 346 (Marshall, C.J., dissenting) (stating that "individuals do not derive from government their right to contract, but bring that right with them into society; that obligation is not conferred on contracts by positive law, but is intrinsic, and is conferred by the act of the parties.").

138. *See id.* at 262 (explaining the distinction "between [laws] which operate retrospectively, and those which operate prospectively. In all of them, the law is pronounced to be void in the first class of cases, and not so in the second.").

139. Kmiec & McGinnis, *supra* note 10, at 538. It is worth noting that the Court was still nearly unanimous regarding the *absoluteness* of the Clause. Justice Trimble, for instance, wrote in his dissent in *Ogden* that while states were free to legislate on future contracts, the Clause still "prohibit[ed] them from retrospecting upon existing obligations, upon any pretext whatever." *Ogden*, 25 U.S. at 327 (Trimble, J., dissenting). It appears that Justice Johnson was the only Justice who did not agree. *See* Hale, *supra* note 82, at 533 ("And, though its position has since changed, the entire Court in *Ogden v. Saunders*, with the exception of Johnson, agreed that the ban on such laws was absolute.").

140. *See* CHARLES D. KELSO & R. RANDALL KELSO, AMERICAN CONSTITUTIONAL LAW: AN E-COURSEBOOK § 18.1, at 814–15 (2016) (citing BENJAMIN F. WRIGHT, THE GROWTH OF AMERICAN CONSTITUTIONAL LAW 64 (1967)), http://libguides.stcl.edu/ld.php?content_id=32389692 [https://perma.cc/YSD3-YMH2]. The Taney Court did cut back on the absoluteness aspect somewhat with regard to cases involving corporate grants of power. *See id.* at 814.

141. Stone v. Mississippi, 101 U.S. 814 (1879).

142. Kmiec & McGinnis, *supra* note 10, at 540.

state had an inherent power to regulate.[143] Thus, any promise *not* to regulate lotteries was void because a state could not bargain away its police powers.[144] This doctrine later became known as the reserved powers doctrine, which was often asserted as a defense to a Contracts Clause challenge.[145]

It is debatable whether *Stone* marked the beginning of the Clause's decline;[146] however, this is not to say that it was incorrectly decided. Scholars noted that:

> *Stone* may be seen as essentially a correction of the overly expansive reading of what constitutes a public contract. . . . [T]he Contract Clause arguably was not framed to restrict unduly the state's police power so long as police power is defined in a way that does not result in the evisceration of the original intent of the Clause.[147]

In any case, carving out a police powers exception did lay the ideal framework for the next case which practically rendered the Clause dormant for several decades afterward.

B. The Blaisdell Era: The Clause Turned on Its Head

In *Home Building & Loan Association v. Blaisdell*, the Court upheld a mortgage moratorium enacted by a Minnesota legislature during the Great Depression to provide relief for homeowners threatened with foreclosure.[148] Although the legislation conflicted directly with lenders' contractual foreclosure rights, the Court there acknowledged that, despite the Contracts Clause, the states retain residual authority to enact laws "to safeguard the vital interests of [their] people."[149] In upholding the moratorium, the Court found five things significant, which ultimately became part of a five-factor test. First, the state legislature had declared in the enacted law itself that an emergency need for the protection of homeowners existed.[150] Second, the state law was enacted to protect a basic societal interest and not a favored group.[151] Third,

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143. *Stone*, 101 U.S. at 818–19.

144. *Id.* at 818. The Court further explained:

> All that one can get by such a charter is a suspension of certain governmental rights in his favor, subject to withdrawal at will. He has in legal effect nothing more than a license to enjoy the privilege on the terms named for the specified time, unless it be sooner abrogated by the sovereign power of the State.

Id. at 821.

145. The case of *Manigault v. Springs* appears to be the first case recognizing the reserved powers doctrine as a defense against Contracts Clause claims. *See* Manigault v. Springs, 199 U.S. 473, 480 (1905); Levine, *supra* note 83, at 927 n.6.

146. *See* Kmiec & McGinnis, *supra* note 10, at 540.

147. *Id.* at 541.

148. *See* Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 447–48 (1934).

149. *Id.* at 434.

150. *Id.* at 444.

151. *Id.* at 445.

the relief was appropriately tailored to the emergency that it was designed to meet.[152] Fourth, the imposed conditions were reasonable.[153] And, finally, the legislation was limited to the duration of the emergency.[154]

C. *The Modern Era: The Clause Revived—Somewhat*

The third and most recent period began in 1977 when the Court decided *United States Trust Company of New York v. New Jersey* and continues today. The Court in *U.S. Trust* appeared to renew some of the Clause's potency, primarily by cutting back on the high deference states enjoyed under *Blaisdell* in cases involving state contracts.[155] In 1974, New York and New Jersey both passed laws that repealed a prior statutory provision which prohibited the two states from using revenues pledged as security for bonds to subsidize railway transportation.[156] The New Jersey trial court upheld the new law on grounds that it served an important public interest, and thus, it was a valid exercise of the state's police powers.[157] The Supreme Court disagreed. Justice Blackmun rejected the reserved powers defense on two grounds. First, the reserved powers doctrine cannot be applied in a way that destroys the Clause's limitation on the state's power; both must be construed in harmony with each other.[158] Justice Blackmun wrote that "the Contract Clause limits otherwise legitimate exercises of state legislative authority, and the existence of an important public interest is not always sufficient to overcome that limitation."[159] Second, obligations involving purely financial matters do not "automatically [ ] fall within the reserved powers that cannot be contracted away."[160] Justice Blackmun reasoned that state and local governments do not act as sovereigns when it comes to purely financial obligations like promising to pay a debt; rather, they act as "ordinary individuals."[161]

Turning to the *Blaisdell* analysis, the Court recognized that "courts properly defer to legislative judgment as to the necessity and reasonableness" of economic and social regulation.[162] Thus, following *Blaisdell*, the *U.S.*

152. *Id.*
153. *Id.* at 445–47.
154. *Id.* at 447.
155. *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 26 (1977) ("[C]omplete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."); *see also* Stephen F. Befort, *Unilateral Alteration of Public Sector Collective Bargaining Agreements and the Contracts Clause*, 59 BUFF. L. REV. 1, 23 (2011).
156. *Id.* at 3.
157. *Id.* at 21.
158. *Id.*
159. *Id.*
160. *Id.* at 24–25.
161. *Id.* at 25 n.23.
162. *Id.* at 22–23.

Trust Court held that "[a]s with laws impairing the obligations of *private* contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose."[163] But when a state wants to impair its contractual obligations, the Court held that "complete deference to a legislative assessment of reasonableness and necessity is not appropriate because the State's self-interest is at stake."[164] On that note, Justice Blackmun observed:

> A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[165]

The Court went on to announce a new standard for determining reasonableness and necessity of legislation impairing state contracts. First, both terms were to be analyzed independently as two separate prongs.[166] Second, a foreseeability component was added to the "reasonableness" prong, thus, any legislation is unlikely to be reasonable if its stated purpose was to cure a foreseeable problem.[167]

The Court concluded that the legislation impairing the bondholder covenant was not reasonable under the circumstances because the likelihood of substantial deficits being produced by increased demand for public mass transit had been well documented and ongoing since 1922.[168] Thus, the Court reasoned that the government should have reasonably expected those financial pressures when it decided to make the covenants.[169] Finally, a least-restrictive means analysis was applied to the "necessity" prong, thus, legislation will not be considered necessary if the government's purpose could have been accomplished by less-drastic alternatives.[170] Justice Blackmun wrote that "[a] State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well."[171] The Court

163. *Id.* at 25 (emphasis added).
164. *Id.* at 26.
165. *Id.*
166. *Id.* at 29–32. Justice Blackmun wrote that:

> [A] State cannot refuse to meet its legitimate financial obligations simply because it would prefer to spend the money to promote the public good rather than the private welfare of its creditors. We can only sustain the repeal of the 1962 covenant if that impairment was *both reasonable and necessary* to serve the admittedly important purposes claimed by the State.

Id. (emphasis added).
167. *See id.* at 31.
168. *See id.* at 31–32.
169. *See id.*
170. *See id.* at 29–30.
171. *Id.* at 31.

ultimately held that the legislation was not necessary because both states could have subsidized mass transit by increasing revenue by other means, such as raising taxes on gasoline and parking, and by increasing tolls during peak commuting hours.[172]

V. APPLICATION OF THE CONTRACTS CLAUSE TO PENSION REFORM

The terms and benefits of state and local pension plans are generally contained within the language of the statutes that created them. As described earlier, much has changed about Contracts Clause jurisprudence since the Marshall era. In *Blaisdell*, the Supreme Court made it clear that the Contracts Clause "is not to be read with literal exactness like a mathematical formula."[173] However, *U.S. Trust* clarified that *Blaisdell* did not give states unbridled discretion to hide behind a self-declared "public purpose" as a convenient way to avoid paying their debts.[174]

Courts now apply a three-part analysis under the *U.S. Trust* framework in determining whether a legislative act caused a substantial impairment to a contractual obligation. The first step is to determine whether a contractual relationship exists.[175] Second, the court must determine whether the changes to benefits constituted a substantial impairment to the contractual relationship.[176] Third, if a substantial impairment is found, courts must ask whether it was nevertheless justified by an important public purpose, and whether the means to accomplish that purpose were both "reasonable and necessary."[177] As noted earlier, because a state's own self-interest is involved, it will not be entitled to the high level of deference it would usually receive regarding the use of its police powers to regulate economic activity.[178]

A. Does a Contract Exist?

The first part of the Contracts Clause analysis looks at whether the challenged pension statute caused a substantial impairment of a contractual obligation.[179] As a sub-inquiry, though, courts must determine whether a contractual obligation exists. While the U.S. Supreme Court has not specifically held

172. *Id.* at 30 n.29.
173. Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 428 (1934).
174. *See* U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25–26 (1977).
175. *See id.* at 17–18.
176. *See id.* at 20-21.
177. *See id.* at 25.
178. Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 412–13 (1983) (citing *U.S. Trust*, 431 U.S. at 22–23); *see also supra* note 167 and accompanying text.
179. *See U.S. Trust*, 431 U.S. at 17.

that employees have a contractual right to pension benefits, it has held that: (1) a contractual right exists regarding compensation already earned;[180] and (2) pension benefits are a form of compensation.[181] Asserting a contractual right to a pension might have been nearly impossible a hundred years ago when pensions were treated as gratuities,[182] however, practically all states have since abandoned the gratuity approach and now recognize the contractual nature of public pensions.[183] Indeed, many states have amended their own constitutions to include language similar to the Contracts Clause.[184]

Though most states have come to recognize the contractual nature of pensions, they vary greatly in how they treat the timing and scope of contractual rights.[185] In states like Arizona, for instance, public employees have a contractual right to a pension from the date they begin employment, even though they may not be entitled to *receive* those benefits until the employer's vesting requirements are met.[186] Other states, such as Illinois and New York, recognize a contractual right once the employee begins contributing to the fund or otherwise "participates" in it.[187] Finally, there are some states which

180. *See* Mississippi *ex rel.* Robertson v. Miller, 276 U.S. 174, 178–79 (1928).

181. *See* Allied Chem. & Alkali Workers, Local Union No. 1 v. Pittsburgh Plate Glass Co., 404 U.S. 157, 180 (1971) ("To be sure, the future retirement benefits of active workers are part and parcel of their overall compensation . . . ."); *see also* Johnson v. Ga. Pac. Corp., 19 F.3d 1184, 1190 (7th Cir. 1994) ("Pensions are deferred compensation; just as the employer may raise the wages of current employees without owing anything to retirees, so it may raise the pensions of current employees without owing anything to persons who found satisfactory the combination of current and deferred pay offered during their years of service.") (citing Shaw v. Delta Air Lines, Inc., 463 U.S. 85, 91 (1983)).

182. Under the gratuity approach, employers enjoyed practically unrestrained power to modify pension benefits at will, even post-retirement. For a more in-depth discussion on the gratuity approach, see Terry A.M. Mumford & Mary Leto Pareja, *The Employer's (In)ability to Reduce Retirement Benefits in the Public Sector*, ALI-ABA COURSE STUDY, Sept. 11, 1997, *available at* WESTLAW, SC14 ALI-ABA 27, and Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992 (1977).

183. *See* Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1037 (2012). Other states use a property approach to pension benefits. *See* AMY MONAHAN, AM. ENTER. INST., UNDERSTANDING THE LEGAL LIMITS ON PUBLIC PENSION REFORM, 1–2 (2013) [hereinafter MONAHAN, LEGAL LIMITS ON PUBLIC PENSION REFORM]. In those states, constitutional challenges to pension reform are generally analyzed under the Takings and Due Process Clauses. *Id.*

184. *See, e.g.*, Pennie v. Reis, 132 U.S. 464, 471 (1889); MONAHAN, LEGAL LIMITS ON PUBLIC PENSION REFORM, *supra* note 183, at 2.

185. *See* Anna K. Selby, Comment, *Pensions in A Pinch: Why Texas Should Reconsider its Policies on Public Retirement Benefit Protection*, 43 TEX. TECH L. REV. 1211, 1232 (2011).

186. *See* Hall v. Elected Officials' Ret. Plan, 383 P.3d 1107, 1118 (Ariz. 2016) ("[A] public employee's interest in a retirement benefit or pension becomes a right or entitlement at the outset of employment, but the right to begin collecting pension benefits is contingent upon completing the requirements for retirement eligibility.").

187. *See, e.g.*, Kraus v. Bd. of Trs., 390 N.E.2d 1281, 1289 (Ill. App. Ct. 1979) (adopting language from legislative history of constitutional provision guaranteeing benefits in effect upon beginning employment); Birnbaum v. N.Y. State Teachers Ret. Sys., 152 N.E.2d 241, 245 (N.Y. 1958)

do not recognize a contract until employees are either fully "vested," or receiving retirement benefits.[188] Naturally, employees in the latter two categories may find it difficult to challenge impairments that occurred during their employment. And while employees in the former category already have some contractual rights from the beginning, they may still have to contend with issues related to the *timing* and *scope* of those rights. For instance, a court might find that a general right to "a pension" exists, while still permitting the state to alter certain provisions such as the method of calculating benefits, the amount of employee-employer contributions, cost-of-living adjustments (COLAs), vesting dates, and even survivor benefits.

1. The Texas Approach

For decades, scholars have recognized Texas as an outlier when it comes to public pensions.[189] While Texas did amend its constitution in 2003 to include an express provision protecting benefits from retroactive impairment,[190] an exception that gave local governments the option to opt out of the provision by vote was also included.[191] Apart from this provision, Texas employees have no constitutional protection against retroactive impairment, as explained further below.

Because Texas does not recognize the contractual nature of pension benefits, employees challenging pension reform on constitutional grounds have sought relief under the state's due process provision.[192] Recently, however, the Supreme Court of Texas decided in *Klumb v. Houston Municipal Employees Pension System* to reaffirm its holding in *City of Dallas v. Trammel*, a 1937 case in which the court held that public employees in Texas had no vested property rights in future pension payments.[193] In *Klumb*, the court rejected a group of city employees' due process claim for lack of standing, on the grounds that no deprivation of property had occurred since the employees

("The purpose of the amendment was to fix the rights of the employee at the time he became a member of the system.").

188. *Compare* Jones v. Cheney, 489 S.W.2d 785, 790 (Ark. 1973) *and* Petras v. State Bd. of Pension Trs., 464 A.2d 894, 896 (Del. 1983) (no contract until years of service requirements are met), *with* Patterson v. City of Baton Rouge, 309 So.2d 306, 311–313 (La. 1975) (discussing different treatment across jurisdictions while holding that rights are not vested until eligibility for pension) *and* Rilling v. Unemployment Comp. Div., 151 N.W.2d 304, 309 (N.D. 1967) (upon retirement).

189. Van Houten v. City of Fort Worth, 827 F.3d 530, 537 (5th Cir. 2016).

190. TEX. CONST. art. XVI, § 66(d).

191. *Id.* § 66(h). Houston voters opted out in 2004. *See* Klumb v. Hous. Mun. Emps. Pension Sys., 458 S.W.3d 1, 16 n.10 (Tex. 2015).

192. *See, e.g.*, *Klumb*, 458 S.W.3d at 14–15 ("Petitioners contend they have been deprived of vested property rights without due process.").

193. *Id.* at 14–15; City of Dallas v. Trammel, 101 S.W.2d 1009, 1017 (Tex. 1937).

had no vested property rights in their pension benefits.[194] Drawing from *Trammel*, the court explained that future pension payments were not property rights but rather a "mere expectancy," which are "subject to the reserved power of the Legislature to amend, modify, or repeal the law upon which the pension system is erected."[195]

The *Klumb* court further held that the legislature's power to amend extended to post-retirement benefits and employee contributions, even if the contributions were mandatory.[196] Before Senate Bill 2190 was passed in 2017, members of the Houston firefighters' pension fund were required by statute to contribute 9.0% of their gross earnings to the fund.[197] The new legislation increased that amount to 10.5%.[198] Nothing under current Texas caselaw would prevent the legislature from making further amendments that would cause members to forfeit all or part of their earned contributions—or from abolishing the statute altogether.

It is impossible to say exactly why Texas has remained reluctant to recognize the contractual nature of pension benefits. One reason might be to avoid the higher scrutiny under current Contracts Clause analysis. While the Texas Supreme Court in *Klumb* imported from *Trammel* language that invoked the reserved powers doctrine (a doctrine historically asserted by states to defend against claims under Contracts Clause),[199] the U.S. Supreme Court expressly rejects the reserved powers defense in cases where the challenged legislation impairs the government's promise to pay money.[200] Given the current prevalence of the contractual method, it is not clear whether Texas can successfully assert the reserved powers defense against a federal claim brought under a different constitutional theory. In any case, it seems unlikely that analyzing pension benefits under a property rubric will be enough to keep Texas statutes outside the reach of the Contracts Clause.

2. *The Unmistakability Doctrine*

One defense against the assertion of a contractual right to a pension benefit is the "unmistakability" defense, a presumption that a statute does not create a contract unless the language and the circumstances clearly show that

194. *Klumb*, 458 S.W.3d at 17.
195. *Id.* at 15–16 (quoting *Trammel*, 101 S.W.2d at 1014) (internal quotation marks omitted)).
196. *See id.* at 17.
197. HOUS. FIREFIGHTERS' RELIEF & RET. FUND, *supra* note 19, at 6.
198. *Id.*
199. *See supra* notes 141–47 and accompanying text.
200. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 23–25 (1977).

the legislature intended to be bound.[201] The presumption is based on the fundamental proposition that "the principal function of a legislature is not to make contracts, but to make laws that establish the policy of the state."[202] That said, the bare language in a pension statute is not conclusive on the issue of contractual intent, however, courts tend to focus more on the language than the circumstances.

Application of the unmistakability defense can be identified in a line of cases stemming from *Dodge v. Board of Education*.[203] In *Dodge*, the Illinois legislature passed a law known as the Miller Law, which reduced pension benefits and increased the age of retirement for teachers in Chicago.[204] The Illinois Supreme Court reasoned that the legislature must have had in mind a line of cases holding that acts like the Miller Law did not create contracts or vested rights.[205] It concluded that "the appellants should have known that no distinction was intended between the rights conferred on them and those adjudicated under like laws with respect to other retired civil servants."[206] The U.S. Supreme Court agreed.[207] Justice Roberts elaborated on the following principles:

> In determining whether a law tenders a contract to a citizen, it is of first importance to examine the language of the statute. If it provides for the execution of a written contract on behalf of the state, the case for an obligation binding upon the state is clear. . . . On the other hand, an act merely fixing salaries of officers creates no contract in their favor, and the compensation named may be altered at the will of the [l]egislature. . . . The presumption is that such a law is not intended to create private contractual or vested rights, but merely declares a policy to be pursued until the [l]egislature shall ordain otherwise. He who asserts the creation of a contract with the state in such a case has the burden of overcoming the presumption.[208]

The problem with *Dodge* and the unmistakability defense, in general, is twofold. First, it was decided at a time when pensions were still being treated

201. *See* Nat'l R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co., 470 U.S. 451, 465–66 (1985) (holding that the *language* of the statute must show an unequivocal intent to be bound); *U.S. Trust*, 431 U.S. at 17 n.14 (holding that courts are not bound by language alone but may also look to the surrounding circumstances).

202. *Nat'l R.R.*, 470 U.S. at 466. The *Atchison* Court further explained that "[p]olicies, unlike contracts, are inherently subject to revision and repeal, and to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body." *Id.*

203. Dodge v. Bd. of Educ., 302 U.S. 74, 77–78 (1937).

204. *See id.* at 75–78.

205. *See id.* at 80–81.

206. *Id.* at 81.

207. *Id.* ("We cannot say that this was in error.").

208. *Id.* at 78–79.

as gratuities. The Court noted that "[i]f, upon a construction of the statute, it is found that *the payments are gratuities* . . . the grant of them creates no vested right."[209] Second, few states today adhere to the same formalist approach that was prevalent in the 1930s.[210] Courts today are more likely to consider both the language *and* the *surrounding circumstances* to determine whether a party intended to make a contract.[211] Moreover, it is not only the text of the pension statute but also other state laws pertaining to contract interpretation and enforcement that are applicable in such an analysis.[212]

Adherence to a rigid application of the unmistakability doctrine would also be at odds with the objective theory of contracts. The objective theory determines contractual intent not by speculating about the offeror's secret purposes but by asking whether it is reasonable to believe that "the promisee [would] infer that intention from his words or conduct."[213] Stated differently, it "measures a party's language *and conduct* against the test of reasonableness and sanctions careless, reckless, or purposeful misleading language by finding an obligation *even if the promisor did not intend one*."[214]

Apart from the language in a pension statute, courts can and should give equal consideration to other factors such as the nature of the employer-employee relationship and any representations made prior to the employment. Such factors would be especially relevant in the public pension context, especially since the average employee cannot reasonably be expected to conduct hours of legal research or hire independent counsel just to be properly informed about a job offer. For instance, the statute governing benefits for Houston firefighters is roughly sixty pages in length. Approximately halfway through the statute lies a paragraph which reads:

> The amounts of all benefits that the member or the member's beneficiaries may become entitled to receive . . . shall be computed on the basis of the schedule of benefits in effect . . . *either on the day the member leaves active service or on the day the member ceases to carry out the member's regular duties as a firefighter* . . . .[215]

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209. *Id.* at 79 (emphasis added).

210. The term "formalism" can have many definitions. Here, it is simply used to describe a theory of contract formation commonly adhered to under the "traditional" approach, which strongly emphasized language when determining the parties' intent. For an in-depth discussion on this topic, see Gregory Klass, Contract Exposition and Formalism 3–4 (Feb. 2017) (unpublished manuscript) (on file with Georgetown Law Library), https://scholarship.law.Georgetown.edu/facpub/1948 [https://perma.cc/P94D-WUQ6].

211. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 17 n.14 (1977).

212. *See id.* at 19 n.17.

213. RESTATEMENT (SECOND) OF CONTRACTS § 2 cmt. b.

214. ROBERT A. HILLMAN, PRINCIPLES OF CONTRACT LAW, 280 (3d ed. 2014) (emphasis added).

215. TEX. REV. CIV. STAT. ANN. art. 6243e.2(1), § 11(b) (emphasis added).

This language appears to suggest that the formula for calculating benefits can be modified at any point during a person's career up to retirement. Such language would likely be dispositive in a formalist jurisdiction applying a strict view of the unmistakability doctrine (despite the real likelihood that few, if any, of the department's 4,000-plus employees ever knew it existed). But in a modern jurisdiction, a court might also consider things such as recruiting materials, employee surveys, and other evidence to show that the language and the circumstances suggest that a reasonable employee would infer that the employer, as an agent for the legislature, was bound to the calculations as they existed upon entering employment.

Alternatively, instead of placing such an enormous burden on employees to prove unequivocally that the legislature intended to be bound, employers, who are in the best position to prove what they intended, should bear the burden of proof by expressly disclaiming any contractual intent or by reserving the right to unilaterally amend.

It is universally recognized that pensions are a powerful recruiting tool governments use to attract qualified employees to public sector jobs and get them to remain there for decades.[216] If this is true about the subjective intent of public employers, and pension benefits are part of an employee's total compensation package, then it hardly seems unreasonable for an employee to infer that same (contractual) intent from the representations an employer makes about those benefits. This is true regardless of whether language buried deep within a statute says otherwise. It seems altogether disingenuous to acknowledge a subjective intent to induce a party's performance on one hand while allowing them to later deny that intent by mere technicality on the other.

Critics might argue that although government employees may interpret another's conduct the same as any other individual, a different standard of contract formation is nevertheless appropriate because most do not view a government's actions the same as they would a private party's. That may be true when the government acts in its sovereign capacity, however, the Supreme Court has already declared that governments do not act as sovereigns when they make a promise to pay money. Instead:

> They come down to the level of ordinary individuals. Their contracts have the same meaning as that of similar contracts between private persons. Hence, instead of there being . . . a reservation of a sovereign right to withhold payment, the contract should be regarded as an assurance that such a right will not be exercised. A promise to pay, with a

216. *See* Kern v. City of Long Beach, 179 P.2d 799, 856 (Cal. 1947) ("[O]ne of the primary objectives in providing pensions for government employees . . . is to induce competent persons to enter and remain in public employment.").

> reserved right to deny or change the effect of the promise, is an absurdity.[217]

The Supreme Court has also affirmed a Fifth Circuit case recognizing that "[t]he role of the Government as an employer toward its employees is fundamentally different from its role as sovereign over private citizens generally."[218]

3. *The Implied Unilateral Contract Theory*

Even without a statutory or constitutional provision recognizing a contractual right to pension benefits, in many cases, those rights can be inferred. As noted earlier, the Supreme Court already recognizes that public employees have a contractual right to compensation already earned,[219] and that pensions are considered a type of deferred compensation[220] which is implied from the fact that the employee performed services in exchange for the promised compensation.[221] The general disagreement among states, however, is not on whether a contract exists, but rather *when* a particular right becomes fixed so that it cannot be modified absent mutual consent. Many states treat only "vested"[222] pension benefits as fixed while leaving those which are contingent on a condition (such as a particular amount of years of service or attaining a certain age) subject to modification. But under a unilateral contract theory, all material terms become binding when performance begins.[223] Defined benefit plans are generally recognized as being a promise to pay a specific benefit to an employee based on a specific formula.[224] Because the formula is central to the promised benefit, any change to the formula would essentially *re*-define the benefit. If the formula for calculating benefits is part of the overall compensation package used to recruit and retain employees, a contract is formed whenever the employment begins.

To illustrate, suppose Party A offers to pay Party B $100 to cut his grass and B begins mowing. Would B have any legal remedy if A decided to reduce the offer to $75 just before the job was complete? Suppose further that to

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217. *U.S. Trust*, 431 U.S. at 25 n.23 (1977) (quoting Murray v. Charleston, 96 U.S. 432, 445 (1878)).

218. United States v. Reyes, 87 F.3d 676, 680 (5th Cir. 1996) (quoting Bush v. Lucas, 647 F.2d 573, 576 (5th Cir. 1981), *aff'd*, 462 U.S. 367 (1983)) (alteration in original) (internal quotation marks omitted). The *Reyes* court also recognized that "[t]here is ample support for constitutionally distinguishing government acting as employer from government acting as sovereign." *Id.* at 680.

219. *See supra* note 180 and accompanying text.

220. *Id.*; *see also* People *ex rel.* Kroner v. Abbott, 113 N.E. 696, 698–99 (1916).

221. *See Kroner*, 113 N.E. at 698–99.

222. In the pension context, to be "vested" means to be entitled to receive a benefit. *See supra* Part IV.A.

223. RESTATEMENT (SECOND) OF CONTRACTS § 62.

224. *See* HOUS. FIREFIGHTERS' RELIEF & RET. FUND, *supra* note 19, at 59.

avoid the hassle and cost of finding a replacement, A promises B that if he continues mowing his grass every week for at least seven years, he would receive one percent of his yearly earnings for each year for the rest of his life. Could A later reduce that amount in year six just because B's right to the money was still "contingent" on finishing the job? Under a unilateral contract, the beginning of B's performance operated as an option contract, making A's promise irrevocable.[225] Of course, A would have no duty to pay what was promised unless and until B finished the job according to the agreed terms.[226] Once finished, B would be entitled to—or "vested"—in the full amount that he bargained for. Assuming the terms of payment were "material" to the bargain, A could not alter the price without B's consent regardless of how insignificant the change would have seemed to A.[227] This is true even though B's right to the money was still contingent on completing the job.

The above illustration is closely analogous to what seems to occur in the typical employer-employee relationship. One scholar writing in the early 1980s observed that cases involving employer-employee relationships were the "largest and most important group of cases" invoking the unilateral contract approach.[228] An excerpt from a 2014 hornbook reads that "an employer may create an employee benefits package in the form of an offer for a unilateral contract: 'If you work for us for twenty years, you will earn a pension.'"[229]

Courts have been applying the unilateral contract theory in public pension cases for decades. In 1947, the Supreme Court of California held:

> While payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.[230]

Some federal circuits also recognize that a public pension creates a type of unilateral contract.[231] In 1996, the First Circuit stated its view on retirement plans:

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225. *See* RESTATEMENT (SECOND) OF CONTRACTS § 62 cmt. b.

226. *See id.*

227. Presumably, if A wanted to reserve a right to modify the terms, he would have to offer more money on the front end or perhaps face a rejection of the modification altogether. In the latter, A would be liable for breach.

228. Mark Pettit Jr., *Modern Unilateral Contracts*, 63 B.U. L. REV. 551, 559 (1983).

229. HILLMAN, *supra* note 214, at 66.

230. Kern v. City of Long Beach, 179 P.2d 799, 803 (Cal. 1947).

231. *See, e.g.*, McGrath v. R.I. Ret. Bd., 88 F.3d 12, 17 (1st Cir. 1996).

> In general, retirement plans are within the reach of the Contracts Clause. To be sure, noncontributory pensions were viewed a century ago not as contracts but as mere gratuities. But times have changed, and evolving legal doctrine recognizes that the promise of a pension is part of the compensation package that employers dangle to attract and retain qualified employees. In line with this evolving doctrine we have held that, in general, pensions are to be regarded as a species of unilateral contracts.[232]

Also recall that in *Fletcher v. Peck*, the Court announced that the term "contract" encompassed both executory and executed agreements.[233] Thus, the mere fact that contingencies such as age attainment and years of service are built into a pension statute should not provide a basis for states to avoid or unilaterally modify their obligations.

B. Substantial Impairment

If a contract is found to exist, the next question is whether changes to the pension benefits constitute a "substantial impairment." The Supreme Court has provided little guidance on how the substantiality requirement is to be determined, and the methods used "borders on arbitrary."[234] Professor Amy Monahan explains it as follows: "An impairment occurs if the action alters the contractual relationship between the parties and is substantial 'where the right abridged was one that induced the parties to contract in the first place' or where the impaired right was one on which there had been reasonable reliance.'"[235] Thus, employees should generally have little problems proving that an *impairment* occurred. The question then becomes whether that impairment was *substantial* enough to warrant constitutional protection. In that regard, Professor Monahan writes that "[i]n the pension context, courts typically find any decrease in the amount of retirement benefits to be a substantial impairment."[236] The Supreme Court has held that "[t]otal destruction of contractual expectations is not necessary for a finding

232. *Id.* at 16–17 (citation omitted) (citing Hoefel v. Atlas Tack Corp., 581 F.2d 1, 4–5 (1st Cir. 1978)). In *Hoefel*, the court held that "the promise of a pension constitutes an offer which, upon performance of the required service by the employee[,] becomes a binding obligation." *Hoefel*, 581 F.2d at 4.

233. Fletcher v. Peck, 10 U.S. 87, 136 (1810).

234. *See* William C. Burnham, Comment, *Public Pension Reform and the Contract Clause: A Constitutional Protection for Rhode Island's Sacrificial Economic Lamb*, 20 ROGER WILLIAMS U. L. REV. 523, 542 (2015).

235. MONAHAN, LEGAL LIMITS ON PUBLIC PENSION REFORM, *supra* note 183, at 3 (citing Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978)).

236. *Id.*

of substantial impairment[,]"[237] however, the severity of the impairment will determine the level of scrutiny given by the courts.[238]

1. Subject to Regulation in the Past?

Courts have also considered whether the industry as a whole has been subject to regulation in the past.[239] The idea is that an area heavily subject to regulation has an effect on the parties' expectations, knowing that today's terms might be subject to more regulation in the future.[240] On its face, this rule appears inconsistent with Madison's notion that "the Contract Clause was intended to protect people from the 'fluctuating policy' of the legislature."[241] Nevertheless, if it is necessary to inquire into the regulatory history of pensions, courts should not only ask *if* but *how* pensions have been regulated.

While pensions for state and municipal employees have received very little regulation at the federal level, laws governing retirement for private employees, such as the Employee Retirement Income Security Act (ERISA),[242] may be enlightening. By enacting ERISA, Congress primarily concerned itself with "assuring employees that they would not be deprived of their reasonably-anticipated pension benefits" as "an employer [would] be prevented from 'pulling the rug out from under' promised retirement benefits upon which his employees had relied during their long years of service."[243] ERISA sets forth minimum rules to ensure that an employee's expectations are not defeated.[244] In creating the law, the idea was to essentially guarantee that "if a worker has been promised a defined pension benefit upon retirement—and if he has fulfilled whatever conditions are required to obtain a vested benefit—he actually will receive it.[245] One of these rules is known as the anti-cutback rule, which generally prohibits amendments that reduce "accrued benefits."[246] Thus, if courts view the regulatory history of pension systems

237. Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 411 (1983) (citing U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 26–27 (1977)).

238. *Id.*

239. *Id.*

240. *See id.* at 416.

241. *See* City of El Paso v. Simmons, 379 U.S. 497, 533 (1965) (Black, J. dissenting) (quoting THE FEDERALIST NO. 44, *supra* note 96, at 301).

242. Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 (2012).

243. Moeller v. Bertrang, 801 F. Supp. 291, 293 (D.S.D. 1992) (quoting Amato v. W. Union Int'l, Inc., 773 F.2d 1402, 1409 (2d Cir. 1985), *cert. dismissed*, 474 U.S. 1113 (1986)).

244. *See, e.g.*, Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 510 n.5 (1981) (citing various ERISA provisions that are intended to protect an employee's pension expectations).

245. Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 720 (1984) (quoting Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 375 (1980)).

246. 29 U.S.C. §§ 1054(g)–(h) (West Supp. 2018).

through the lens of ERISA, a large portion of recent pension reform measures would likely be considered *substantial* impairments.

C. *Important Public Purpose*

"[I]f a substantial impairment is found, the change to the relevant contract may nevertheless be constitutional" if it was reasonable and necessary to further an important public purpose.[247] A clear definition of what an "important public purpose" has yet to be established, however, the Supreme Court has explained that the legislation "need not be addressed to an emergency or temporary situation" to qualify.[248] It has also held that laws aimed at addressing "broad and generalized economic or social problems" are permissible under this standard.[249] "[S]ince the New Deal, the judiciary has generally given more deference to a state's articulated 'purpose' behind legislation."[250] But recall that under *U.S. Trust*, complete deference is inappropriate "because the [s]tate's self-interest is at stake."[251] On this point, Justice Blackmun observed:

> A governmental entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[252]

The idea behind the important public purpose element was to ensure that states were "exercising [their] police power[s], rather than providing a benefit to special interests."[253] The implication is that courts should be willing to look beneath the surface for evidence of influence by any Madisonian "factions" who stood to gain from the act.[254] States will undoubtedly offer broad concepts like "economic stability" and "fiscal responsibility" as purposes behind pension legislation. A more specific argument is commonly made that pension liabilities may negatively impact a government's credit or bond ratings. This may be true in some cases, but as discussed above, governments are no different than private individuals when it comes to financial obligations—and individuals must face the consequences of their own financial decisions.

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247. MONAHAN, LEGAL LIMITS ON PUBLIC PENSION REFORM, *supra* note 183, at 3.
248. Energy Reserves Grp., Inc. v. Kan. Power & Light Co., 459 U.S. 400, 412 (1983).
249. Burnham, *supra* note 235, at 545 (quoting Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 250 (1978)).
250. *Id.* at 544.
251. U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 25–26 (1977).
252. *Id.* at 26.
253. *Energy Reserves Grp.*, 459 U.S. at 412.
254. *See supra* notes 74–81 and accompanying text.

Indeed, even governments must pay their bills when they come due. Nevertheless, courts that are diligent in this part of the inquiry may also find that some states had other hidden purposes in mind. Without any standard of proof, however, it is unlikely that this prong of the analysis will be dispositive.

D. Reasonable and Necessary

As noted earlier, the reasonableness and necessity prongs are applied independently from one another. In other words, the "means must be both reasonable *and* necessary."[255] The reasonableness of pension reform depends on the extent of the contractual impairment[256] and whether the reason for the impairment was foreseeable "in light of the surrounding circumstances" at the time the contract was made.[257] The "necessity" analysis asks whether the state's articulated purpose could have been achieved by less-restrictive means.[258]

1. Reasonableness of Pension Reform

It seems unlikely that state and local governments could not have foreseen the future cost of pension contributions when they decided to include a defined benefit retirement as part of their compensation packages. Concerns about the funding status and liquidity of defined benefit plans are far from new.[259] Indeed, debates among legal scholars and commentators in the 1970s concerning such issues were likely what motivated Congress to enact ERISA to protect employees in the private sector.[260] Most of today's employees and retirees affected by recent pension reform in the public sector were hired years after the ERISA debates.[261] It is hard to imagine how a post-ERISA employer could be ignorant of the future costs associated with defined-benefit plans and the fluctuating nature of investments when offering benefits to

255. Burnham, *supra* note 235, at 547.

256. *See Energy Reserves Grp.*, 459 U.S. at 411–13.

257. *U.S. Trust*, 431 U.S. at 31.

258. *See id.* at 29–31.

259. *See* Richard Eisenberg, *The Next Retirement Crisis: America's Public Pensions*, FORBES (Oct. 22, 2018), https://www.forbes.com/sites/nextavenue/2018/10/22/the-next-retirement-crisis-americas-public-pensions/#2cb59b7a26f2 [https://perma.cc/PG8M-XLYN].

260. *See* Bob Sector & Rick Pearson, *Pension Debate at 1970 Constitutional Convention Echoes in Today's Crisis*, CHI. TRIB. (Sept. 22, 2013), https://www.chicagotribune.com/news/ct-met-public-pensions-1970-20130923-story.html [https://perma.cc/F5MZ-U2Q2].

261. Roderick B. Crane, *Regulation and Taxation of Public Plans: A History of Increasing Federal Influence*, *in* PENSIONS IN THE PUBLIC SECTOR 122 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001).

new employees. Thus, it would seem that the present situation regarding the cost of maintaining pensions in the public sector was hardly unforeseeable.

In contrast, the circumstances before the Court in *U.S. Trust* were not as easily foreseeable.[262] There, Justice Blackmun noted that even though the public's perception of the importance of mass transit had increased during the twelve-year period following the adoption of the bond covenants, the concerns were nonetheless present at the time the covenants were promised; any subsequent changes were merely of "degree and not of kind."[263] Likewise, because pension systems like those in Illinois have been underfunded for several decades,[264] a court may find that the recent changes in funding ratios were merely changes of degree, thus making reductions to benefits unreasonable.[265]

2. *Necessity of Pension Reform*

As discussed, much of the recent commentary on public pensions in the legal community assumes that a bona fide crisis exists, so for the sake of discussion, this subsection assumes likewise. It is important to note, however, that courts may (and arguably should) decide individual cases based on local and not national circumstances. Also, recall that the states with the lowest funding ratios do not represent public pensions as a whole, and it is questionable whether those states are truly at risk of not having enough assets to pay their retirees. As noted earlier, public pensions on average are between 72% and 76% funded.[266] For Houston firefighters, that ratio is substantially higher, and fund assets have grown by over $1 billion since 2008,[267] yet the legislature retroactively impaired COLAs and increased employee contributions.[268] Under those circumstances, a federal court may very well determine that the least-restrictive alternative would have been to simply leave it alone.[269]

Even if we accept the general proposition that " a legislature may make reasonable changes to public pension systems to accommodate legislative flexibility and account for changing circumstances[,]"[270] there are ways to ensure the financial health of state and local pensions which do not involve

262. *See U.S. Trust*, 431 U.S. at 31–32. The Court rejected the states' argument that changes in "public perception of the importance of mass transit" were unanticipated, thus, making the legislation reasonable. *Id.*

263. *Id.* at 32.

264. *See supra* note 6 and accompanying text.

265. *U.S. Trust*, 431 U.S. at 32.

266. *See supra* notes 14–18 and accompanying text.

267. *See* HFRRF Graph, *supra* note 37.

268. HOUS. FIREFIGHTERS' RELIEF & RET. FUND, *supra* note 19, at 22.

269. This assumes, of course, that a contract is found to exist.

270. *See* Burnham, *supra* note 235, at 575.

retroactively reducing benefits or dismantling pension plans altogether. As noted in Part I, recent studies suggest that the entire concept of adequate funding in public sector pension systems should be revisited.[271] Notwithstanding funding status, pension assets nationwide continue to grow, reaching levels higher than they were before the Great Recession.[272] Another less-restrictive alternative would be to ensure that states and municipalities continue to make their required annual contributions—which is often cited as a leading cause of pension funding gaps.[273] This should not be too difficult considering that employer contributions between state and local governments have historically accounted for only three to six percent of their combined budgets.[274] In many states, far more money is spent on corporate subsidies.[275] Extending the amortization period for paying back un-funded liabilities would be yet another way governments could reduce funding gaps and soften the blow to their annual budgets. As noted in Part I, pension funds across the country operated at a surplus in fourteen of the last twenty years. Finally, many funding gaps could be rectified by making prospective-only changes—or perhaps even by mutual agreement if both sides can come to better understandings at the bargaining table.

VI. CONCLUSION

For the last decade or so, many commentators have claimed that public pension systems across the country are in crisis because they are underfunded and too costly to maintain.[276] Recent changes in accounting standards have made the magnitude of this problem even more apparent.[277] In response, many state and local pension plans have reduced the value of retirement benefits to current, future, and even retired employees. But there are credible

271. *See* discussion *supra* Part I.

272. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 11.

273. *See* GAO, *supra* note 32, at 22–24. "A number of governments reported not contributing enough to keep up with yearly costs. Governments need to contribute the full annual required contribution (ARC) yearly to maintain the funded ratio of a fully funded plan or improve the funded ratio of a plan with unfunded liabilities." *Id.* at 22.

274. ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH AT BOS. COLL., THE IMPACT OF PUBLIC PENSIONS ON STATE AND LOCAL BUDGETS 4 (Oct. 2010). The report also projects an increase in contributions in the upcoming years as governments begin to amortize their respective liabilities over a thirty-year period. *Id.* at 4–5.

275. SIROTA, *supra* note 81, at 1; *see also* Edward Siedle, *Rhode Island Pensioners 3% COLA Will Go to Pay Wall Street 4%+ Fees*, FORBES (Apr. 16, 2013, 11:04 AM), https://www.forbes.com/sites/edwardsiedle/2013/04/16/rhode-island-pensioners-3-colas-will-help-pay-wall-street-high-rollers-4-fees/#289c1ac67584 [https://perma.cc/3JAW-9UB5] (An "[estimated] $2.1 billion in [hedge fund] fees (out of the $2.3 billion in COLA savings) will be paid by the pension to hedge[ ] private equity and venture capital tycoons.").

276. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 1.

277. *See* Craig Foltin et al., *supra* note 44.

reasons to believe that pensions are not facing a funding crisis. Recent studies showed that funding ratios have little to do with the financial health of public pensions, and that overzealous efforts to ensure that plans remain fully-funded is a "misguided goal" and "a waste of taxpayer money."[278] The primary goal in pension funding is to ensure that a pension fund has enough assets to pay expected benefits when they come due.[279] The data suggests that even states with the lowest funding ratios in the country can meet this goal indefinitely, provided their average annual income from contributions and investment earnings continue to exceed benefit payments.[280]

The Contracts Clause was intended to provide a powerful check on legislative interference with individual rights. For the first century of its existence, it was used by the U.S. Supreme Court more than any other constitutional provision to invalidate state legislation.[281] The language of the Clause is clear and absolute, and while an absolute prohibition on any contractual impairment may be too extreme, so was the complete deference standard that prevailed for most of the 21st century. Though the *Blaisdell* era rendered the Clause nearly impotent regarding private contracts, its power was restored somewhat by *U.S. Trust* regarding state contracts.

Employees have a contractual right to compensation already earned, and courts have long-recognized pension benefits as comprising a substantial part of an employee's compensation.[282] Most states now recognize a contractual right to pension benefits as well, and many have added statutory and constitutional provisions like the Contracts Clause.[283] However, even those protections have failed to prevent retroactive reform in all but a few instances. It appears then that the only available remedy for most state and local employees moving forward is under the Contracts Clause of the U.S. Constitution.

Under the current analysis, employees in many states have a reasonable chance at successfully challenging pension reform, however, there are substantial obstacles as well. The hardest battle is likely to be waged on the threshold question of whether a contract exists. A few states still do not recognize the contractual nature of pension benefits and those that do have consistently argued that only certain aspects of the pension are beyond the reach of the legislature.

Courts should be cautious in applying a strict formalist approach to the unmistakability doctrine because it is unreasonable to expect public employees to sift through complicated and lengthy pension statutes to determine

278. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 1.
279. *See* ANGELO & LOWMAN, *supra* note 51, at 9.
280. NCPERS, DON'T DISMANTLE PUBLIC PENSIONS, *supra* note 4, at 1.
281. Simon, *supra* note 9, at 145–46.
282. *See supra* notes 180–81 and accompanying text.
283. *See supra* notes 182–88 and accompanying text.

whether their employers meant what they said at the start of employment. Instead, courts should consider adopting a more universal framework that recognizes pensions as a species of unilateral contracts because such a standard would best capture the typical nature of employer-employee relationships. It would also provide a way to protect the reliance interest of employees who agreed to devote years of dedicated service based on the promise of a specific future benefit, without inferring a return promise by the employees to do so.

Even assuming that a substantial impairment to a contractual obligation exists, states still may find it difficult to satisfy the "reasonable and necessary" test under *U.S. Trust*. First, while ensuring the financial health of public pensions and overall economic stability are important public purposes, many pension reform measures are not considered to be a *reasonable* means to further those interests. This is because issues regarding pension liabilities have been around for decades, and thus, it was hardly *unforeseeable* when governments were using pensions to induce qualified employees into many years of faithful service. Second, most pension reform measures were not *necessary* because recent studies show that funding ratios have little to say about a public pension fund's ability to pay benefits year to year—and even the worst-funded pensions in the country are not at risk of insolvency.

NEIGHBORHOOD CENTERS, INC. V. WALKER: THE CURIOUS OUTCOMES OF NEW CHARTER SCHOOL LEGISLATION IN TEXAS

BRITTNY MANDARINO†

I. INTRODUCTION

The state of Texas is home to 1,247 school districts and charter school systems.[1] Notwithstanding enrollment of students in traditional school districts, Texas has the second largest public charter school system in the country, second only to California.[2] These school systems operate under the statutory provisions of the Texas Education Code,[3] which includes laws that

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1. *Overview of Texas Schools*, TEX. EDUC. AGENCY, https://tea.texas.gov/Texas_Schools/General_Information/Overview_of_Texas_Schools/Overview_of_Texas_Schools [https://perma.cc/DZB7-ECMQ].

2. *Estimated Charter School Enrollment, 2016-2017*, NAT'L ALL. FOR PUB. CHARTER SCHS., http://www.publiccharters.org/sites/default/files/migrated/wp-content/uploads/2017/01/EER_Report_V5.pdf [https://perma.cc/AV9E-2785].

3. *See* TEX. EDUC. CODE ANN. § 12.

govern both public and private entities that operate charter school systems throughout the state.[4]

In Texas, open-enrollment charter schools are afforded many of the same protections and benefits as their traditional public school counterparts, thanks in part to the progressive policy-making of our state's legislature over the past twenty years.[5] However, while open-enrollment charter schools are routinely recognized as a "part of the public school system of [the] state,"[6] recent amendments to the Texas Charter Schools Act (CSA)[7] have disrupted the statutory alignment between charter schools and other public schools, leaving many to question the status of charter schools as government entities under the law.[8]

This Note will examine how these recent amendments have uniquely impacted charter school employees in Texas.[9] In Section II, this note will discuss the evolution of applicable Texas law that govern charter schools and its employees in our state.[10] Sections III and IV provide a brief summary of the recent Supreme Court of Texas decision, *Neighborhood Centers, Inc. v. Walker*,[11] and points both to how the court got it right in its interpretation of the 2015 amendments of the CSA,[12] but also how it got it wrong when considering protections for employees' rights with regards to the Texas Whistleblower Act (WBA).[13] This Note concludes in Section V, with recommendations of how the Texas legislature can justly rehabilitate the critical statutory protections they prematurely stripped away from charter school employees with the 2015 amendments to the CSA.[14]

II. THE EVOLUTION OF APPLICABLE TEXAS LAW AFFECTING CHARTER SCHOOLS

The following discussion of the evolution of applicable Texas law affecting charter schools will focus on legislative enactments, including the

4. *See* Neighborhood Ctrs., Inc. v. Walker, 544 S.W.3d 744, 749–50 (Tex. 2018).
5. *Walker*, 544 S.W.3d at 750.
6. *See id.* (quoting EDUC. § 12.105) (alteration in original).
7. *See* EDUC. § 12.1058.
8. *See* Emma Platoff, *Are Charter Schools Private? In Texas Courts, It Depends Why You're Asking*, TEX. TRIB. (May 7, 2018, 12:00 AM), https://www.texastribune.org/2018/05/07/are-charter-schools-private-texas-courts-it-depends-when-you-ask [https://perma.cc/RDY6-CSWN] (quoting Texas attorney Thomas Fuller about his reactions to recent charter school legislation related to the Texas Whistleblower Act).
9. *See id.*
10. *See* EDUC. § 12.
11. *Walker*, 544 S.W.3d at 744.
12. *See* EDUC. § 12.1058; *see also Walker*, 544 S.W.3d at 753.
13. TEX. GOV'T CODE ANN. § 554.002(a); *see also Walker*, 544 S.W.3d at 754.
14. *See* EDUC. § 12.1058.

CSA and the WBA, and will also discuss the relevant case law considered in the *Walker* decision.[15]

A. The Texas Charter Schools Act

The Texas Charter Schools Act, first enacted in 1995,[16] states that "an open-enrollment charter school is subject to federal and state laws and rules governing public schools,"[17] adding tremendous protections and benefits to the students and employees of these newly founded educational institutions. With aims to "improve student learning," "attract new teachers to the public school system," and "establish a new form of accountability for public schools,"[18] the legislature, through the CSA, authorized the creation of open-enrollment charter schools, which now enroll more than 247,000 students, state-wide.[19] The CSA and its amendments are found in Chapter 12 of the Texas Education Code.[20]

In 2001, the legislature amended the CSA to include protections addressing nepotism, conflicts of interest, and employee retirement benefits,[21] further mirroring laws applicable to public school systems. Amendments in 2003 and 2007 provided for additional protections to prohibit the unauthorized removal and expulsion of students from open-enrollment charter schools, as well as the requirement for agency approval and review of their criminal history before certain new employees could begin work in open-enrollment charter schools.[22]

In 2015, the legislature amended the CSA to address the "[a]pplicability of other [state] laws" to open-enrollment charter schools, largely as it pertains to immunities from liabilities and suit.[23] The legislature explicitly restricted the applicability of other laws unless the language of a statute "specifically states that [it] applies to an open-enrollment charter school."[24]

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15. *See Walker*, 544 S.W.3d at 749–50.
16. *Id.* at 749.
17. EDUC. § 12.103(a).
18. *Id.* § 12.001(a).
19. *Walker*, 544 S.W.3d at 750.
20. EDUC. § 12; *see also* Jason L. Wren, Note, *Charter Schools: Public or Private? An Application of the Fourteenth Amendment's State Action Doctrine to These Innovative Schools*, 19 REV. LITIG. 135, 137–38 (2000).
21. *Walker*, 544 S.W.3d at 751.
22. EDUC. § 12.131 (amending the CSA to require more uniform procedures for school-related punishments); *Id.* § 12.1059 (amending the CSA to require more stringent background checks for prospective employees of charter schools).
23. EDUC. § 12.1058.
24. *Id.*

B. *The Texas Whistleblower Act*

The Texas Whistleblower Act, first enacted in 1983, states that an employer "may not suspend or terminate the employment of, or take other adverse personnel action against, a public employee who in good faith reports a violation of the law by the employing governmental entity . . . to an appropriate law enforcement authority."[25] The WBA protects employees by providing a legal remedy if they face retaliation for reporting the wrongdoings of their employers, allowing employees to sue for damages and other relief.[26] The WBA waives the employer's governmental immunity from liability in these cases.[27]

As whistleblower retaliation cases were litigated throughout the 1990s,[28] the legislature grew more cautious in extending these protections for public employees, and in turn, enacted strict provisions further limiting who falls under the scope of its protections.[29] The WBA applies only to public employees of state and local governmental entities,[30] which makes it challenging for courts to enforce when faced with an employee and employer whose legal status is not entirely clear.[31] This law, along with the 2015 amendments that stripped protections under the CSA, are at the heart of the issues raised in the *Walker* case.[32] This issue will be addressed in greater detail below in Section III.

C. *Relevant Case Law*

In the last decade, the Supreme Court of Texas issued two seminal opinions interpreting the statutory provisions of the CSA and the protections it offers to employees of open-enrollment charter schools.[33] As mentioned above, the Texas legislature, in its original enactment of the CSA, intended for open-enrollment charter schools to enjoy many of the protections afforded to other public schools.[34] However, due to ambiguities in the statutory language of the CSA, categorizing charter schools as governmental entities un-

25. TEX. GOV'T CODE ANN. § 554.002(a).
26. *Id.* § 554.003(a).
27. *Id.* § 554.0035.
28. *See* Neighborhood Ctrs., Inc. v. Walker, 544 S.W.3d 744, 748–49 (Tex. 2018) (criticizing Tex. Dep't of Human Servs. v. Green, 855 S.W.2d 136 (Tex. App.—Austin 1993, writ denied)).
29. *Id.*
30. *See* GOV'T § 554.002(a).
31. *See Walker*, 544 S.W.3d at 749.
32. *See id.* at 747–49.
33. *See* LTTS Charter Sch., Inc. v. C2 Constr., Inc., 342 S.W.3d 73 (Tex. 2011); *see also Walker*, 544 S.W.3d at 744.
34. *See supra* text accompanying note 21.

der the law, many petitioners bringing claims under the WBA are left to question whether or not they are protected. The Supreme Court of Texas set out to quiet this confusion.[35]

First, in *LTTS Charter School Inc. v. C2 Construction*,[36] a breach of contract claim forced the court to address whether an open-enrollment charter school qualifies as a governmental unit under the Tort Claims Act.[37] The court held that "[t]he [l]egislature's own pronouncements declare the status and authority of open-enrollment charter schools."[38] The court reasoned that because the Tort Claims Act defines a governmental unit as any "'institution . . .' derived from state law,"[39] and the Texas Education Code defines open-enrollment charter schools as being "created in accordance with the laws of this state,"[40] it follows that the legislature "considers open-enrollment charter schools to be 'governmental entit[ies]'" under the law.[41]

A second case, *Neighborhood Centers, Inc. v. Walker*, forced the court to address a charter school's classification under similar legislation: the Texas Whistleblower Act.[42] Although the *LTTS* decision held true as the *Walker* case reached the First Court of Appeals in 2015,[43] the Supreme Court of Texas instead envisioned a new outcome for Texas charter school employees.

III. *NEIGHBORHOOD CENTERS, INC. V. WALKER*: NEW LAW & NEW OUTCOMES FOR CHARTER SCHOOL EMPLOYEES

Doreatha Walker was a third-grade teacher employed with Promise Community School, an open-enrollment charter school operated by Neighborhood Centers, Inc., in 2014 when she complained to her school's principal that she and her students were getting sick from possible mold spores in the classroom.[44] After the school refused to move her class to another room and instructed Walker *not* to file a workers' compensation claim for her alleged injuries, Walker then complained to the Houston Health Department about the classroom conditions.[45] Walker also complained to the Texas Education Agency, asserting that the school submitted falsified test scores to the

35. *See, e.g.*, *LTTS Charter Sch., Inc.*, 342 S.W.3d at 73; *see also Walker*, 544 S.W.3d at 744.
36. *LTTS Charter Sch., Inc.*, 342 S.W.3d at 73.
37. *Id.* at 75; *see* TEX. CIV. PRAC. & REM. CODE § 101.001(3)(D).
38. *LTTS Charter Sch., Inc.*, 342 S.W.3d at 82.
39. *Id.* (citing CIV. PRAC. & REM. § 101.001(3)(D)).
40. *Id.* (citing TEX. EDUC. CODE ANN. § 12.105).
41. *Id.* (citing EDUC. §§ 12.1051–.1053) (alterations in original).
42. Neighborhood Ctrs., Inc. v. Walker, 499 S.W.3d 16, 27–28 (Tex. App.—Houston [1st Dist.] 2016), *rev'd*, 544 S.W.3d 744 (Tex. 2018) (opinion consistent with *LTTS Charter Sch., Inc.*).
43. *Id.* at 31–32.
44. *See Walker*, 544 S.W.3d at 746.
45. *Id.*

Agency, among a host of other claims.[46] Walker was terminated from her employment the following week.[47]

Walker sued Neighborhood Centers for retaliating against her in violation of the Texas Whistleblower Act, and in response, Neighborhood Centers asserted immunity from suit under the CSA.[48] The trial court denied the school's plea to the jurisdiction asserting immunity and allowed Walker's suit to proceed.[49] Neighborhood Centers appealed.[50] In July 2015, the court of appeals affirmed the trial court's decision, concluding that because the WBA's waiver of immunity applied to governmental entities, which included open-enrollment charter schools under the *LTTS* decision, Walker was entitled to bring suit against her employer under the WBA's anti-retaliation provision after reporting its alleged wrongdoings to an appropriate law enforcement body.[51] The court of appeals, however, granted Neighborhood Centers a rehearing the following year to address the 2015 amendments to the CSA, which were passed while the case was pending on appeal.[52] On rehearing, the court of appeals again affirmed.[53] Holding that the "[CSA's] newly enacted amendments . . . [did] not affect or in any way alter the express immunity provision" that provided for open-enrollment charter schools to enjoy the same immunities as public schools, the court concluded that Neighborhood Centers would indeed fall under the waiver of immunity provision prescribed by the WBA.[54]

Without pause, Neighborhood Centers filed a petition for review with the Supreme Court of Texas and proceeded to oral arguments in November 2017.[55] Neighborhood Centers argued that the court of appeals erred when it did not follow the new 2015 amendments of the CSA, which required the Whistleblower Act to explicitly state that it applied to open-enrollment charter schools.[56] The court agreed with Neighborhood Centers, holding that "[b]ecause the WBA contains no such specific statement, . . . [the WBA] does not apply to open-enrollment charter schools . . . ."[57] Accordingly, the

46. *Id.*
47. *Id.*
48. *Id.* at 747.
49. *Id.*
50. *Id.*
51. Neighborhood Ctrs., Inc. v. Walker, No. 01-14-00844-CV, 2015 Tex. App. LEXIS 7950, at *30 (Tex. App.—Houston [1st Dist.] July 30, 2015), *reh'g*, 499 S.W.3d 16 (Tex. App.—Houston [1st Dist.] 2016), *rev'd*, 544 S.W.3d 744 (Tex. 2018).
52. *Walker*, 499 S.W.3d at 18.
53. *Id.* at 32.
54. *Id.* at 28.
55. *See Walker*, 544 S.W.3d at 747.
56. *See id.*
57. *Id.* at 746.

court reversed the court of appeals' decision and rendered judgment that Walker take nothing.[58]

IV. HOW THE *WALKER* COURT TRIED TO GET IT RIGHT, BUT GOT IT WRONG

In Texas, after years of progressive legislation adding protections for charter school employees, the 2015 amendments of the CSA brought forth curious outcomes as it relates to the real-life applicability of other state laws to open-enrollment charter schools. The court had an opportunity to affirm these protections while setting forth a charge to the Texas legislature to provide more clarification on what they intended the new laws to be.

As mentioned in the final *Walker* ruling, Chief Justice Hecht stresses in the majority opinion that the legislature "has already gone a long way" in requiring other state laws to expressly apply to open-enrollment charter schools.[59] However, the legislature still stopped short when it failed to review other critical state laws and discern where supplemental amendments were needed to address gaps created through the 2015 amendments to the CSA.

Although the court tried to get it right in its application of the new amendments, policy-wise, it truly got it wrong—employees of publicly-funded and publicly-served, open-enrollment charter schools are now without legal recourse if they report the wrongdoings of their employers and face retaliation. Do we want to bolster protections for charter schools while excising critical protections for their employees?

V. CONCLUSION

The Texas legislature, in its 2015 amendments to the Texas Charter Schools Act, delimited critical protections for open-enrollment charter school employees, creating a gaping hole in the law for charter schools when sued by former employees for retaliation claims under the Texas Whistleblower Act. These statutory restrictions move policy in the opposite direction of reform, tying up the strings of progress Texans have made under the 2001, 2003, and 2007 amendments, then enacted to expand the protections and benefits for charter school employees.

Although the *Walker* court did not move in the direction of progress, one can be hopeful that the curious outcomes of the *Walker* case will charge the Texas legislature to either amend the WBA to explicitly state that it applies to open-enrollment charter schools or they should repeal the 2015 amendments of the CSA, reinstating these necessary protections.

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58. *Id.* at 754.
59. *Id.*

GUNN V. MCCOY: SHOULD A DEAD PERSON RECEIVE OVER SEVEN MILLION DOLLARS IN FUTURE MEDICAL EXPENSES?

JOLENE ROBIN-MCCASKILL†

I. INTRODUCTION

Should a deceased person be awarded over $7,000,000 in future medical expenses? Yes, according to the Texas Rules of Appellate Procedure. Typically, the post-judgment death of a plaintiff will not affect the outcome of a defendant's appeal.[1] However, if the appellate court remands the case for a new trial, the fact that the plaintiff is deceased may warrant a different result.[2] This works well for most cases. But, in cases where future medical expenses have been awarded—such as a medical malpractice lawsuit—is it fair to force a defendant to pay (possibly in the millions) for the future medical expenses of a person that does not require future medical care?

A medical malpractice lawsuit is proper when a medical professional's standard of care falls below the level required by law, causing a patient harm

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1. *See* Gunn v. McCoy, 554 S.W.3d 645, 657, 678–79 (Tex. 2018).
2. *Id.*

or death.[3] The fact-finder in such a lawsuit must determine fault, causation, and damages.[4]

Shannon McCoy (Shannon), was thirty-seven weeks pregnant with her first child.[5] The pregnancy was uneventful until September 13, 2004, when she was admitted into the hospital after complaining of severe abdominal pain.[6] After admission, Dr. Jacobs, the OB/GYN on call, diagnosed her with placental abruption[7] and disseminated intravascular coagulation (DIC).[8] The DIC caused Shannon to hemorrhage, and despite receiving over twelve units of blood products, she went into cardiac arrest and suffered severe brain damage from which she never recovered.[9] Shannon hemorrhaged until her heart could no longer pump, and eventually suffered serious and irreparable brain damage.[10] Shannon initially showed signs of improvement but, two years after the initial brain injury, she suffered another brain injury which left her in a permanent state of vegetation requiring 24-hour care.[11] Shannon died December 12, 2015, ten days prior to the court of appeals delivering its decision.[12]

This Note addresses the relief granted by the jury along with the lack of jury instructions given in a medical malpractice case against several doctors, a hospital, and a medical group. The jury awarded $10,626,369 to compensate the plaintiffs for the irreversible brain injury caused by the doctors' negligence.[13] Part II describes the case facts and history. Part III describes the case issues and the court's reasoning. Part IV discusses whether Texas appellate rules concerning future medical expenses are fair and whether the court's ruling is consistent with precedent. Part V concludes the note. Although the holding in this case is legally correct, there is something wrong with a defendant required to pay millions in future medical expenses for a plaintiff who dies before the case has been decided on appeal.

3. *See* Coronel v. Providence Imaging Consultants, P.A., 484 S.W.3d 635, 638 (Tex. App.—El Paso 2016, pet. denied); Morrell v. Finke, 184 S.W.3d 257, 271–72 (Tex. App.—Fort Worth 2005, pet. denied); Linan v. Rosales, 155 S.W.3d 298, 302 (Tex. App.—El Paso 2004, pet. denied).

4. *See Morrell*, 184 S.W.3d at 288–89.

5. *Gunn*, 554 S.W.3d at 654.

6. *Id.*

7. *Id.* (explaining placental abruption is when the placenta detaches from the uterine wall).

8. *Id.* (explaining that DIC is a "blood-clotting disorder which causes both abnormal blood clotting throughout the body and profuse bleeding. DIC can occur for multiple reasons, including placental abruption").

9. *Id.* at 654–56.

10. *Id.*

11. *Id.* at 656.

12. *Id.*

13. *Id.* at 657.

II. CASE OVERVIEW

A. *Trial Court's Judgment*

Shannon's husband, Andre McCoy (McCoy), acting individually and as his wife's guardian, sued the defendants, Dr. Debra Gunn, Obstetrical and Gynecological Associates (OGA), Dr. Jacobs, Dr. Collins, and Women's Hospital, claiming that Shannon's injuries were caused by their negligence.[14] Dr. Collins was dropped from the lawsuit before trial, and both Women's Hospital and Dr. Jacobs settled with Andre McCoy (McCoy) for a total of $1,206,773.50.[15] The remaining defendants, Dr. Gunn and OGA, advanced to trial, where the jury entered a judgment in favor of plaintiffs in the amount of $10,626,369, including $703,985.98 for past medical expenses and $7,242,403 for future medical expenses.[16] The trial court credited the amount paid by Women's Hospital and Dr. Jacobs to the total amount awarded, leaving Dr. Gunn and OGA responsible for $9,419,595.50.[17]

B. *Defendant's Appeal*

Dr. Gunn and OGA appealed the trial court decision.[18] In the ruling from the Fourteenth Court of Appeals, all issues were dismissed except the court held that the evidence submitted by the plaintiffs was insufficient to support $159,854 of the future medical expenses award.[19] The court of appeals suggested a voluntary remittitur, which the plaintiff submitted. The defendants appealed to the Supreme Court of Texas, who dismissed all seven issues raised by the defendants and affirmed the court of appeals decision.[20]

III. CASE ISSUES AND COURT'S REASONING

In a medical malpractice case, the plaintiff is required to show "proof to a reasonable medical probability that the injuries complained of were proximately caused by the negligence of the defendant."[21] The jury determines if the plaintiff has met the burden required to prove negligence. If so, then they

14. *Id.*
15. *Id.*
16. *Id.*
17. *See id.*
18. Gunn v. McCoy, 489 S.W.3d 75, 81 (Tex. App.—Houston [14th Dist.] 2016), *aff'd*, 554 S.W.3d 645 (Tex. 2018).
19. *Id.*
20. *Id.*
21. *Gunn*, 554 S.W.3d at 658 (quoting Columbia Rio Grande Healthcare, L.P. v. Hawley, 284 S.W. 3d 851, 860 (Tex. 2009)).

may award damages to the plaintiff commensurate with the level of negligence.[22] The jury is presented with expert testimony to assist them in reaching a judgment.[23] As with most medical malpractice cases, this case is a battle of the experts.[24] Expert testimony is necessary for the jury to reach an informed decision when the subject matter is outside their common knowledge.[25] Here, with the benefit of expert testimony, the plaintiffs were awarded a judgment of over ten million dollars.[26]

A. Did the Trial Court Err by Refusing the Unavoidable Accident Instruction?

A trial court has discretion to include or exclude any requested jury instruction.[27] A court's decision to include or exclude jury instructions is reviewed for abuse of discretion.[28] Under Texas law, a jury instruction "is proper if it assists the jury, accurately states the law, and finds support in the pleadings and evidence."[29] However, even if the jury instruction is improper, it will not be a reversible error unless the error "probably caused the rendition of an improper judgment or prevented the petitioner from properly presenting the case to the appellate courts."[30] The issue for appellate courts when reviewing an excluded jury instruction is "whether the request was reasonably necessary to enable the jury to render a proper verdict."[31] Here, the jury instruction proposed by the defense and refused by the trial court pertained to the unavoidable accident defense.[32] "An unavoidable accident is 'an event not proximately caused by the negligence of any party to it.'"[33] The purpose of this instruction "is to advise the jurors that 'they do not have to place blame on a party to the suit if the evidence shows that conditions beyond the party's control caused the accident.'"[34] Generally, an unavoidable accident instruction is used when there is some natural occurrence that caused the injury, or

22. *Id.* at 671.
23. *Id.* at 684 (Johnson, J., dissenting) (citing Dall. Ry. & Terminal Co. v. Gossett, 294 S.W.2d 377, 382–83 (Tex. 1956)).
24. *Id.* at 665.
25. *Id.* at 658 ("In medical-malpractice cases, the general rule is that 'expert testimony is necessary to establish causation as to medical conditions outside the common knowledge and experience of jurors.'") (citations omitted).
26. *Id.* at 657.
27. *Id.* at 675.
28. *Id.*
29. *Id.*
30. *Id.*; TEX. R. APP. P. 61.1.
31. *Gunn*, 554 S.W.3d at 675 (citing Shupe v. Lingafelter, 192 S.W.3d 577, 579 (Tex. 2006) (per curiam)).
32. *Id.*
33. *Id.* (quoting Reinhart v. Young, 906 S.W.2d 471, 472 (Tex. 1995)).
34. *Id.* (quoting Dillard v. Tex. Elec. Co-op., 157 S.W.3d 429, 432 (Tex. 2005)).

when a child below the age of legal negligence is a party in the lawsuit.[35] However, this instruction is only proper when "there is evidence that the event was proximately caused by a nonhuman condition and not by the negligence of any party to the event."[36]

The Fourteenth Court of Appeals held that the instruction was improper because there was "no testimony that Shannon's placental abruption and DIC were 'catastrophic' complications 'predetermined' to result in severe brain damage."[37] The Supreme Court of Texas disagreed, stating the complications caused the death of Shannon's child—and possibly Shannon herself—which was enough to deem them "catastrophic" under the plain meaning of the word.[38] Additionally, the court stated there was enough evidence to submit the instruction.[39] An unavoidable accident instruction could have been proper.[40] However, even though the court found the instruction to be proper, it held that it was within the trial court's discretion to refuse to submit it to the jury.[41] Simply because an instruction is proper does not make it a requisite.[42] Therefore, even if the trial court erred when it excluded the unavoidable accident instruction, since the defendant did not prove additional harm, the exclusion was not a reversible error.[43]

IV. THE TEXAS SUPREME COURT RULED CORRECTLY

The court's ruling is correct for two reasons: First, the Texas Rule of Appellate Procedure states that an appeal continues as if the plaintiff is alive if he or she dies after the trial court's ruling but before the appellate court decision. Secondly, the missing jury instruction was not a reversible error because an excluded instruction without additional proof of harm is not an abuse of discretion.[44]

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35. *See Reinhart*, 906 S.W.2d at 472 ("The instruction is most often used to inquire about the causal effect of some physical condition or circumstance such as fog, snow, sleet, wet or slick pavement, or obstruction of view, or to resolve a case involving a very young child who is legally incapable of negligence.").

36. *Gunn*, 554 S.W.3d at 675.

37. *Gunn*, 489 S.W.3d at 115 (citing Williams v. Viswanathan, 64 S.W.3d 624, 629 (Tex. App.—Amarillo 2001, no pet.)).

38. *Gunn*, 554 S.W.3d at 676 n.18 (citing *Dillard*, 157 S.W.3d at 432–34) ("Without a full analysis of the plain meaning of 'catastrophic' . . . placental abruption and DIC cost this woman her child and possibly her life. [The complications] were catastrophic.") (internal citations omitted).

39. *Id.* at 676.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *See Gunn*, 489 S.W.3d at 114 (quoting Towers of Town Lake Condo. Ass'n v. Rouhani, 296 S.W.3d 290, 301 (Tex. App.—Austin 2009, pet. denied.)).

The result was correct because it was based on the Texas Rules of Appellate Procedure. However, this outcome should be grounds for legislative reevaluation. Here, Shannon died after the trial courts' judgment but prior to the appellate court ruling.[45] Texas Rule of Appellate Procedure 7.1 pertains to the death of a party in a civil lawsuit:

If a party to a civil case dies after the trial court renders judgment but before the case has been finally disposed of on appeal, the appeal may be perfected, and the appellate court will proceed to adjudicate the appeal as if all parties were alive. The appellate court's judgment will have the same force and effect as if rendered when all parties were living. The decedent party's name may be used on all papers.[46]

Rule 7.1 should be modified in cases where the trial court's judgment includes an award for future medical expenses and the plaintiff dies while the case is being decided on appeal.

Although the case continues as if the plaintiff is alive, if the case were to be reversed or remanded, the damage award would have to be amended.[47] The $10,626,369 awarded in damages by the trial court included $703,985.98 for past medical expenses and $7,242,403.00 for future medical expenses, based on a life span of twenty years.[48] In 2009, based on a twenty-year plan, Shannon's future medical expenses consisted of about 70% of the award.[49] She died six years later on December 12, 2015.[50] Experts forecasted that Shannon's medical care would amount to roughly $370,000 per year.[51] She survived for six years; all things equal, her total medical expenses for that amount of time would be estimated at $2,220,000.[52] Should a deceased plaintiff be awarded a surplus of $5,000,000 for future medical expenses? No. The rule should be amended so that actual medical expenses during appeal, but before the plaintiff's death, are included in past medical expenses. Future medical expenses awarded should be removed. In order for this to happen, the Texas legislature would have to modify the rule.

This could be a reason the Texas Supreme Court seemed reluctant to reverse or remand this case. Although the omission of the unavoidable accident jury instruction was within the court's discretion, and not an error, it

45. *Gunn*, 554 S.W.3d at 657.
46. TEX. R. APP. P. 7.1.
47. *See Gunn*, 554 S.W.3d at 678–79.
48. *Id.* at 657, 669.
49. *Id.* at 669.
50. *Id.* at 657.
51. *See id.* at 669–70.
52. *See id.* at 657, 669.

would have directed the jury to consider another theory of causation for Shannon's injury.[53] The parties had different theories about the cause of Shannon's brain injury. McCoy's theory was that the defendant was negligent in Shannon's care for three main reasons: (1) she did not order FFP blood transfused to assist in clotting the wound to stop the hemorrhage;[54] (2) she ordered Lasix to increase the Shannon's urine output, but the medication also decreases blood volume, which caused or at least contributed to the her cardiac arrest;[55] and (3) she never was ahead of the blood loss.[56] The doctor must stay ahead of the blood loss or the body starts shutting down vital organs other than the brain, heart, and lungs.[57]

The defendants' theory was: (1) Shannon received the right mix of blood and blood products to stop the hemorrhaging and promote blood clotting; and (2) Shannon's brain injury was the result of multiple microthrombi clotting small vessels in the brain, which caused the death of surrounding tissue due to lack of oxygen.[58] Therefore, the defense alleged Shannon's brain damage was an unavoidable accident caused by microthrombi created by her body in reaction to the DIC treatment, which caught in the small vessels of her brain, resulting in a mini-stroke.[59] The defense argued that an accumulation of the localized mini-strokes caused Shannon's brain injury absolving them of fault.[60] This is a reasonable argument, but it required the unavoidable accident instruction for the jury's consideration.[61] The jury could have adopted the defendants' theory if the jury had fully understood the implication of an unavoidable accident and were directed by the trial court to consider it.[62] The jury may have rejected this theory because of the diagnosis of multiple neurologists that attributed the injury to a non-local brain injury.[63] Both theories are reasonable and should have been presented to the jury for consideration. It is uncertain how juries will react to different information and the instruc-

53. *Id.* at 660–61 (discussing the defendant's theory of causation for Shannon's injuries).

54. *Id.* at 659–60 ("[Y]ou can replace blood until the cows come home, but if you can't clot and you have an open wound like inside the uterus, they're going to continue to bleed. And . . . without the clotting factors, you cannot control this coagulation disorder." *Id.* at 659.).

55. *Id.* at 655, 660.

56. *Id.*

57. *Id.*

58. *Id.* at 660–61.

59. *Id.* at 661.

60. *See id.* at 661, 665.

61. *See id.* at 666–67.

62. *See id.* at 677 (citing Hous. Unlimited, Inc. Metal Processing v. Mel Acres Ranch, 443 S.W.3d 820, 833 (Tex. 2014)) ("Provided with these alternative theories, the jury was free to determine which to credit.").

63. *Id.* at 660 (discussing the plaintiff's experts' testimony that she had "anoxic encephalopathy, which is global damage to the brain caused by lack of oxygen").

tion could have materially changed the result of this case. However, the appellate court did not find that the trial court abused its discretion in refusing to submit the unavoidable accident jury instruction.[64] The Supreme Court of Texas agreed.[65] Jury instructions are provided to teach the jury about the law and assist them in reaching a judgment.[66] Without guidance from the court, the jury may have believed that an unavoidable accident was not a plausible medical explanation. Instead, the jury may have thought it was a mere theory crafted by defense counsel to relieve their clients of responsibility. Here, the absence of the unavoidable accident instruction was not reversible error because the defense did not prove that the missing instruction probably caused an improper judgment. Therefore, the trial court was within its discretion to refuse to include the jury instruction.

V. CONCLUSION

Although the holding in this case is legally correct, there is something wrong with a defendant being required to pay millions in future medical expenses for a plaintiff that no longer needs medical care. If the damages were for any other reason, such as pain and suffering, wrongful death, or loss of consortium, then the defendants should have to pay the amount owed. But to uphold an award for future medical expenses, based on life care of an injured plaintiff who died during the appeals process, seems like an unjust burden on the defendant. The court noted that, had Shannon lived longer than the estimated twenty-years, that the judgment could not be adjusted to increase the amount paid.[67] This is fair. The expert's role is to provide the jury with information to determine how long the plaintiff is expected to live. Once that decision is made, it is adhered to—even if the plaintiff lives longer. However, while the case is still in the appeals process, future medical expenses should be modified if the plaintiff's death occurs.

64. *Gunn*, 489 S.W.3d at 115 (quoting Williams v. Viswanathan, 64 S.W.3d 624, 629 (Tex. App.—Amarillo 2001, no pet.). The court of appeals held that the instruction was improper because there was no evidence "that Shannon's placental abruption and DIC were 'catastrophic' complications 'predetermined' to result in severe brain damage from the moment she arrived at Woman's." *Id.*

65. *See Gunn*, 554 S.W.3d at 676–77.

66. Williams v. State, 964 S.W.2d 747, 750 (Tex. App.—Houston [14th Dist.] 1998, pet. denied).

67. *Gunn*, 554 S.W.3d at 679.