UTAH LAW REVIEW

Volume 2008 Number 3

ARTICLES

SYMPOSIUM
SUBPRIME MELTDOWN: THE LAW AND FINANCE OF THE AMERICAN HOME MORTGAGE FORECLOSURE CRISIS

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PROTECTING RELIGIOUS LIBERTY THROUGH THE ESTABLISHMENT CLAUSE: THE CASE OF THE UNITED EFFORT PLAN TRUST LITIGATION

Eric G. Andersen*

The Fundamentalist Church of Jesus Christ of Latter Day Saints is best known for its open practice of polygamy, long abandoned by the church from which it broke away generations ago. The Fundamentalist Church's particular version of the practice includes requiring girls in their lower and middle teenaged years to enter into marriages, often with much older men. Less notorious than, and distinct from, these marriage practices is its communitarian economic program involving the centralized ownership and management of many real estate and other assets of the church and its members. Their houses, farms, and businesses, located in a remote community straddling the Utah-Arizona border, are owned by the United Effort Plan Trust, a public charitable trust. The terms of the trust have obligated the trustees to administer its assets in accordance with religious principles. The trustees have historically been leaders of the church.

In 2005, in a petition brought before the Utah District Court, the Utah Attorney General alleged that the trustees were committing serious breaches of their fiduciary duty, putting the trust's assets at risk. In response to the Attorney General's petition, the court placed control of the trust in the hands of a "special fiduciary." The court then reformed the trust extensively, converting it into an essentially secular instrument. For example, trustees selected and controlled by the church president are to be replaced with a board approved by the court who are to accept only non-binding advice from ecclesiastical leaders. The "needs and just wants" of beneficiaries are no longer to be gauged by religious purposes and the mandates of scripture, but by the new trustees' assessment of their need for adequate housing and education. The changes wrought by the court impose deeply upon the religious character of the trust.

The reformation of the trust, which the court explicitly refused to justify as a response to the church's marriage practices, raises challenging issues under the religion clauses of the First Amendment. The reformation may pass muster under

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 Associate Academic Dean and Professor of Law, University of Iowa. I am grateful to Brooke Adams, Catherine H. Andersen, M. Steven Andersen, Randall P. Bezanson, William G. Buss, Arthur E. Bonfield, Frederick M. Gedicks, Todd E. Pettys, Jeffrey L. Shields, Mark Sidel, and Bruce Wisan for many helpful comments and suggestions. The Legal Studies Workshop at the University of Iowa College of Law provided an invaluable session of constructive criticism. Austin Frost provided important research assistance, particularly into the history of and current events surrounding the FLDS Church. Taylor Dix contributed both valuable research assistance and substantive insights through two outstanding student papers on First Amendment religion clause issues.

the Free Exercise Clause, but the court did trespass the bounds of the Establishment Clause, which constrains the state from intruding into the functioning of a religious community.

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I. INTRODUCTION

In 1890, the Church of Jesus Christ of Latter-day Saints formally announced that it would abandon the practice of polygamy.[1] After a half century of defending the practice in the face of increasing persecution and eventual prosecution, it was not an easy change to make. Some Mormons refused to accept it. Over time, a number of polygamous groups formed, some living in geographical seclusion. They became organizationally and doctrinally distinct from, and antagonistic toward, the church with which they had been historically connected. One of the better known groups, eventually named the Fundamentalist Church of Jesus Christ of Latter Day Saints (FLDS Church or Church) settled in a remote area straddling the Arizona-Utah border originally known, and still often referred to, as Short Creek. It now officially consists of the adjacent municipalities of Colorado City, Arizona and Hildale, Utah.

The Church has made headlines over the years because of its practice of polygamy, as have the various attempts by state authorities to deal with that illegal practice. A notorious official action against the Church was the "Short Creek Raid" in 1953.[2] More recently, criminal charges were brought against current Church President Warren Jeffs and others for sexual abuse against minors. It was alleged that under his direction, girls in their early and mid-teens have been pressured into polygamous marriages. Jeffs went underground to avoid the law, but was later apprehended and convicted in Utah on two counts of rape by accomplice.[3] Other criminal charges are pending in Arizona. In the spring of 2008, the Church exploded into national and international headlines when law enforcement authorities entered another FLDS community located in Eldorado, Texas. They took custody of over 400 children, acting in response to a phone call said to have been made by a teenage girl claiming to have been sexually and physically abused by her much older husband. Recently, the Texas Supreme Court affirmed the appellate court's decision finding that the "removal of the children was not warranted."[4] As this article goes to press, the children had been returned to their parents, although further civil proceedings in relation to particular families, as well as possible criminal proceedings, continue. [5]

An element of the Church's communal life much less known than, and not necessarily connected to, polygamy and child marriage is an economic arrangement that came to be called the "United Effort Plan" (UEP). It involves the common ownership of assets, especially real property, eventually held under a

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[1] Wilford Woodruff, OFFICIAL DECLARATION-1, *in* DOCTRINE AND COVENANTS, 291–92 (1983 ed.).

[2] *See* RICHARD S. VAN WAGONER, MORMON POLYGAMY 194–96 (2d ed. 1989).

[3] Jeffs v. Jeffs, No. 040915857, slip op. (Utah Dist. Ct. July 29, 2004)

[4] *In re* Tex. Dep't of Family and Protective Servs., No. 08-0391 (Tex. May 29, 2008) (per curiam).

[5] David A. Fahrenthold, *Case Against Sect May Not Be Over*, WASHINGTON POST, June 4, 2008, at A2; Terri Langford, *Sect Leader's Daughter Takes Legal Steps,* HOUSTON CHRON., June 21, 2008, at B3.

formally organized charitable trust (UEP Trust or Trust). The residents of Short Creek live in houses, and many work on farms and in businesses, owned by the Trust. These properties are built or improved through communally organized efforts. As discussed below, the rights to their occupancy and use have sometimes been the subject of internal dispute.[6]

On May 26, 2005, the Utah Attorney General (AG) petitioned a state trial court in Salt Lake City, Utah to take over the control and administration of the Trust. Over many years, Church members had transferred real and personal property to the Trust and contributed labor to increase its value. At the time of the AG's petition, the beneficiaries of the Trust—essentially the present (and some former) members of the Church who had contributed to the Trust estate and who lived or had lived in the Short Creek area—were probably between 6,000 and 8,000 in number.[7] The value of the Trust estate was estimated to be over $100,000,000, consisting primarily of improved and unimproved real estate.[8]

The Trust's stated purpose was "to preserve and advance the religious doctrines and goals" of the FLDS Church.[9] The trustees were obligated to administer the Trust's assets on behalf of a beneficiary class consisting of FLDS Church members "according to their wants and their needs, insofar as their wants are just."[10] The AG claimed that the trustees had been derelict in their fiduciary obligations by failing to defend the Trust against tort claims brought against it, by taking actions that endangered the Trust's charitable status, and by transferring Trust assets to FLDS Church "insiders" for consideration far below their fair market value.[11]

For reasons that are not entirely clear, church leaders declined to participate in the litigation, just as they had refused to defend the tort actions that prompted the AG's intervention in the first place.[12] These serious allegations were not disputed

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[6] *See infra* part II.B.

[7] Brooke Adams & Pamela Manson, *Battling Polygamy: State of Siege*, SALT LAKE TRIB., Aug. 21, 2005 at A1.

[8] In an early report filed in the case, the court-appointed special fiduciary stated that, according to tax records, the value of the Trust's real estate assets in the community totaled $91,633,846. *In re* United Effort Plan Trust, No. 053900848, slip op. ¶¶ 48, 50 (D. Utah Aug. 2, 2005). Assessed values on the tax rolls are not necessarily accurate gauges of genuine market values, however, and those values may be especially elusive given the unusual ownership and social arrangements that characterize this particular community. The special fiduciary later stated informally that the true market value of Trust assets could be in the range of $150 to 200 million. Telephone Interview with Bruce Wisan, Special Fiduciary, United Effort Plan Trust, in Iowa City, Iowa (May 24, 2007).

[9] Amended and Restated Declaration of Trust of the United Effort Plan Trust 1 (Nov. 2, 1998) (on file at Mohave County, Arizona Recorder's Office) [hereinafter 1998 Trust].

[10] *Id.* at 3.

[11] *See* A.G. Petition at 10–15.

[12] Throughout the litigation described here, as well as the criminal proceedings against Church President Warren Jeffs, *see infra* notes 41–42 and accompanying text, the FLDS community, as instructed by its leaders, has consistently refused to cooperate with state officials and agents, or to participate in legal proceedings. Interview with Bruce Wisan,

by the leaders of the Church. The court appointed a "special fiduciary" to take over the management of the Trust and proceeded to supervise its administration and reform the Trust so as to alter its character dramatically. Governance by ecclesiastical leaders obligated to act in accordance with religious principles has thus been replaced by court-appointed management instructed to pursue essentially secular goals.[13]

The Utah court's reformation of the Trust has imposed significantly on the religious exercise of the members of the FLDS Church, raising serious questions under the religion clauses of the First Amendment. Yet, the application to the Trust iitigation of the Supreme Court's existing jurisprudence under the religion clauses is problematic. The Court redefined its approach to the Free Exercise Clause in *Employment Division v. Smith.*[14] After *Smith*, state action may substantially interfere with religious exercise as long as that action is "neutral," "generally applicable," and does not fall within certain exceptions outlined in *Smith.*[15] It is likely that the Utah court's remedy passes muster under *Smith* even though the court specifically disclaimed the suppression of polygamy, unlawful everywhere in the United States, as a basis for its action.[16] The Supreme Court's Establishment Clause decisions have been closely focused on attempts by the state to benefit religion, making those decisions questionable templates for a fact pattern such as this. A series of decisions known as the "church autonomy cases" dealing with property disputes arising from doctrinal schisms provides, at best, an unfocused basis for decision on these facts.

This article argues that although the reformation of the Trust satisfies the requirements of the Free Exercise Clause, it invites a re-examination of the Establishment Clause as a basis for protecting religious liberty. It concludes that the Utah court's reformation of the Trust trespasses the boundaries of that clause. In reaching that conclusion, the court is taken at its word that the reformation of the Trust was not to be understood as an attempt to suppress or control the Church's marriage practices.[17] Accordingly, the analysis does not consider whether some reformation of the Trust might have been defensible as part of a response to those practices. Rather, the article focuses on the character of the particular reformation that was made and its effects on the lawful practices of a religious community entitled to First Amendment protection. The contraction of the Free Exercise Clause under *Smith* unveils important Establishment Clause values previously cloaked by the Free Exercise Clause. In particular, the facts of this case illustrate that the Establishment Clause has a role not only in limiting state support for religion, but in protecting religion from the state as well. That understanding of

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supra note 8. Although cooperation continues to be withheld, the policy of refusing to participate in legal proceedings has evidently changed. *Infra* note 70.

[13] *See infra* note 44 and accompanying text.

[14] 494 U.S. 872 (1990).

[15] *Id.* at 881–85, 886 n.3.

[16] *See* HOMER C. CLARK, JR., THE LAW OF DOMESTIC RELATIONS IN THE UNITED STATES § 2.6 at 64–65 (2d ed. 1998).

[17] *See infra* notes 117–119 and accompanying text.

the Establishment Clause has implications for religious freedom extending well beyond the story of the FLDS Church and its Trust.

II. BACKGROUND

Understanding the legal issues raised by the UEP Trust litigation requires some familiarity with the history of both the FLDS Church in general and the Trust in particular. This Part provides a brief overview of those subjects.

A. Origins of the FLDS Church and the UEP Trust

Early in the twentieth century, the families settling the Short Creek area acquired tracts of land. They organized themselves communally under the name of the "Work" or the "Priesthood Work" and contributed land to their project. Eventually, the group was formally organized as a religious corporation named the Corporation of the President of the Fundamentalist Church of Jesus Christ of Latter Day Saints. It has since been known as the FLDS Church.

The legal status of the group's earliest communitarian economic arrangements is unclear. At some point a trust was formed, but then discontinued. In 1942, documents were filed in Mohave County, Arizona, establishing the United Effort Plan Trust. The group's property, then held by the group in the name of the "Work," was transferred to the Trust.[18] The Trust has continued to the present, although it has been subject to a series of changes.[19] As discussed below, a critical "restatement" of the Trust was made by the trustees in 1998, followed by the court's "reformation" of the Trust in 2006.[20] When required in the interests of clarity, the versions of the Trust as it existed before 1998 are referred to collectively as the Original Trust, and the instruments making the changes described above are referred to as the 1998 Trust and the 2006 Trust, respectively.

During the second half of the twentieth century, as the Trust continued to acquire land from Church members, the history of the FLDS Church was part of a complex and often tumultuous series of events involving various polygamous sects located in the western United States and Canada. Individual groups splintered and recombined. Denominations in addition to the FLDS Church also formed and continue to function today.[21] Of relevance to this article was a Church schism in

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[18] *See generally* Jeffs v. Stubbs, 970 P.2d 1234, 1239 (Utah 1998) (summarizing the facts of the creation of the UEP).

[19] In 1946, the Trust was amended in ways insignificant to this article. *See* Certificate of Amendments to Declaration of Trust of the United Effort Plan (April 10, 1946) (on file at Mohave County, Arizona Recorder's Office).

[20] *See infra* Part II.C.

[21] *See generally* RICHARD S. VAN WAGONER, MORMON POLYGAMY 177–217 (2d ed. 1989) (summarizing the history of polygamist groups among which the FLDS Church is counted).

the late 1970s and early 1980s, during which some of those who had contributed land to the Trust were expelled from the Priesthood Work.[22]

B. Disputes over the Use of Trust Properties

In 1986, Rulon Jeffs, the president of the FLDS Church and the individual with de facto control over the administration of the Trust, declared that all those residing on Trust lands were tenants at will, thus lacking any rights to remain in their homes if directed by the management of the Trust to vacate. Those residents included some former Church members and members who had fallen out of favor with Church leaders. They were expelled, or threatened with expulsion, from their Trust-owned residences, which they had constructed themselves.[23] In 1987, they brought an action in the Federal District Court for the District of Utah seeking, among other things, to establish their rights to certain Trust properties.[24] They alleged that Church leaders had assured them that they could continue to reside in their houses for the remainder of their lives.[25]

Over the next 11 years, litigation between the FLDS Church, the Trust, its leaders, and the claimants in the original federal court action took place in federal and state courts. The federal court eventually dismissed for lack of subject matter jurisdiction, and the litigation culminated in the Utah Supreme Court's 1998 decision in *Jeffs v. Stubbs*.[26]

The Utah Supreme Court concluded that the original claimants against the Trust had established a right to recover in unjust enrichment for the improvements made to the land they had occupied.[27] It remanded for further proceedings under Utah's Occupying Claimants Act, which grants rights to claimants who occupy land under "color of title" (which the court said could include a life estate), and who have made valuable improvements to the land in good faith.[28]

Contrary to the stated intention of the Trust instrument, the position taken by Church leaders, and the trial court, the Utah Supreme Court also decided that the UEP Trust was not a "public charitable" trust at all, but a "private" trust.[29] A public charitable trust must, among other requirements, serve a "definite class and

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[22] *See* Centennial Park and the "Second Ward," http://www.mormonfundamentalism.com/ChartLinks/CentennialPark.htm (last visited Sept. 30, 2008); *see also* BENJAMIN G. BISTLINE, COLORADO CITY POLYGAMISTS 109–18 (2004); Brooke Adams, *Polygamy Leadership Tree: Religious Ideal Grows, Branches Out*, SALT LAKE TRIB., http://extras.sltrib.com/specials/polygamy/PolygamyLeaders.pdf (last visited Sept. 30, 2008) (discussing the expulsion of some members from the Priesthood Work).

[23] *Jeffs*, 970 P.2d at 1239–40.

[24] *Id.*

[25] *Id.*

[26] *Id.* at 1234.

[27] *Id.* at 1242–48.

[28] UTAH CODE ANN. §57-6-1 (2007).

[29] *Jeffs*, 970 P.2d at 1251–53.

indefinite beneficiaries within that definite class."[30] The Original Trust failed that test because its beneficiaries were a specifically identified group of persons: individuals who had contributed property to the Trust estate.[31]

That ruling was significant. Had the Trust been classified as "charitable," the claimants against it might have found it difficult to establish standing to assert their specific, trust-related claims—that the trustees had breached their fiduciary duty and that they were obligated to perform an accounting and distribution of the Trust estate.[32] The Utah Supreme Court directed the trial court on remand to proceed consistent with its holding that the Trust was private and not charitable.[33]

C. The Restatement of the Trust

Following the decision in *Jeffs v. Stubbs*, the trustees moved promptly to convert the Trust from a private to a public charitable one. On November 3, 1998, they filed an "Amended and Restated Declaration of Trust of the United Effort Plan Trust" in Mohave County, Arizona. They broadened the class of beneficiaries under the 1998 Trust instrument substantially. It now consisted not only of those who had contributed property to the Trust, but of all FLDS Church members who

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[30] *Id.* at 1252. The court also stated that a charitable trust must have a "purpose beneficial to the community." *Id.*

[31] *Id.*

[32] The trial court in *Jeffs v. Stubbs* relied upon *Restatement (Second) of Trusts* as its authority to reject the claimants' standing. *Id.* at 1251 (citing section 391 as authority for the trial court's conclusion that the claimants had no standing if the UEP was a public charitable trust). *See* Restatement (Second) of Trusts § 391 (1959) ("A suit can be maintained for the enforcement of a charitable trust by the Attorney General or other public officer, or by a co-trustee, or by a person who has a special interest in the enforcement of the charitable trust."); *see also* Stone v. Salt Lake County, 356 P.2d 631, 634 n.2 (Utah 1960) (citing section 391 as authority for rejecting the claims of a contributor to a charitable religious organization for alleged misuse of the complainant's funds). (The Utah Supreme Court erroneously referred to section 391 of the Restatement of *Restitution*, which was published in 1937 and contains no section 391. The Restatement (Second) of Trusts § 391 is precisely germane to the issue being addressed by the court, making it clear that the court had that source in mind.) Thus, the plaintiffs apparently would have lacked standing to bring their claims unless they could prove they had the requisite "special interest," a concept not developed in Utah law. After *Jeffs v. Stubbs* was decided, the Utah Legislature enacted the Uniform Trust Code. Utah Uniform Trust Code, UTAH CODE ANN. § 75-7-101 (2007) [hereinafter UTC]. The comment to UTC section 1001 states: "In the case of a charitable trust, those with standing include the state attorney general, a charitable organization expressly entitled to receive benefits under the terms of the trust, and other persons with a special interest." *Id.* at § 75-7-1001, cmt. Although the legislature did not formally adopt the official comments to the UTC, the comment to section 1001 suggests that the standing rule referred to in *Jeffs v. Stubbs* remains in effect.

[33] On remand, the Utah District Court concluded that some of the plaintiffs had rights under Utah's Occupying Claimants Act, and that the plaintiffs had no beneficial interests in the Trust. United Effort Plan v. Stubbs, No. 89-2850, slip op. (Utah Dist. Ct. Jan. 21, 2000).

"consecrate their lives, times, talents and resources to the building and establishment of the Kingdom of God on Earth under the direction of the President of the [FLDS] Church."[34] The attempt to convert the Trust from "private" to a "public charitable" succeeded. As noted below, in the litigation brought by the AG, the court concluded that the 1998 UEP Trust should now be classified under the latter heading.[35]

The restated UEP Trust made other changes designed to consolidate control of the Trust in the Church President. The Original Trust called for the election and removal of trustees by a majority vote of the board.[36] By contrast, the 1998 Trust gave the President of the FLDS Church the authority to appoint the members of the Trust's board of trustees, all of whom "shall serve at [his] pleasure . . . and may be removed or replaced at any time by the President."[37] The 1998 Trust also made clear that those residing on its properties did so at the sufferance of the presidency of the church, who could order their removal for failure to "live their lives according to the principles of the United Effort Plan and the Church."[38] Moreover, the 1998 Trust also mandated that "[t]he Board of Trustees shall have no obligation whatsoever to return all or any part of the consecrated property back to a consecrator or to his or her descendants."[39]

D. The UEP Trust Litigation

The actions of which the AG complained represent a fresh round of disputes occurring in the context of the well-publicized legal problems of the Church and its president Warren Jeffs relating to polygamy and child marriages.[40] Two tort actions were brought against Jeffs and other Church leaders individually, and against the Trust as Jeffs' alter ego. The first alleged child sexual abuse, assault, and fraud.[41] The other claimed civil conspiracy, fraud, breach of fiduciary duties, and various negligent and intentional torts.[42] When the defendants declined to enter a defense in these actions, their attorney presumably recognized that failure to defend could result in expensive default judgments against the Trust to the detriment of its beneficiaries. He successfully moved that he be permitted to withdraw as counsel, and to require the plaintiffs in those cases to notify the AG

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[34] 1998 Trust, *supra* note 9, at 3.

[35] *In re* United Effort Plan Trust, No. 053900848, slip op. ¶¶ 26–30 (Utah Dist. Ct. Dec. 13, 2005) (mem.) [hereinafter Memorandum Opinion].

[36] Declaration of Trust of the United Effort Plan 3 (Nov. 9, 1942) (on file at Mohave County Arizona Recorder's Office) [hereinafter Original Trust].

[37] 1998 Trust, *supra* note 9, at 4.

[38] 1998 Trust, *supra* note 9, at 3.

[39] 1998 Trust, *supra* note 9, at 3.

[40] *See supra* notes 2–5 and accompanying text.

[41] Jeffs v. Jeffs, No. 040915857, slip op. (Utah Dist. Ct. July 29, 2004).

[42] Ream v. Jeffs, No. 040918237, slip op. (Utah Dist. Ct. Aug. 27, 2004).

prior to the entry of default judgments.[43] The plaintiffs in the tort actions filed an additional action in state court alleging that Church leaders had begun to make transfers of Trust real estate holdings for insufficient or illusory consideration, thus dissipating its assets.

Believing that the Trust was in danger of losing its assets to the serious detriment of its beneficiaries, the AG petitioned the Utah District Court to suspend immediately the authority of the existing trustees and to appoint a "special fiduciary" to manage and protect the Trust pending consideration of a request to remove the existing trustees and to appoint new ones.[44] The court granted the AG's *ex parte* motion for temporary relief and set the matter for a hearing.[45]

After making a number of preliminary rulings, the court issued a detailed Memorandum Decision on December 13, 2005.[46] It resolved some critical issues in the case and established a framework for the reformation of the Trust. The court decided that the 1998 UEP Trust fully superseded the Original Trust and qualified as a "charitable" trust.[47] The Utah AG and Arizona AG therefore had standing to seek relief. Moreover, the court concluded that the 1998 Trust needed to be "reformed," and that it had the power to reform it.[48]

The court invited the parties to make proposals for the reformation of the 1998 Trust consistent with the following general principles:

a. The Trust must continue to satisfy the requirements of a "charitable trust," including that its beneficiaries "constitute a definite class, but

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[43] Motion to Withdraw as Counsel, Ream v. Jeffs, No. 040918237 (D. Utah Dec. 16, 2005).

[44] Memorandum Opinion, *supra* note 35. The AG was joined by a number of private petitioners who were present or former members of the FLDS Church and had contributed to the Trust, or who were plaintiffs in the separate tort actions against the Trust. The issue of the standing of the private petitioners is problematic. In general, private parties, including beneficiaries, lack standing to enforce a public, charitable trust. The AG alleged that the Trust was a "mixed" private and public charitable trust, and that the private plaintiffs had standing in relation to its "private" character. *In re* United Effort Plan Trust, No. 053900848, slip op. (Utah Dist. Ct. July 19, 2005). The court concluded, however, that the Trust was entirely charitable. In principle, that could have resulted in a finding of no standing for the private plaintiffs. The court discussed the standing issue inconclusively. Memorandum Opinion, *supra* note 35, at ¶16; *In re* United Effort Plan Trust, No. 053900848 (Utah Dist. Ct. July 19, 2005) (minute entry). Had the action been defended, that issue might have been raised. It was not raised, however, and the court permitted the private parties to remain in the case. The private plaintiffs apparently did not seek any relief inconsistent with that requested by the AG, so their presence in the case may not have been significant.

[45] *Ex Parte* Temporary Restraining Order Appointing a Special Fiduciary and Suspending the Trustees, *In re* United Effort Plan Trust, No. 053900848, (Utah 3rd Dist. May 27, 2005).

[46] Memorandum Opinion, *supra* note 35.

[47] Memorandum Opinion, *supra* note 35, ¶ 13–15.

[48] Memorandum Opinion, *supra* note 35, ¶¶ 17–23.

the beneficiaries within that class are indefinite," and the Trust's purpose is "beneficial to the community."[49] The "beneficial purpose" requirement could not include the promotion of the FLDS Church's religious doctrines and goals, but could include providing for the "needs" and "just wants" of the beneficiaries.[50]

b. Only the "legitimate and legal" purposes of the Trust would be carried into the reformed instrument. The Trust could not be used to support polygamy, but it could support "*lawful* religious and charitable purposes."[51]

c. "Neutral principles" must be employed to reform the Trust, consistent with the decision of the United States Supreme Court in *Jones v. Wolf*[52] and related cases.[53]

These principles, said the court, must govern the future administration of the reformed Trust. The Trust must "provide a vehicle for ecclesiastical input," but it must also "provide future trustees with a set of neutral criteria to apply in evaluating the relative needs of potential beneficiaries," including "a mechanism—independent of priesthood input—for establishing their 'just wants.'"[54] The court then engaged in a section-by-section analysis of the 1998 Trust, discussing how these principles might apply.

E. Reformation of the Trust by the Court

The special fiduciary submitted a proposed reformation of the Trust on April 6, 2006. On October 25, 2006, the court promulgated the 2006 Trust.[55] It is dramatically different from its predecessor. Seventeen paragraphs were replaced with over 175 and a lengthy appendix. Much of the new material consists of typical, boilerplate trust language. The most important changes relate to the role of FLDS Church doctrine and leaders under the Trust.

Although the Trust and the Church have always been separate entities, the connection between them had been close. For example, the 1998 Trust existed "to preserve and advance the religious doctrines and goals" of the FLDS Church.[56] Moreover:

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[49] Memorandum Opinion, *supra* note 35, ¶¶ 26–27.
[50] Memorandum Opinion, *supra* note 35, ¶¶ 31–32.
[51] Memorandum Opinion, *supra* note 35, ¶ 33 (emphasis in original).
[52] 443 U.S. 595, 602 (1979).
[53] Memorandum Opinion, *supra* note 35, ¶ 35.
[54] Memorandum Opinion, *supra* note 35, ¶¶ 36–37.
[55] Reformed Declaration of Trust of the United Effort Plan Trust, *In re* United Effort Plan Trust, No. 053900848 (Utah Dist. Ct. Oct. 25, 2006) [hereinafter 2006 Trust].
[56] 1998 Trust, *supra* note 9, at 1.

> The United Effort Plan is the effort and striving on the part of Church members toward the Holy United Order. This central principle of the Church requires the gathering together of faithful Church members on consecrated and sacred lands [i.e., Trust property] to establish as one pure people the kingdom of God on earth under the guidance of Priesthood leadership. The Board of Trustees, in their sole discretion, shall administer the Trust consistent with its religious purpose to provide for Church members according to their wants and their needs, insofar as their wants are just (*Doctrine and Covenants*, Section 82:17-21).[57]

As this paragraph illustrates, the concepts of "needs" and "just wants" were thoroughly embedded in religious doctrine and practice.[58] The purpose of the Trust was to promote the "Holy United Order," which required Church members to gather on "consecrated and sacred lands." Those lands were among the Trust's assets. The trustees were charged with using those lands to achieve the Trust's religious purpose.[59]

> By contrast, the reformed 2006 Trust states:
>
> The reformation and administration of the Trust shall be based on neutral principles of law; the reformation shall not be based on religious doctrine or practice and shall not attempt to resolve underlying controversies over religious doctrine. The reformation shall allow for ecclesiastical input of a non-binding nature and a mechanism—independent of priesthood input—for establishing benefits under the Trust.[60]

According to the 2006 Trust, "the Trust's property shall be devoted to providing for the just wants and needs of the beneficiaries which purpose is beneficial to the community."[61] The instrument goes on to say:

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[57] 1998 Trust, *supra* note 9, at 2–3.

[58] The cited passage from *Doctrine and Covenants*, considered scripture by the Church, includes the following: "[a]nd you are to be equal, or in other words, you are to have equal claims on the properties, for the benefit of managing the concerns of your stewardships, every man according to his wants and his needs, inasmuch as his wants are just—And all this for the benefit of the church of the living God, that every man may improve upon his talent, that every man may gain other talents, yea even an hundred fold, to be cast into the Lord's storehouse, to become the common property of the whole church—Every man seeking the interest of his neighbor, and doing all things with an eye single to the glory of God." CHURCH OF JESUS CHRIST OF LATTER-DAY SAINTS, DOCTRINE AND COVENANTS, 152 .

[59] 1998 Trust, *supra* note 9, at 2–3.

[60] 2006 Trust, *supra* note 55, § E.3.

[61] 2006 Trust, *supra* note 55, § E.1.

> Just wants and needs concern primarily housing, with the goal of securing residences for Trust Participants. Secondarily just wants and needs concern education, including scholarships, occupational training and economic development. Just wants and needs may also include food, clothing, medical needs and other items within the discretion of the Board.[62]

The 2006 Trust imposes separation between the Trust and the Church in additional ways. Under the 1998 Trust, the Church President is a trustee and president of the board of trustees, with the authority to appoint and dismiss other trustees at will.[63] The 2006 Trust requires the court to appoint the initial board, which eventually becomes self-perpetuating, with detailed rules governing appointments and removal from office.[64] Further, the Church was the remainder beneficiary under the 1998 Trust.[65] Under the 2006 Trust, in the case of termination, assets are to be distributed to "Trust Participants," which is broadly defined to include those who have contributed to the Trust.[66]

Acting under the court's direction, the special fiduciary now administers the Trust. He has settled litigation pending against it and instituted a system under which beneficiaries can formally apply for benefits.[67] Relatively few potential beneficiaries have done so.[68] A new board of trustees has not yet been appointed. Instead, the court has put in place a group of advisors.[69] Leaders and members of the Church have refused to participate.[70]

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[62] 2006 Trust, *supra* note 55, § 3.1.

[63] 1998 Trust, *supra* note 9, at 12.

[64] 2006 Trust, *supra* note 55, art. 5.

[65] 1998 Trust, *supra* note 9, at 4.

[66] 2006 Trust, *supra* note 55, § 1.25, art. 4.2.

[67] *See* Petition for Benefits, United Effort Plan Trust, http://www.ueptrust.com/UEPTImages/5-29-07_%20BENEFIT_%20PETITION.pdf.

[68] The special fiduciary reported that, as of May, 2007, fewer than 200 applications had been received. Interview with Bruce Wisan, *supra* note 8.

[69] Memorandum Opinion, *supra* note 35, ¶¶ 57–62; *see* Report of the Special Fiduciary, *In re* United Effort Plan Trust, No. 053900848, slip op. ¶¶ 222–29 (D. Utah Sept. 17, 2007), *available at* http://www.ueptrust.com/UEPTImages/SF-report-9-17-07.pdf.

[70] Interview with Bruce Wisan, *supra* note 8. After years of refusing to participate in the litigation surrounding the reformation of the Trust or to challenge its management by the special fiduciary, the FLDS community recently began doing so. As this article goes the press, attorneys for the Trust's beneficiaries sought to remove the special fiduciary or to limit his powers. Motion for Temporary Restraining Order Removing Special Fiduciary or Limiting Special Fiduciary's Powers, *In* re United Effort Plan Trust, No. 053900848, (D. Utah July 15, 2008). The court promptly denied the motion on both procedural and substantive grounds. Minute Entry, *In re* United Effort Plan Trust, No. 053900848, (D. Utah July 15, 2008). Attorneys for certain Church members have also filed an action objecting to the special fiduciary's sale of a farm owned by the Trust. Brooke Adams, *FLDS Suit Seeks Compensation for Farm*, SALT LAKE TRIB., July 17, 2008 at B3. If the FLDS community continues its new policy of actively resisting the management of the

The court's reformation of the Trust fundamentally secularizes it. Not only has the purpose of "preserving and advancing" "religious doctrines and goals" disappeared, but the beneficiaries' "needs" and "just wants" are to be determined with, at most, "non-binding" ecclesiastical input into the meanings of those terms. The tight structural connection between the Church and the Trust has been cut. By its own terms, the Trust is no longer an integral part of the religious life of the community.

Instead, the vision that emanates from the 2006 Trust is of a professionally managed body of assets administered by a benevolent board of directors, beyond the control of Church leaders, though affording them a respectful hearing. The board is sympathetic to the needs of Church members, but their religious convictions fade into the background, replaced by a focus on housing, education, and the other benefits of an economically secure and comfortable life.

The court's argument that this reformation was required as a matter of trust law is troubling.[71] That issue is not the focus of the current analysis, however. For present purposes, the reformation is treated as given, with the First Amendment issues discussed on that basis.

Trust in the courts, further legal developments relevant to the analysis in the article are likely.

[71] The Memorandum Opinion is somewhat confusing in identifying the provisions of the 1998 Trust that are "fundamentally flawed and unworkable," and that therefore require reformation of the Trust. Memorandum Opinion, *supra* note 35, ¶ 23. The court refers to its section-by-section analysis of the 1998 Trust, where these problems are "more fully discussed." Memorandum Opinion, *supra* note 35. But that portion of the opinion focuses primarily on eliminating religious principles from the governing terms of the Trust and on minimizing ecclesiastical control over its administration. Those steps arguably may be required by the First Amendment's religion clauses *after* one has determined that reformation is necessary. But recognizing them as a *consequence* of reformation does not make them a ground for reformation. A careful reading of the Memorandum Opinion reveals a discussion of only two elements of the 1998 Trust that might be characterized as inherent flaws in the instrument itself. The first is the power granted to the President of the FLDS Church, who is designated as a trustee and president of the board of trustees, and is given the power to appoint and remove other trustees at will. It is precisely that individual, Warren Jeffs, whom the court concluded had committed serious and continuing breaches of his fiduciary duties making it necessary to remove him from Trust administration. Memorandum Opinion, *supra* note 35, ¶¶ 21-22, 50. The second flaw is allowing the FLDS Church to be the remainder beneficiary of the 1998 Trust, in line to take ownership of all its assets should the Trust be terminated for any reason. 1998 Trust, *supra* note 9, at 4. The court noted that it is not unusual for religious corporations to be remainder beneficiaries of trusts. But "[a]llowing the Corporation of the President of the FLDS Church to be the remainder beneficiary of Trust assets would directly further illegal practices [such as polygamy] espoused by the FLDS Church and its current president." Memorandum Opinion, *supra* note 35, ¶ 52. Both of these difficulties could have been remedied with a reformation less sweeping in its scope than the complete overhaul and secularization of the Trust wrought by the court.

III. THE ISSUES UNDER THE RELIGION CLAUSES

The UEP Trust litigation cannot avoid the trip wire that sounds First Amendment warnings. When the state, acting through its AG and courts, assumes control of a charitable trust created expressly "to preserve and advance the religious doctrines and goals"[72] of a church, one must ask whether that action squares with the religion clauses: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof."[73] Framing the constitutional issues, however, is not a simple task. This Part considers how the Supreme Court's current Free Exercise and Establishment Clause jurisprudence applies to the story of the UEP Trust litigation. It also views that litigation through the lens of a series of decisions known as the "church autonomy cases," which consider the two religion clauses jointly.

A. The Free Exercise Clause

In typical Free Exercise Clause fact patterns, the state interferes with, or refuses to accommodate or exempt, an individual or a religious body in religious observance. Thus, when actions by the City of Hialeah and Florida state officials made illegal the practice of animal sacrifice practiced by the Santeria religion, the Free Exercise Clause was the most relevant text for testing the constitutionality of that action.[74] Similarly, when the State of Oregon refused to exempt from its ban on ingesting peyote Alfred Smith's use of that substance for sacramental purposes,[75] the Supreme Court engaged in a free exercise analysis, as it did when the State of Washington excluded from its "Promise Scholarship" program the degree in theology that Joshua Davey chose to pursue.[76]

The UEP Trust litigation appears to invite a similar analysis. Utah, through its AG and district court, is interfering in obvious ways with the exercise of religion by the members of the FLDS Church. It has taken control of, secularized, and—apparently for a substantial period of time—will administer the Trust, which was created for the purpose of enabling Church members to participate in a religiously based, communitarian economic program.

In an important respect, however, this case is not a typical free exercise story. The question is not whether the Constitution permits the government to enforce the substantive terms of a statute or regulation that, as written, obviously inhibits religious conduct. The statute here regulates behavior not necessarily connected to religion at all: a breach of fiduciary duty that imperiled the assets of a trust. The focus is on a highly discretionary judicial remedy to be applied once a breach of

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[72] 1998 Trust, *supra* note 9, at 1.

[73] U.S. CONST. amend I.

[74] Church of the Lukumi Babalu Aye, Inc. v. Hialeah, 508 U.S. 520, 532 (1993).

[75] Emp. Div. v. Smith, 494 U.S. 872 (1990).

[76] Locke v. Davey, 540 U.S. 712 (2004).

the statute has been established.[77] This element of the story distinguishes it from a classic free exercise case. It is still important to view it from a free exercise perspective, but that analysis is not simple.

The key free exercise case is *Employment Division v. Smith*.[78] Alfred Smith and Galen Black were fired from their jobs as counselors in a private drug rehabilitation program because they had ingested peyote, an illegal drug, for sacramental purposes in a ceremony of the Native American Church.[79] Their applications for unemployment compensation benefits were denied on the ground that they had been discharged for work-related misconduct.[80] Their claim that the denials violated their rights under the Free Exercise Clause failed in a state trial court, but was accepted by an intermediate appellate court and the Oregon Supreme Court. When their case came before the United States Supreme Court,[81] they argued that, under the Court's prior decisions, their conduct was protected by the First Amendment and the state therefore could not require them to forgo that conduct as a condition of receiving unemployment benefits.[82]

The Supreme Court reversed. In an opinion that dramatically reinterpreted its prior cases, it ruled that the Free Exercise Clause did not prohibit the state from applying to Smith and Black its prohibition on ingesting peyote, even though they had used it as part of a traditional religious ceremony.[83]

Smith is based on the principle that the Free Exercise Clause is not offended by "generally applicable, religion-neutral laws that have the effect of burdening a

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[77] The remedial powers granted the court to respond to the breach, taken directly from the Uniform Trust Code and adopted by the Utah legislature in 2004, are broad and vague. *See* UNIF. TRUST CODE § 1001; UTAH CODE ANN. § 75-7-1001 (2007); *see also id.* § 75-7-101 & cmt. ("This chapter is known as the 'Utah Uniform Trust Code . . . [E]ffective July 1, 2004."). The relevant statutory provisions do not prescribe any particular result or even lay out a menu of options. Instead, they give the court "full power to make orders, judgments, and decrees and take all other action necessary and proper to administer justice." *Id.* § 75-7-412(1). They permit it to "modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust." *Id.* Moreover, the court may terminate a trust or modify its substantive provisions using the cy pres doctrine "in a manner consistent with the settlor's charitable purposes." *Id.* § 75-7-413(1)(c).

[78] 494 U.S. 872 (1990).

[79] *Id.* at 874.

[80] *Id.*

[81] The case came before the U.S. Supreme Court twice. The first time it was remanded to determine whether the use of peyote for sacramental purposes was actually proscribed by state criminal law. Emp. Div. v. Smith, 485 U.S. 660 (1988). After the Oregon Supreme Court answered that question in the affirmative in *Employment Division v. Smith*, 763 P.2d 146 (Or. 1988), the U.S. Supreme Court then decided the Free Exercise Clause issue on the merits.

[82] *Smith*, 485 U.S. at 669.

[83] *Smith*, 494 U.S. at 890.

particular religious practice."[84] *Smith* thus eliminated the presumption that exemptions or accommodations from such laws are required if they burden religious exercise.[85]

Under *Smith*, as long as the Utah statutory or common law under which the court acted in the UEP Trust litigation is religiously "neutral" and "generally applicable," there is no obvious free exercise objection to its reformation of the Trust, even if doing so works a religious hardship on Trust participants.

The Supreme Court has said that the concepts of "neutrality" and "general applicability" are interrelated.[86] Indeed, the distinction between them is not entirely clear, and members of the Court have not understood them in precisely the same way.[87] It appears, however, that "neutrality" forbids the state from using religion as a basis of classification, thus protecting against overt discrimination on religious grounds, while "general application" means that state action cannot in fact be applied unevenly to an individual or a particular religious group compared with others similarly situated.[88]

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[84] *Id.* at 886 n.3. The key concepts of neutrality and generally applicability were developed in *Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah*, 508 U.S. 520 (1993).

[85] An important question not discussed in the *Smith* opinion is whether the rule of the case applies not only to individuals seeking to be excused from the reach of state action, but also to organizations. The Trust, after all, is a form of religious organization, with a separate legal existence from the Church. A narrow reading of *Smith* limits its holding to individuals, since the facts of that case involved two men who claimed that their free exercise rights had been violated. If the nature of a free exercise claim raised by a religious organization is different in kind from one raised by an individual, then the rule of *Smith* might apply only to the latter. The Supreme Court has not resolved that issue. Scholars disagree about how the Court should resolve it. Kathleen Brady argues that a core, individual right acknowledged by *Smith* is to believe and express religious doctrine, and that a broad autonomy for religious groups is essential to the development of such doctrine. Kathleen A. Brady, *Religious Organizations and Free Exercise: The Surprising Lessons of* Smith, 2004 BYU L. Rev. 1633, 1677. Perry Dane maintains that applying the strictures of *Smith* to religious organizations is not necessary to avoid the evil central to the Court's analysis in that case: a state of affairs in which the individual becomes "a law unto himself." Perry Dane, *"Omalous" Autonomy*, 2004 BYU L. REV. 1715, 1735–36. (quoting *Smith*, 494 U.S. at 885 (quoting Reynolds v. U.S., 98 U.S. 145, 167 (1878))). By contrast, Marci Hamilton reads *Smith* as "reiterat[ing] . . . the familiar doctrine that the rule of law applies to religious entities." Marci A. Hamilton, *Religious Institutions, the No-Harm Doctrine, and the Public Good*, 2004 BYU L. REV. 1099, 1108. Likewise, Laura Underkuffler finds "no convincing basis for distinguishing individual religious exemptions, struck down in *Smith*, from aggressive forms of religious-group autonomy." Laura S. Underkuffler, *Thoughts on* Smith *and Religious-Group Autonomy*, 2004 BYU L. REV. 1773, 1787. Whatever the merits these answers to the question may have, the Supreme Court itself has not answered it. I assume that *Smith* does apply to religious organizations.

[86] *Hialeah*, 508 U.S. at 531.

[87] *See id.* at 557–58 (Scalia, J. concurring).

[88] Frederick M. Gedicks, *The Permissible Scope of Legal Limitations on the Freedom of Religion or Belief in the United States*, 19 EMORY INT'L L. REV. 1187, 1212–18 (2005).

On its face, the relevant Utah law appears entirely "neutral" and "generally applicable." It grants a state court broad discretion to fashion a remedy appropriate to the circumstances of a particular case. It makes no reference to religion, but only to trusts generally. It does not look like the statutory provisions under which free exercise claims typically arise. It does not forbid, burden, or inhibit any particular conduct that one might claim to be religiously required.

Rather than look solely to the text of the statute itself, however, one must also focus on the remedy devised by the court as a relevant locus of state action. The question would then be whether the court's remedy complies with the requirements of *Smith*. It is not a simple matter to think about *Smith* in such terms. The analysis in that case is based on the assumption that a state actor applies a legal rule rather than, as in the UEP Trust litigation, makes an essentially ad hoc, discretionary judgment based on a variety of relatively abstract factors. Nevertheless, a court's remedy is state action, so it is necessary to apply the principles on which *Smith* is grounded.

In theory, one might seek empirical evidence about how the courts apply the relevant statutory provisions in comparable situations by collecting and reviewing all of the trust reformations carried out by the Utah courts. It is highly unlikely that helpful evidence exists, however, given the fact-specific nature of trust reformation issues.[89] In that sense, it is probably not possible to say whether the court's remedy in reforming the UEP Trust was neutral and consistent with general application.

One could, however, look for any evidence that the remedy had been used to target the Trust because of its religious nature. Thus, if those opposing the court's remedy could show that the remedy was based on religious reasons, a free exercise violation might be established.[90] That case might be made, for example, by proving that the court's remedy was merely a pretext for state action against the FLDS Church. The argument would be that, rather than make a politically and legally messy attack on the practice of polygamy, or an enforcement action against the practice of pressuring teenaged girls to marry, the authorities were coming through the back door by taking over substantial economic assets of the church through the UEP Trust litigation. Nothing in the record supports that case, however. Indeed, the court took pains to make clear that the reformation of the Trust was not to become the basis for disadvantaging those practicing polygamy and it said nothing about the "child bride" problem.[91]

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[89] In addition, Utah first enacted the relevant Uniform Trust Code provisions in 2004, leaving little time for its courts to develop a body of precedent. *See* UTAH CODE ANN. § 75-7-101 (2007).

[90] As the Supreme Court has put it, "[t]he Free Exercise Clause protects against government hostility which is masked, as well as overt." *Hialeah*, 508 U.S. at 534.

[91] *See infra* notes 117–119, and accompanying text. The AG deliberately kept the UEP Trust litigation separate from the evidence gathered for use in the criminal proceedings against Warren Jeffs. Interview with Timothy Bodily, Utah Assistant Attorney General, in Salt Lake City, Utah (March 13, 2007). Former church leader Sam Barlow (who since has apparently been excommunicated, *FLDS Leadership in Flux as Pressure on Group Increases*, THE ELDORADO SUCCESS (Eldorado, Texas), Sept. 9, 2004, at A1), suggested to

The *Smith* analysis itself recognizes two exceptions to its general rule.[92] First, heightened scrutiny might be required when the state interferes with the exercise of a "hybrid right"—i.e., when conduct is protected by both the Free Exercise Clause and another constitutional principle.[93] Second, if a state permits exemptions from neutral laws of general applicability based on individual circumstances, religious hardship cannot be excluded from the set of circumstances to be considered.[94] Does either exception apply here?

It is unclear how much bite the hybrid rights analysis really has. Some scholars think it may be little more than a technique for distinguishing cases such as *Sherbert v. Verner*[95] and *Wisconsin v. Yoder*[96] that employed the compelling state interest test discarded in *Smith*. It appears not to have been widely applied in the courts.[97] In any event, it is difficult to see how the hybrid-rights exception would apply in this case. Apart from the free exercise of religion, there is no apparent, constitutionally protected interest at stake for the Trust, the FLDS Church, or its leaders.

Smith's exception for taking account of individual circumstances is more promising. The classic case is *Sherbert v. Verner*[98] as reconstructed by *Smith*. In *Sherbert*, an unemployment compensation scheme included a rule denying benefits to those who left employment without good cause.[99] An employee was discharged for refusing to work on Saturday, her religious Sabbath Day.[100] The Supreme Court held that the Free Exercise Clause prohibited the state from refusing to provide her with unemployment benefits.[101]

FLDS adherents in 2002, however, that attempts by the States of Utah and Arizona to suppress polygamy included casting "a broad net over this entire people including the church and the United Effort Plan, which is a conspiracy net." *The FLDS Battle for Plural Marriage, Part Two*, SALE LAKE TRIB., Apr. 5, 2006, at A1, *available at* http://blogs.sltrib.com/plurallife/2006/04/flds-battle-for-plural-marriage-part.htm.

[92] In addition, *Smith* permits, but does not require, State legislatures to grant accommodations to those exercising their religion that are not available to others governed by such laws, but courts may not require such accommodations in the name of the First Amendment. Dep't. of Human Res. of Or. v. Smith, 494 U.S. 872, 890 (1990). That principle is not relevant here. There appears to be no legislatively mandated accommodation or exemption based on religious exercise to which the Trust might lay claim. The AG and the court are simply exercising statutory and common law power to remedy the breach of fiduciary duty by those charged with administering a charitable trust.

[93] *Smith*, 494 U.S. at 881–82.

[94] *Id.* at 882–84.

[95] 374 U.S. 398 (1963).

[96] 406 U.S. 205 (1972).

[97] *See* Frederick Mark Gedicks, *The Permissible Scope of Legal Limitations on the Freedom of Religion or Belief in the United States*, 19 EMORY INT'L. L. REV. 1187, 1219–20 (2005).

[98] 374 U.S. 398 (1963).

[99] *Id.* at 399–401.

[100] *Id.*

[101] *Id.* at 410.

As the *Smith* court construed its decision in that case, the unemployment compensation scheme should be understood as stating a general rule subject to individual exemptions. Since an exemption could be granted for non-religious reasons, then it must also be available for reasons of religious hardship, unless the state has a "compelling reason" to withhold it.[102]

Whether the reformation of the Trust falls within this exception involves two questions. The first is whether the exception applies at all on these facts. If so, the second question is whether its requirements are satisfied.

On the face of things, the exception itself is not an obvious fit. The relevant statute does not put "in place a system of individual exemptions"[103] from the relevant general rule, which was that the court was entitled to intervene upon a breach of trust by a trustee.[104] On the facts of the case, there can be little doubt that the general rule applied, and the court proceeded to apply it.

Upon a finding of breach, however, the statute granted the court discretion to apply a broad range of remedies.[105] The question is whether the grant of discretion as to remedy is equivalent to "a system of individual exemptions." The argument in favor is that the court unavoidably must take account of the individual circumstances of the trust, trustees, and beneficiaries when devising a remedy. If it could consider non-religious burdens or hardships—say, the costs or practicality of a remedy—then it must also take account of the religious burdens a remedy might impose. It should not make a difference, the argument goes, that the consideration of individual circumstances is made pursuant to a broad grant of judicial discretion rather than statutorily specified exemptions from a general rule. Therefore, the court's remedy violates the Free Exercise Clause if it imposes religious hardships without a "compelling reason."[106]

The argument is bolstered by the observation that we should be suspicious of broad grants of discretion to state actors, especially when used to regulate the exercise of constitutionally protected rights. Professor Gedicks analogizes the individualized assessment exception in *Smith* to the Supreme Court's doctrine relating to "standardless licensing" of expression under the Free Speech Clause. He suggests that the cases underlying that doctrine "resonate with *Smith*'s requirement that strict scrutiny be applied to government decisions that deny religious

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[102] Dep't. of Human Res. of Or. v. Smith, 494 U.S. 872, 884 (1990).

[103] *Id.*

[104] UTAH CODE ANN. §75-7-1001 (2007).

[105] *Id.*

[106] *Cf.* Murphy v. Zoning Comm'n, 289 F. Supp. 2d 87, 106–07 (D. Conn. 2004), *vacated on other grounds*, 402 F.3d 342 (2d Cir. 2005) (zoning commission's "cease and desist" order against regular prayer meetings in a house located in a residential neighborhood, issued under broad and vague zoning regulations, make the "case . . . specifically *about* individualized governmental assessments on exemptions from a general requirement.")

exemptions within the context of a system providing for individualized assessment of a law's burdens on secular conduct."[107]

The argument for broadly construing *Smith*'s exception for "individual exemptions" is substantial. In the final analysis, however, applying it to the statutory scheme governing the reformation of the Trust is not convincing. Courts and other state actors often—perhaps usually—have substantial discretion in carrying out their duties. If the existence of that discretion itself is sufficient to trigger the exception, then the compelling state interest test would become the de facto rule of *Smith*, which is precisely the opposite of what it intended to accomplish. As Professor Michael W. McConnell has pointed out, most of the Supreme Court's free exercise cases "involve individuated governmental assessments of the claimant's circumstances."[108] Indeed, he notes, if the *Smith* case itself had arisen as a criminal prosecution for peyote use, "there would be an individual governmental assessment of the defendants' motives and actions in the form of a criminal trial."[109]

Critics of *Smith* might argue that this reasoning proves that *Smith* itself is flawed, that the exception inevitably undermines the viability of that decision's basic analysis.[110] *Smith* remains good law, however, and its "individual exemptions" exception should be understood in a way that does not swallow up the basic rule of the case. A common-sense reading of the Utah statute under which the Trust was reformed is that the legislature did not grant exemptions from a general rule, but directed the courts to use good judgment in finding remedies responsive to the myriad circumstances they might encounter. That is not the kind of statutory scheme to which the individualized assessment exception can reasonably be applied.

Suppose, however, that the exception were relevant to the UEP Trust litigation. The second issue would then arise—whether its requirements were satisfied in this case. The specific questions are whether the reformation creates a "religious hardship," and whether any such hardship was justified by a "compelling reason." If so, then the reformation of the Trust would fall under the Free Exercise Clause.[111]

There is no doubt that the action of the court and special fiduciary intrude deeply into the practice of the FLDS religion. The UEP Trust is the organizing vehicle for a communitarian economic arrangement, directed by ecclesiastical leaders and managed for the express purpose of inculcating religious beliefs and values. By breaking the link between ecclesiastical authority and the management of the Trust, the state undoubtedly works a "religious hardship." For example, the

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[107] Frederick M. Gedicks, *The Permissible Scope of Legal Limitations on the Freedom of Religion or Belief in the United States*, 19 EMORY INT'L, L. REV. 1187, 1223 (2005).

[108] Michael W. McConnell, *Free Exercise Revisionism and the* Smith *Decision*, 57 U. CHI. L. REV. 1109, 1123 (1990).

[109] *Id.* at 1124.

[110] *See Hialeah*, 508 U.S. 520, 567–69 (1993) (Souter, J. concurring in part and concurring in the result).

[111] Dep't. of Human Res. of Or. v. Smith, 494 U.S. 872, 884 (1990).

court's reformation of the Trust will allow FLDS Church leaders to provide only non-binding input into the administration of the Trust,[112] and it explicitly removes from the Trust's purposes the goal included in the first substantive paragraph of the 1998 restated Trust: that it "exists to preserve and advance the religious doctrines and goals of the [FLDS Church]."[113]

If this imposition on religion—compared with typical secular hardships that a court might be willing to avoid—were sufficient to trigger the individual exemption analysis, the question would then become whether the state had a "compelling reason" to impose the religious hardship created by the proposed reformation of the Trust.

When it comes to compelling reasons for intruding on the administration of the Trust, the eight hundred pound gorilla in the room is polygamy, especially when it involves putting pressure on girls in their early- to mid-teens to enter into marriages. Polygamy, long illegal and repeatedly held by the courts to be outside the protection of the First Amendment, is arguably a powerful basis for wresting control of the Trust from the FLDS Church leadership and reforming its terms.[114] The protection of children against sexual exploitation surely carries equal if not greater weight. If the court had established that the existence of the Trust in its present form and under the current trustees significantly facilitated and promoted polygamy or the abuse of children, cutting off the economic support supplied by the Trust would be a sufficiently compelling reason to satisfy the *Smith* exception.

But there is no necessary or even intuitive link between polygamy and child abuse on the one hand, and the communitarian program embodied in the UEP Trust on the other. The latter could easily exist independent of the former. Perhaps for that reason, the court conspicuously failed to base its remedy on those grounds. Although it did rely on polygamy in a tangential fashion as a reason to reform the Trust, it expressly chose not to make its reformation a tool for suppressing polygamy or regulating marriage.[115] Indeed, the court took pains to say that, while its 2006 reformation of the Trust should not facilitate polygamy, neither should the fact that its beneficiaries engage in the practice be a factor in the administration of

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[112] Memorandum Opinion, *supra* note 35, ¶ 37.

[113] Memorandum Opinion, *supra* note 35, ¶ 33, (quoting 1998 Trust, *supra* note 9, at 1). The court notes that it must not only avoid promoting the illegal practice of polygamy; its reformation of the Trust must also refrain from supporting religious practices that do not offend law or public policy. To do so would "risk excessive entanglement with protected religious expression" in contravention of the First Amendment. Memorandum Opinion, *supra* note 35, n. 54. I argue below that the court cannot so easily avoid "excessive entanglement" by reforming the Trust as it has done.

[114] *See, e.g.*, State v. Holm, 2006 UT 31, 137 P.3d 726.

[115] The court noted that the 1998 Trust made the FLDS Church itself the remainder beneficiary should the Trust terminate for any reason. It concluded that a possibility that the Church, rather than its members, would receive the Trust's assets would "directly further illegal practices [such as polygamy] espoused by the FLDS Church and its current President." Memorandum Opinion, *supra* note 35, ¶ 52.

the Trust.[116] Accordingly, the court accepted terms in the 2006 Trust that essentially ignored polygamy as a relevant factor in the administration of its benefits.[117]

The court had another obvious, and less delicate, candidate to fill the compelling state interest role—the need to remedy and prevent the serious fraud and dissipation of assets that were alleged by the AG, and found by the court to have occurred. Most courts would probably find that interest sufficiently compelling to justify restricting otherwise protected religious exercise.

But the matter is not quite that simple. It is one thing to say that the trustees' breach of fiduciary duty justifies *some* remedy; however, where a range of possible remedies is available, a court might well be required to search for one that both accomplishes its legitimate objectives and avoids infringing upon constitutionally protected interests.[118] Part V below discusses the remedial options open to the court, concluding that its reformation of the Trust was not the least intrusive means of protecting the State's obvious interest in remedying the breach of fiduciary duties it faced. The court lacked the requisite "compelling reason" to reform the Trust as it did.

Judged solely with reference to the Free Exercise Clause, then, the court's reformation of the Trust might or might not be justified. But the free exercise analysis is only part of the puzzle. The court's actions must also be evaluated under the Establishment Clause.

B. The Establishment Clause

The Establishment Clause states: "Congress shall make no law respecting an establishment of religion."[119] The ban on establishment has long been held applicable to the States as well as to Congress.[120] The UEP Trust litigation does not, at first glance, fit the mold of typical Establishment Clause fact patterns. In those cases, the state assists religion or religiously controlled organizations. For example, States may issue school vouchers that end up putting money in the

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[116] Memorandum Opinion, *supra* note 35, ¶ 37 & n.62.

[117] *See* 2006 Trust, *supra* note 55, §§ 6.4, 6.5; Special Fiduciary's Response to the Court's Memorandum Opinion Regarding Reformation of the Trust, *In re* United Effort Plan Trust, No. 053900848, slip op. 6–9 (D. Utah Apr. 6, 2006). *See generally* United Effort Plan Trust, http://www.ueptrust.com (last visited Sept. 30, 2008).

[118] This requirement might be cast in terms of narrowly tailoring the remedy to accomplish the State's objective, as was part of the standard, pre-*Smith* analysis. *See* Dep't. of Human Res. of Or. v. Smith, 494 U.S. 872, 894 (1990) (O'Connor, J. concurring). The Court's opinion in *Smith* does not mention the "narrow tailoring" requirement in connection with the "compelling reason" needed to impose a religious hardship under a regime taking account of individual circumstances.

[119] U.S. CONST. amend I.

[120] Everson v. Bd. of Educ., 330 U.S. 1, 15 (1947) (holding that the Fourteenth Amendment prohibits State establishment of religion).

coffers of parochial schools,[121] or they may promote a religious symbol, as by displaying a crèche on public property.[122] Establishment issues may also arise when a state resists a claim for assistance on the ground that doing so would violate the Establishment Clause, as when the University of Virginia declined to provide economic support for the overtly religious student paper, *Wide Awake*, while providing such support for secular publications.[123]

The State of Utah is clearly not attempting to assist or promote the mission of the FLDS Church or its members, but rather to regulate the behavior of their leaders. The typical Establishment Clause cases therefore do not seem apposite.[124] In any event, the analyses in those cases are, to put it charitably, murky. The governing standards have changed substantially in the last decade or so, but there is no analogue to the Free Exercise Clause's *Smith* case that publicly announces a bold, new direction.

Faced with the common issue of attempts by local governments to provide assistance to private, sectarian schools, the Supreme Court struggled to strike a balance between separation of religion and state, and accommodation of religion. In *Lemon v. Kurtzman*, the Court announced its well-known, three-part test.[125] To survive an Establishment Clause challenge, a state law must have a secular legislative purpose, its principal or primary effect must not be one that either inhibits or advances religion, and it must not foster an "excessive entanglement" with religion.[126]

Lemon was decided when separation between religion and the state was the Supreme Court's primary Establishment Clause value. But since *Lemon* was decided in 1971, the importance of that value to the Supreme Court has faded. It has not been replaced with any single principle that consistently commands a Court majority. Perhaps because the *Lemon* test is so malleable, the case has never been overruled. Instead, its rule is either pressed into service from time to time in support of other approaches to the non-establishment principle, or—as an alternative analysis might require—largely ignored.

Several policies are candidates to replace separation as the primary policy under the Establishment Clause. Three appear to be particularly important: non-discrimination, non-endorsement, and non-coercion. The first has become more

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[121] Zelman v. Simmons-Harris, 536 U.S. 639 (2002).

[122] *See, e.g.*, Lynch v. Donnelly, 465 U.S. 668 (1984); County of Allegheny v. ACLU, 492 U.S. 573 (1989).

[123] Rosenberger v. Rector of the Univ. of Va., 515 U.S. 819 (1995).

[124] As the Supreme Court said in an analogous situation, "our Establishment Clause cases . . . . for the most part have addressed governmental efforts to benefit religion or particular religions, and so have dealt with a question different, at least in its formulation and emphasis, from the issue here. Petitioners allege an attempt to disfavor their religion because of the religious ceremonies it commands, and the Free Exercise Clause is dispositive in our analysis." Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520, 532 (1993).

[125] 403 U.S. 602 (1971).

[126] *Id.* at 612–13.

firmly entrenched in Established Clause jurisprudence than the latter two. Non-discrimination requires that the state treat a religious organization evenhandedly, in relation both to other religious bodies and to analogous, secular groups. Non-endorsement forbids the state from sending a message that a particular religious belief or group is officially endorsed. Non-coercion prohibits state action that presses citizens to adopt or conform to religious practice or belief. The factual setting of an Establishment Clause challenge influences the Court's choice of principle. Thus, for example, endorsement and coercion are likely to be invoked in the public school setting since young children are considered more impressionable than adults.

The principle that religious and analogous secular organizations be treated evenhandedly was on prominent display in *Rosenberger v. Rector and Visitors of University of Virginia*.[127] The University of Virginia provided subsidies to about 120 student organizations. Fifteen of them, classified as "student news, information, opinion, entertainment, or academic communications media groups," received assistance in the form of payments to third parties to cover printing costs.[128] A group of Christian students founded an organization whose mission included publication of *Wide Awake*, an overtly evangelical publication. The university refused to provide the printing subsidy on the ground that the paper was a "religious activity."[129] The students brought an unsuccessful action in federal district court, followed by an unsuccessful appeal to the Fourth Circuit. They came before the Supreme Court arguing that the University's action violated their First Amendment right to free speech. On its way to resolving that issue, the Court examined the requirements of the Establishment Clause.

The University of Virginia argued (among other things) that were it to fund *Wide Awake*, it would transgress the anti-establishment barrier.[130] The Court concluded, however, that since the University was in the business of providing support to a wide variety of other student-run activities, including financial subsidies for the cost of printing student publications, it could legitimately do so for this one as well. The Court characterized the university's rule as "viewpoint discrimination."[131] It emphasized that the subsidy was drawn from a specific fund meant to aid student groups and was paid to a third party rather than directly to the religious group.[132] Thus, the Court concluded that the Establishment Clause's "guarantee of neutrality is respected, not offended, when the government, following neutral criteria and evenhanded policies, extends benefits to recipients

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[127] *Rosenberger*, 515 U.S. 819 (1995).

[128] *Id.* at 825.

[129] *Id.*

[130] For reasons of its own, the University did not press this argument before the Supreme Court, although it had done so consistently in the lower courts. *Id.* at 837–38. All of the justices' opinions in the case addressed it, however.

[131] *Id.* at 829–31.

[132] *Id.* at 841. Justice Thomas, in a concurring opinion, argued that even direct cash subsidies paid to the student organization would pass Establishment Clause muster if part of a neutral, evenhanded program. *Id.* at 862 (Thomas J., concurring).

whose ideologies and viewpoints, including religious ones, are broad and diverse."[133]

Rosenberger examined the meaning of neutrality between religious and similarly situated secular organizations. A second non-discrimination dimension exists between various religious groups and activities. An otherwise unobjectionable benefit given to one group must be available to others similarly situated. In *Board of Education Kiryas of Joel Village School District v. Grumet*, the Court found that setting up a school district whose boundaries coincided precisely with a neighborhood populated entirely by a Jewish community practicing a strict form of Judaism violated the Establishment Clause. [134] The only analytical ground around which a majority coalesced was that the benefit of religiously drawn school district boundaries might not be provided equally to other religious groups.[135]

Non-endorsement, a test most closely associated with Justice O'Connor, was developed in her concurring opinion in *Lynch v. Donnelly*.[136] The non-endorsement test commanded a court in *County of Allegheny v. ACLU*, in which the Court struck down the display of a crèche at a county building during the Christmas season, and upheld the display of a menorah in a nearby city building.[137] Examining the context in which the displays were found, the Court considered whether the display in question conveyed a message "that religion or a particular religious belief is favored or preferred."[138] Non-endorsement, however, has not consistently succeeded in attracting a majority of the Court as a governing Establishment Clause principle.

Competing with non-endorsement is the non-coercion principle. It asks whether state support for religion goes beyond a message of endorsement to the point of applying pressure to accept religious belief or conform to religious practice. A non-coercion test competed for support in the fractured Court that decided the *Allegheny County* case, but managed to attract only four votes.[139] It did command a majority in *Lee v. Weisman*,[140] however, which held that the Establishment Clause forbids the inclusion of prayers by clergy at an official public school graduation ceremony.[141] Non-coercion provides an attractive rationale for disputes involving the inclusion of religious influences on impressionable, captive audiences such as children attending public school. But

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[133] *Id.* at 839.

[134] 512 U.S. 687 (1994).

[135] *Id.* at 702–703.

[136] 465 U.S. 668, 687–94 (1984).

[137] 492 U.S. 573 (1989).

[138] *Id.* at 593 (quoting Wallace v. Jaffree, 472 U.S. 38, 70 (O'Connor, J., concurring)).

[139] *Id.* at 655 (Kennedy, J., concurring and dissenting). Justice Kennedy's separate opinion is joined by Chief Justice Rehnquist and Justices White and Scalia and is based on the non-coercion principle.

[140] 505 U.S. 577 (1992).

[141] *Id.* at 599.

like the endorsement approach, it has not become an established, predictable analysis under the Establishment Clause.

This brief summary of some of the Supreme Court's more important Establishment Clause decisions provides some context for the UEP Trust litigation. In an important sense, however, much of it is not highly relevant to the Utah District Court's reformation of the Trust. Almost all Establishment Clause cases involve attempts by the state to benefit religion in some manner. As the separation principle has receded, the Supreme Court has become more permissive of such attempts. As applied in the Court's decisions, non-discrimination, non-endorsement, and non-coercion all focus on the constraints that apply when a benefit is given. But nothing of the sort occurred in the UEP Trust litigation. Far from bestowing an advantage on the FLDS Church, the court took control of its Trust and thus seriously interfered with the Church's ability to conduct its own affairs, albeit for the purpose of protecting the Trust from the misfeasance of its trustees.

A twofold response comes immediately to mind: (1) an imposition of that nature should be considered under the auspices of the Free Exercise Clause;[142] and (2) this is therefore not an Establishment Clause case. The first statement is obviously correct. The second, on examination, may not be.

As discussed above, the actions of the Utah court and its special fiduciary do warrant close examination under the Free Exercise Clause. Under the *Smith* analysis those actions survive that examination if they are genuinely neutral and are generally applied—that is, if they do not target religion generally, or this religion in particular, for disadvantageous treatment—and if they are not subject to, or satisfy the requirements of, the *Smith* individualized assessment exception. But even if those hurdles are crossed, is it not possible that the court's reformation of the Trust nevertheless violated Establishment Clause norms? The 2006 Trust intrudes deeply into the operation of the Trust, and thus into the religious life of the Church. An examination of the church autonomy cases shows that the Establishment Clause also has something to say about such an intrusion.

C. Considering the Two Religion Clauses Together: The Church Autonomy Cases and the First Amendment

It is not unusual for state action to require consideration of two First Amendment clauses simultaneously.[143] In *Rosenberger v. University of Virginia*, for example, the state claimed that refusing to subsidize *Wide Awake* did not

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[142] The Court has noted in dictum that state action burdening religious exercise might, in principle, also transgress the Establishment Clause. Rosenberger v. Rector of the Univ. of Va, 515 U.S. 819, 846 (1995) ("[F]ostering a pervasive bias or hostility to religion . . . could undermine the very neutrality the Establishment Clause requires.").

[143] When religiously motivated conduct is exempted from state regulation under the Free Exercise Clause, an Establishment Clause issue is often raised. *See, e.g.*, Wisconsin v. Yoder, 406 U.S. 205, 221–22 (1972). Such exemptions are much less likely since the *Smith* case was decided.

violate the Free Speech Clause because doing so would transgress the Establishment Clause.[144] In *Locke v. Davey*, the plaintiff claimed that since including his theology degree within the state's Promise Scholarship program would not violate the Establishment Clause, that support was required by the Free Exercise Clause.[145] The Supreme Court rejected those arguments, finding some space between the demands of the two constitutional provisions on the facts of those cases.[146]

Sometimes, however, an issue invites consideration under both religion clauses taken together because the values of both clauses are simultaneously implicated. Scholars commonly consider the two religion clauses together, proposing a unified or integrated way of understanding them.[147] The courts have done so considerably less often. But in a series of decisions sometimes referred to as the "church autonomy cases," the Supreme Court came close to applying an integrated analysis of the religion clauses. Those cases, one from the nineteenth century and the others from the twentieth,[148] deal with the constitutionally appropriate role of the courts in resolving internal schisms within churches. They present legal questions about the ownership and control of property, but arise from disputes over religious doctrine and practice. The church autonomy cases are factually and doctrinally distinctive, so a reasonably detailed description of them is in order. This article now moves on to review a few of these cases, discuss their immediate relevance to the UEP Trust litigation, and consider how the analyses they set out should be understood in light of the Court's current religion clause jurisprudence.

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[144] *See supra* text accompanying notes 125–131.

[145] 540 U.S. 712, 719–720.

[146] *Id.* at 720. *But see Rosenberger*, 515 U.S. at 849 (O'Connor, J., dissenting) (stating that an "unavoidable conflict" between "two principles of equal historical and jurisprudential pedigree" existed in that case).

[147] *See, e.g.*, Ira C. Lupu & Robert Tuttle, *The Distinctive Place of Religious Entities in our Constitutional Order*, 47 VILL. L. REV. 37 (2002); Carl H. Esbeck, *The Establishment Clause as a Structural Restraint on Governmental Power*, 84 IOWA L. REV. 1 (1998); Douglas Laycock, *Toward a General Theory of the Religion Clauses: The Case of Church Labor Relations and the Right to Church Autonomy*, 81 COLUM. L. REV. 1373 (1981).

[148] The church autonomy cases invoking the First Amendment are Jones v. Wolf, 443 U.S. 595 (1979); Serbian Eastern Orthodox Diocese v. Milivojevich, 426 U.S. 696 (1976); Presbyterian Church v. Mary Elizabeth Blue Hull Mem'l. Presbyterian Church, 393 U.S. 440 (1969); and Kedroff v. St. Nicholas Cathedral of Russian Orthodox Church, 344 U.S. 94 (1952). Although *Kedroff* was the first case to invoke the First Amendment, it in essence constitutionalized the analysis in earlier, influential cases that predated the rule of Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938): Gonzales v. Roman Catholic Archbishop, 280 U.S. 1 (1929); Watson v. Jones, 80 U.S. (13 Wall.) 679 (1871). A case dismissed for want of a substantial federal question, but containing an influential concurring opinion by Justice Brennan, is Maryland and Virginia Eldership of the Churches of God v. Church of God at Sharpsburg, 396 U.S. 367 (1970).

Jones v. Wolf,[149] the most recent and doctrinally developed of these cases, is now about three decades old. It has been neither overruled nor further developed by the Supreme Court.[150] Three distinct analyses underlie the justices' opinions in *Jones* and its predecessors.[151] Significantly, they usually frame them in terms of the "First Amendment," thus employing an integrated treatment of the religion clauses.[152] All recognize, at least implicitly, that the courts often cannot resolve these issues without implicating both free exercise and non-establishment values. As discussed below, the facts in the UEP Trust litigation are different than those in the church autonomy cases in important respects. Those cases, however, re-evaluated in light of the Supreme Court's modern religion clause jurisprudence, illuminate the First Amendment issues raised by the Trust litigation, and in particular shed light on the relevance of the Establishment Clause.

The three analytical threads running through the church autonomy cases render them complex. But the analyses can be reasonably illustrated by briefly examining *Jones* and two cases that preceded it.

1. The Brennan Position: Non-Involvement with Doctrine

In *Maryland and Virginia Eldership of the Churches of God v. Church of God at Sharpsburg*,[153] a regional church brought an action against local congregations to prevent them from withdrawing from the regional church and to establish control over church properties. The Maryland Court of Appeals affirmed the trial court's dismissal of the complaint. In a brief, per curiam opinion, the United States Supreme Court dismissed the regional church's appeal for want of a substantial federal question "[s]ince . . . the Maryland court's resolution of the dispute involved no inquiry into religious doctrine."[154] In a concurring opinion joined by Justices Douglas and Marshall, Justice Brennan emphasized that the "First

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[149] 443 U.S. 595 (1979).

[150] *Smith* cites *Jones* in way clearly suggesting that it remains viable. Dep't. of Human Res. of Or. v. Smith, 494 U.S. 872, 887 (1990). Major, recent schisms within the Episcopal Church over the ordination of openly homosexual clergy have prompted litigation to which *Jones* is relevant. Such litigation may be of sufficient importance to reach the Supreme Court in the relatively near future. *See* Jeffrey B. Hassler, Comment, *A Multitude of Sins? Constitutional Standards for Legal Resolution of Church Property Disputes in a Time of Escalating Intradenominational Strife*, 35 PEPP. L. REV. 399, 400–02 (2008).

[151] For a concise description of the three approaches, see Dallin H. Oaks, *Trust Doctrines in Church Controversies*, BYU L. REV. 805, 887–97(1981).

[152] A helpful phrase describing this approach is "clause transcendence." A "clause transcendent" analysis "recognize[s] those aspects of church-state concern that are sufficiently general and pervasive to attach to both clauses (or, to put it differently, to attach to neither, but to constitute instead an integral part of a general and persuasive account of the appropriate boundaries on church-government relations)." Lupu & Tuttle, *supra* note 147, at 50.

[153] 396 U.S. 367 (1970).

[154] *Id.* at 368.

Amendment"[155] mandates that courts not attempt to resolve or take into consideration doctrinal issues. Subject to that constraint, a court might apply "neutral principles"[156] of various sorts, such as deferring to the decisions made by the governing authorities in the church itself, applying a formal title doctrine, or acting under appropriate state statutes. But "interference in doctrine"[157] is always forbidden.

The concurring opinion does not ground its analysis explicitly in either religion clause, but evidently invokes the policies of both. It argues that the avoidance of doctrinal questions is the best way to walk the line between "inhibiting the free development of religious doctrine" and "implicating secular interests in matters of purely ecclesiastical concern."[158]

In *Serbian Eastern Orthodox Diocese v. Milivojevich*,[159] the Court was faced with a protracted struggle between the leadership of the Serbian Orthodox Church and the bishop of its American-Canadian diocese. After a lengthy period of dissension between the two, the mother church suspended and ultimately removed the bishop and divided the diocese into three separate dioceses. The bishop brought a civil action in the Illinois Circuit Court. The case eventually reached the Illinois Supreme Court, which ruled for the bishop. Examining the internal church regulations and procedures under which the bishop had been suspended and the diocese divided, that court concluded that the church had failed to apply them properly. It effectively reinstated the bishop and declared the division of the diocese to be without legal effect.[160]

The United States Supreme Court reversed. In his opinion for the Court, Justice Brennan again emphasized that the First Amendment precludes a court from inquiring into matters of religious law or polity. Relying on his concurring opinion in *Maryland and Virginia Eldership*, he wrote: "[T]he First and Fourteenth Amendments mandate that civil courts shall not disturb the decisions of the highest ecclesiastical tribunal within a church of hierarchical polity, but must accept such decisions as binding on them, in the application to the religious issues of doctrine or polity before them."[161] Justice Brennan's opinion also repeats the oblique reference from his *Maryland and Virginia Eldership* concurrence to the coexistence of free exercise and establishment concerns that the Court's analysis must take into account.[162]

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[155] *Id.*

[156] *Id.* at 370.

[157] *Id.*

[158] *Id.* at 368 (quoting Presbyterian Church v. Mary Elizabeth Blue Hull Mem'l. Presbyterian Church, 393 U.S. 440, 449 (1969)).

[159] 426 U.S. 696 (1976).

[160] Serbian Eastern Orthodox Diocese v. Milivojevich. 328 N.E.2d 268, 284 (Ill. 1975).

[161] *Serbian Eastern Orthodox*, 426 U.S. at 709.

[162] *See supra* notes 150–159 and accompanying text.

2. The Rehnquist Position: Evenhanded Treatment of Religious and Non-Religious Organizations

The *Serbian Eastern Orthodox* case prompted a dissent setting out a different understanding of First Amendment constraints. Justice Rehnquist, joined by Justice Stevens, concluded that the necessary neutrality was to be achieved by treating religious organizations evenhandedly with non-religious ones. The teaching of prior cases, he argued, was "that the government may not displace the free religious choices of its citizens by placing its weight behind a particular religious belief, tenet, or sect."[163] According to the dissent,

> [t]he protracted proceedings in the Illinois courts were devoted to the ascertainment of who [was entitled to exercise diocesan authority], a question which the Illinois courts sought to answer by application of the canon law of the church, just as they would have attempted to decide a similar dispute among members of any other voluntary association."[164]

The dissent was not alarmed by the risk that that course of action would intrude on free exercise interests. The greater risk was that "mak[ing] available the coercive powers of civil courts to rubber-stamp ecclesiastical decisions of hierarchical religious associations when such deference is not accorded similar acts of secular voluntary associations would, in avoiding the free exercise problems petitioners envision, itself create far more serious problems under the Establishment Clause."[165]

The Rehnquist and Brennan positions aligned in the Court's opinion in *Jones v. Wolf*, which presented facts permitting an analysis compatible with both. *Jones* involved a schism within a local congregation of the Presbyterian Church in the United States (PCUS) over certain doctrinal matters. [166] A majority of the congregation voted to leave the PCUS and affiliate with another denomination, the Presbyterian Church in America. A minority faction objected, preferring to remain part of the PCUS. After attempting unsuccessfully to resolve the schism, the Augusta-Macon Presbytery of the PCUS declared the minority faction "the true congregation" and withdrew authority of the majority faction to act.[167] Representatives of the minority faction brought a class action suit in a Georgia trial court seeking declaratory and injunctive relief giving them control of the local church property. Purporting to apply "neutral principles of law," the trial court denied the requested relief, giving a judgment to the majority faction.[168] That ruling was affirmed by the Supreme Court of Georgia.[169]

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[163] *Serbian Eastern Orthodox*, 426 U.S. at 733.
[164] *Id.* at 726.
[165] *Id.* at 734.
[166] 443 U.S. 595 (1979).
[167] *Id.* at 598.
[168] *Id.* at 599.
[169] *Id.*

The "neutral principles" accepted by the State Supreme Court consisted of examining relevant church documents, such as deeds to properties, and also state statutes dealing with implied trusts. Finding that the property was legally owned by the local congregation, and that nothing in the documents or relevant statutes gave rise to a trust, the court awarded the property, on the basis of legal title, to the trustees of the local church.[170] The court went on to decide that the local congregation was represented by a majority of its members.[171]

In an opinion by Justice Blackmun, the Supreme Court remanded, requiring the State courts to state the basis of its rule that a majority of the local congregation was entitled to speak for that organization.[172] But in general, it approved of the approach taken by the Georgia Supreme Court. It concluded that the state court could resolve the legal questions about property ownership and control, while avoiding involvement in doctrinal issues, by reading, from a secular perspective, the relevant documents, including the constitution of the general church, the Book of Church Order, and property deeds.[173] A legal presumption that a majority of a local congregation speaks for that body (if the remand showed such a presumption to have been applied) would also be a satisfactory neutral principle.[174]

The Court's opinion acknowledged the possibility that the relevant church documents could not be properly interpreted without reference to doctrine. It therefore said that if "the deed, the corporate charter, or the constitution of the general church incorporates religious concepts . . . relating to the ownership of property, . . . [then] interpretation of the instruments of ownership would require the civil court to resolve a religious controversy [and] the court must defer to the resolution of the doctrinal issue by the authoritative ecclesiastical body."[175]

This analysis managed to meet the demands of both the Rehnquist and Brennan positions. The former was satisfied because the Court had permitted the state courts to examine and apply church documents, the core position taken by Justice Rehnquist in his *Serbian Eastern Orthodox* dissent. The latter was satisfied because, by insisting that inquiries into internal church documents be made on a secular basis, the analysis kept the courts out of the business of adjudicating doctrinal controversies.

3. The Powell Position: Deference to Relevant Authorities Within the Religious Organization

The effect of that analysis, however, revealed a third position, one that had remained in the background of the *Serbian Eastern Orthodox* majority, but was now flushed out by the Court's willingness in *Jones* to allow courts to probe into,

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[170] *Id.* at 600.
[171] *Id.* at 607.
[172] *Id.* at 607–10.
[173] *Id.* at 600–01.
[174] *Id.* at 607.
[175] *Id.* at 604.

interpret, and apply church documents from a secular perspective. Writing for himself, Chief Justice Burger, Justice Stewart, and Justice White, Justice Powell dissented based on the principle that, when a dispute arises within a religious organization, the First Amendment requires courts to defer to the resolution of the dispute made by the organization itself.[176] According to the dissent, therefore, a strengthened version of the majority's fallback position—deferring to the religious organization's internal dispute resolution procedure—was the constitutionally required approach. The dissent took the position that any secular interpretation of such documents was to be avoided, and deference to the organization's own decision-making authority is to be respected as a first priority. Thus, the courts should do no more than determine "where within the religious association the rules of the polity, accepted by its members before the schism, had placed ultimate authority over the use of church property,"[177] "whether the dispute has been resolved within that structure of government and, if so, what decision has been made."[178] Once those inquiries have been completed, deference to the decision is required.

The Powell analysis, like that of Justice Brennan, is generally framed in terms of the requirements of the "First Amendment" rather than the individual religion clauses.[179] It seems primarily focused on the risk to free exercise values of a court's refusal to honor the internal decision-making procedure of a religious organization,[180] although some establishment related concerns appear to be in play as well.[181]

IV. THE RELEVANCE OF THE CHURCH AUTONOMY CASES

The church autonomy cases are not on all fours with the UEP Trust litigation. But they do share with it some important, structural similarities, and therefore warrant a close evaluation. This Part considers how the church autonomy cases might apply to the Trust litigation as a matter of case law, and how the teachings of those cases are shaped by the Supreme Court's modern religion clause jurisprudence.

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[176] *Id.* at 616–20.

[177] *Id.* at 618–19.

[178] *Id.* at 619 n.6.

[179] *E.g.*, *id.* at 610, 613, 616 n.3.

[180] *E.g.*, *id.* at 616 (stating that because church property disputes "arise almost invariably out of disagreements regarding doctrine and practice . . . . civil courts should decide them according to principles that do not interfere with the free exercise of religion").

[181] *Id.* at 611 (implying that the majority's analysis "will increase the involvement of civil courts in church controversies").

A. Application of the Church Autonomy Cases to the UEP Trust Litigation

The reformation of the UEP Trust does not fit easily into the mold of the church autonomy cases for at least two reasons. First, in those cases the dispute was between members or factions within the religious organization. In the UEP Trust case the dispute is between the AG (and the outside plaintiffs) and the FLDS Church/Trust leadership. But one might argue that the difference is not quite as stark as first appears. The AG is involved to represent the interests of the beneficiaries, who by definition are (or were) Church members. In objective economic terms, putting the Trust's assets at risk harms the beneficiaries, who are members of the Church. In one respect, then, the autonomy cases and the UEP Trust litigation are structurally similar: the interests of members/beneficiaries clash with those of leaders.

That conflict exists, however, only from the perspective of outsiders. The FLDS faithful do not see it that way. The rank and file seem to be solidly behind their leaders, who served as trustees until suspended by the court. They did not seek the involvement of the AG, and they do not consider the court or the special fiduciary an ally. Although there have been a number of expulsions and public defections from the Church,[182] there is not a substantial faction of the current community vying for control of the Trust or other Church assets. This is not a straightforward, intra-church dispute in which a court must simply decide who owns the property.

The second difference is in the nature of the dispute that brings the matter before a court in the first place. Although a dispute over property ownership or control is invariably involved in the autonomy cases, they arise from disputes over religious doctrine and practice. The issues that brought the AG into the UEP Trust litigation, by contrast, consist of breaches of fiduciary duty not necessarily linked to religious doctrine:[183] dissipating the assets of the Trust, and failing to protect those assets by refusing to defend litigation brought against it.[184] Adjudicating the

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[182] *See generally* Carolyn Jessup, ESCAPE (2007) (describing instances of expulsion and public defection from the Church).

[183] It may well be that the failure of the trustees to defend the actions brought against the Trust, in which they themselves had been named as defendants, were factually related to other legal difficulties between them and the state. In particular, Warren Jeffs was under criminal investigation for his role in certain polygamy-related conduct and has since been tried and convicted of rape by accomplice. But there is no reason in principle that the kinds of breach of fiduciary duty involved in this case should have any particular connection with religious doctrine.

[184] Had the trustees chosen to defend the UEP Trust litigation, they might have raised additional issues. The prior, undefended tort claims against the Trust were the basis for the AG's petition. Some of the tort claims arose when the trustees, acting in their ecclesiastical capacity, expelled the plaintiffs from certain Trust properties. The resolution of those tort cases, which the trustees also refused to defend, might well have involved difficult religious questions. The tort plaintiffs were permitted to enter the UEP litigation as parties, so those issues conceivably might have become involved in the case. The AG, however,

case, therefore, required the AG to prove only garden-variety breaches of fiduciary duty.

Although the issues that triggered the Court's jurisdiction were of a kind that would not necessarily implicate religious values, the remedies available to the Court did not let it off the hook so easily. The Court could not, as in *Jones*, simply declare who gets the property and be done with it. The nature of the case demanded that the Court do something with the Trust. The Court no doubt concluded that it could not return control of the Trust to the existing trustees or to other Church members controlled by them, given their obvious failures to perform their fiduciary duties. Unless it terminated the Trust outright (a remedy not without its own difficulties, as discussed below), it was squarely confronted with problems analogous to those in *Jones*: providing a remedy while attempting to avoid involvement with religious doctrine and practice.

As it turned out, the Court was willing to go quite a distance in the direction of involvement. It removed the trustees from office, replacing them with a special fiduciary, who will control and administer the Trust for an indefinite period of time. The special fiduciary is aided by a board of advisors but still supervised by the court.[185] The court retained continuing oversight of the Trust while the special fiduciary is in place, and may do so even after new trustees are appointed.[186] Finally, it reformed the Trust, dramatically changing its character and the principles governing its administration. The reformation, among other things, made any ecclesiastical input into the Trust's administration non-binding, and required that references to "needs" and "just wants" be interpreted from a secular perspective.

The court's remedy thrusts the Court and its special fiduciary into a relationship with religious doctrine and principles, a matter of concern under all of the analyses found in those cases. Specifically, Church members find themselves deeply involved with the Court or its special fiduciary for an indefinite, and possibly extensive, period of time during which they can neither dispose of the property held for their benefit (including using that property to form a new trust operated under UEP-type principles) nor live under circumstances in which their ecclesiastical leaders administer the Trust expressly in accordance with religious principles. [187] Those remedial steps have important implications under the First

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carefully avoided relying on religious questions in bringing the case, the tort plaintiffs did not press their claims, and the court acquiesced in that framing of the issues.

[185] 2006 Trust, *supra* note 55, § 4.1.2 (stating that a new board of trustees is to be appointed "at such time as the Court determines is appropriate," and that the Court "may transfer duties and authority to the Board of Trustees in stages" based on its determination that the trustees "can effectively administer such assigned duties"; until that time, the Court retains "oversight over the Trust and shall determine how and by whom the assets of the Trust shall be administered").

[186] 2006 Trust, *supra* note 55, §4.6.1(a) (stating that the trustees are required to make "such reports as are requested by the court").

[187] 2006 Trust, *supra* note 55, § 4.16. Under the 2006 Trust, the trustees apparently have the power to transfer property outright to the beneficiaries. But there is no obligation

Amendment as it has been interpreted in the church autonomy cases. It is therefore important to ask how those cases apply to the Court's actions.

On a first analytical pass, the majority and dissent in the *Jones* case point in the same direction when applied to the court's remedy in the UEP Trust litigation. The *Jones* majority would require the court to attempt to apply the 1998 Trust by reading it as a secular document, avoiding any interpretation of religious doctrine or procedure, if possible. But the 1998 Trust manifestly cannot be so read. By its terms, it is specifically intended "to preserve and advance the religious doctrines and goals" of the FLDS Church.[188] In addition, it is "to provide for Church members according to their wants and their needs, insofar as their wants are just."[189] The former statement obviously cannot be interpreted and applied except in terms of religious doctrine. As noted above, even the latter, taken in context, requires a religious interpretation, especially in relation to the meaning of "just" wants.[190]

The *Jones* majority, therefore, would resort to its fall-back position, requiring the court to "defer to the resolution of the doctrinal issue by the authoritative ecclesiastical body."[191] The four dissenters, of course, would even more emphatically require the same result. The problem, of course, is that on the facts of this case, the court could not do that, either. The "authoritative ecclesiastical body" consists of, or is controlled by, precisely those individuals who have been found to have breached their fiduciary duties and are therefore properly disqualified from administering the Trust.

The Utah court attempted to navigate these waters by eliminating or vitiating the parts of the trust explicitly requiring application of religious doctrine as a basis for decisions about the administration of Trust benefits, retaining only the general references to "needs" and "just wants," which it said should be understood in a secular context. Eliminating "religious doctrine and goals" as bases for Trust administration, and reading "needs" and "just wants" in a purely secular fashion, keeps the court out of the business of interpreting and applying religious precepts. At the same time, however, it has a dramatically inhibiting effect on the church members' exercise of religion. As the Supreme Court said in *Serbian Eastern Orthodox*:

> [I]t is the essence of religious faith that ecclesiastical decisions are reached and are to be accepted as matters of faith whether or not rational or measurable by objective criteria. Constitutional concepts of due process, involving secular notions of "fundamental fairness" or

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on the Trustees to do so, and the general tone of the relevant Trust language suggests an intention to retain ownership in the Trust, with beneficiaries having "occupancy and use" of Trust property. 2006 Trust, *supra* note 55, § 4.3.3.

[188] 1998 Trust, *supra* note 9, at 1.

[189] 1998 Trust, *supra* note 9, at 3.

[190] *See supra* text accompanying notes 8–10.

[191] Jones v. Wolf, 443 U.S. 595, 604 (1979).

> impermissible objectives, are therefore hardly relevant to such matters of ecclesiastical cognizance.[192]

The court created a very different instrument by replacing religious concepts with "secular notions," and by removing all effective ecclesiastical control over Trust assets in favor of judicially approved choices or the decisions of court-appointed trustees. The result works an imposition on religious exercise that might have made even Justice Rehnquist blush.

The court in the UEP Trust litigation faced an unappealing array of remedial choices. Before considering them further, it is helpful to reexamine the doctrine of the church autonomy cases themselves under the Supreme Court's current religion clause jurisprudence. That reexamination suggests that the Establishment Clause has a more important role to play than in the pre-*Smith* era.

B. The Church Autonomy Cases Under Current Religion Clause Jurisprudence: The Emergence of the Establishment Clause

A characteristic common to the church autonomy cases is that some degree of state involvement with the organization is inevitable. Even if a court takes pains to avoid taking sides in the underlying religious controversy—and how to do so is essentially the point of the competing analyses in the church autonomy cases—it will end up creating winners and losers on religious questions. Depending upon whose ox is gored, the court's resolution of the case will either repress or promote one religious practice, point of view, or group at the expense of another.

Precisely because the effect of resolving the case will be both to advance and inhibit religious positions, the policies of both the Free Exercise and the Establishment Clauses are implicated simultaneously. It is probably for that reason that the proponents of the three different positions in the church autonomy cases framed their analyses in general "First Amendment" terms rather than focusing on one religion clause or the other.

In contrast to the church autonomy cases, the typical religion clause case involves a contest between the state and an individual or organization. In the classic, free exercise case, a person claims that the state has imposed upon her religious exercise; in the establishment setting, someone contends that the state has benefited religion inappropriately. Although these cases may well involve simultaneous consideration of more than one clause of the First Amendment, the analytical focus is typically on one religion clause or the other. Resolution of the matter does not create winners and losers within the religious body itself.

For that reason, the church autonomy cases do not lend themselves to easy classification under the Court's current Free Exercise and Establishment clause jurisprudence. Nevertheless, a few general observations are possible.

The church autonomy cases pre-date *Smith*. They assume a religion clause jurisprudence in which the requirements of neutrality and general application are

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[192] Serbian Eastern Orthodox Diocese v. Milivojevich, 426 U.S. 696, 714–15 (1976).

not the sole constraints placed by the Free Exercise Clause on state action that burdens religious exercise.[193] *Smith* changed the nature of the First Amendment terrain through which the courts must travel.[194]

In particular, *Smith* undermines the Powell position that courts must defer to the internal decisions of a religious organization. Simultaneously, it greatly strengthens the Rehnquist position that treating such an organization the same as any other voluntary association is constitutionally acceptable. The pressures on state action originating from the free exercise side of the First Amendment have thus been reduced.

There remains the core of the Brennan position that the courts should not be involved in the interpretation of religious doctrine, for fear "of inhibiting the free development of religious doctrine and of implicating secular interests in matters of purely ecclesiastical concern."[195] Under *Smith*, concerns about "inhibiting doctrine" carry little weight if the state action involved is neutral and generally applied. The courts in the church autonomy cases, after all, are not forbidding or coercing any particular religious belief or point of view, but attempting to resolve an unavoidable legal question.

The non-establishment concerns reflected in the Brennan position, however, are not addressed by *Smith*. Are the values of the Establishment Clause relevant to the issue of "implicating secular interests in matters of purely ecclesiastical concerns," or, for that matter, "inhibiting the free development of religious doctrine"?

V. PROTECTING RELIGIOUS FREEDOM THROUGH THE ESTABLISHMENT CLAUSE

These are not the questions raised by the facts of modern Establishment Clause cases, which are occupied with finding the constitutional limits of the state's authority to benefit or promote a religious organization. The notions of non-discrimination, non-endorsement, and non-coercion, as developed in those cases, have little to say about how to resolve a case growing out of a religious dispute.

Nevertheless, the Establishment Clause remains salient. It is a sufficient basis to support the legal doctrine of the church autonomy cases, and it applies more broadly to cases such as the UEP Trust litigation to constrain state action that, although it passes muster under *Smith*, negatively affects religious liberty.

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[193] I continue to assume that *Smith* applies to free exercise claims by organizations as well as individuals. *See supra* note 81.

[194] The *Smith* Court, however, cites these cases in a way that suggests it sees no inconsistency between them and the analysis it there lays out. Dep't of Human Res. of Or. v. Smith, 494 U.S. 872, 877, 887 (1990).

[195] *Serbian Eastern Orthodox Diocese*, 426 U.S. at 710 (quoting Presbyterian Church in U.S. v. Mary Elizabeth Blue Hull Mem'l. Presbyterian Church, 393 U.S. 440, 449 (1969)).

A. Protecting Religion as an Establishment Clause Value

A strand of Establishment Clause policy with venerable origins is that, whatever harm establishing a religion may do to the state, it may also have the effect of corrupting religion itself. Even before there was a First Amendment, Madison made that point in his famous Memorial and Remonstrance against Religious Establishments:

> [E]very page of [the Christian Religion] disavows a dependence on the powers of this world . . . . [Establishment] weaken[s] in those who profess this Religion a pious confidence in its innate excellence, and the patronage of its Author; and . . . foster[s] in those who still reject it, a suspicion that its friends are too conscious of its fallacies, to trust it to its own merits. . . . [E]cclesiastical establishments, instead of maintaining the purity and efficacy of Religion, have had a contrary operation. [Historically, the fruits of establishment have been,] [m]ore or less in all places, pride and indolence in the Clergy, ignorance and servility in the laity; in both, superstition, bigotry and persecution.[196]

The Supreme Court has spoken approvingly of the idea that protecting religion from the state is one purpose of the Establishment Clause. For example, as Justice Black wrote for the Court in *Engel v. Vitale*:

> [T]he purposes underlying the Establishment Clause go much further than [preventing the coercion of religious belief by the state.] Its first and most immediate purpose rested on the belief that a union of government and religion tends to destroy government and to degrade religion. The history of governmentally established religion, both in England and in this country, showed that . . . many people had lost their respect for any religion that had relied upon the support of government to spread its faith. The Establishment Clause thus stands as an expression of principle on the part of the Founders of our Constitution that religion is too personal, too sacred, too holy, to permit its 'unhallowed perversion' by a civil magistrate.[197]

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[196] James Madison, *Memorial and Remonstrance Against Religious Establishments*, *in* BASIC DOCUMENTS RELATING TO THE RELIGIOUS CLAUSES OF THE FIRST AMENDMENT 7, 8 (1965). This sentiment echoes earlier sentiments from reformers such as Roger Williams, who was almost obsessively concerned about protecting the purity of the church from the pollution of the state. PHILIP HAMBURGER, SEPARATION OF CHURCH AND STATE 38–45 (2002).

[197] Engel v. Vitale, 370 U.S. 421, 431–32 (1962); *accord*, School Dist. of Abington Twp. v. Schempp, 374 U.S. 203, 222 (1963) ("[T]o withstand the strictures of the Establishment Clause there must be a secular legislative purpose and a primary effect that neither advances nor inhibits religion."); *id.* at 259 (Brennan, J., concurring) ("It is not only

Engel and similar cases involved officially sponsored prayer or devotional exercises in public schools. The anti-establishment principle doing the real work in these cases was the need to prevent the state from imposing religious practice on students. Like other Establishment Clause cases, they were therefore focused on constraining government attempts to benefit or strengthen religion. Concerns about the corrupting influence of the state on religion, while mentioned in the opinions, were not what these cases were fundamentally about. Indeed, the actual holdings of the Supreme Court's cases show that it has not been in the business of applying the Establishment Clause to protect religion from incursions by the state, relying instead upon the Free Exercise Clause for that purpose. [198] We thus live in a world in which there is firm historical and theoretical grounding for recognizing, as an Establishment Clause value, the importance of maintaining a protective distance between religious organizations and the state for the benefit of the former.[199] The Supreme Court, however, has not had much occasion to develop that value doctrinally.

The Court has therefore not explored the specific kinds of harms that might constitute an Establishment Clause violation of this sort. Scholars have noted that, historically, governmental influence over an established church has been manifested in such matters as defining or approving doctrine, regulating ecclesiastical governance, and composing prayers.[200] Such gross impositions are highly unlikely in modern America. But these vivid illustrations do point to the fundamental value at stake—the ability of religious organizations to define themselves, their doctrines, their principles, and their practices. The Establishment Clause's policy of maintaining a distance between church and state is intended to keep the heavy hand of the state out of these sensitive matters.

One would expect the Free Exercise Clause, the presumptive primary guardian of religious freedom, to do the heavy lifting when the state steps in to

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the nonbeliever who fears the injection of sectarian doctrines and controversies into the civil polity, but in as high degree it is the devout believer who fears the secularization of a creed which becomes too deeply involved with and dependent upon the government."); Everson v. Bd. of Educ., 330 U.S. 1, 53 (1947) (Rutledge, J., dissenting) ("The great condition of religious liberty is that it be maintained free from sustenance, as also from other interferences, by the state. For when it comes to rest upon that secular foundation it vanishes with the resting." (footnotes omitted)). Both opinions, as well as that of Justice Black in *Engel*, cite Madison's Memorial and Remonstrance. The classic historical treatment of these issues is MARK D. HOWE, THE GARDEN AND THE WILDERNESS: RELIGION AND GOVERNMENT IN AMERICAN CONSTITUTIONAL HISTORY (1965).

[198] Carl H. Esbeck, *Establishment Clause Limits on Governmental Interference with Religious Organizations*, 41 WASH. & LEE L. REV. 347, 379–82 (1984).

[199] *See* Frederick Mark Gedicks, *A Two-Track Theory of the Establishment Clause*, 43 B.C. L. REV. 1071, 1087–95 (2002); Carl H. Esbeck, *The Establishment Clause as a Structural Restraint on Governmental Power*, 84 IOWA L. REV. 1 (1998); *see also* Lupu & Tuttle, *supra* note 148, at 57–62 (finding protection of religion against that power under a "clause transcendent" interpretation of both religion clauses).

[200] Esbeck, *supra* note 147, at 10-11; Gedicks, *supra* note 88, at 1092.

control or regulate a religious organization. But under *Smith*, the reach of that clause has been curtailed. Assuming that it applies to organizations as well as to individuals, principles of neutrality and general application immunize much state action from its reach.[201] The immunity is too broad. The Establishment Clause should serve as a guardian of religious liberty.

B. A Religion-Protecting Doctrine Under the Establishment Clause

As noted, the tests found in the Supreme Court's modern Establishment Clause cases are oriented toward regulating attempts to benefit religion.[202] Thus, any state action benefiting a particular religion must be evenhanded in relation both to other religions and analogous secular organizations.[203] The state is not to endorse a religion,[204] much less coerce religious exercise.[205] To the extent *Lemon* retains vitality, the state may not act with a religious purpose or a primary effect of advancing religion, and it is to avoid entangling itself in religious matters.[206] As even-handed treatment, non-endorsement, and non-coercion have competed for influence in the Court's Establishment Clause jurisprudence, the three-part test in *Lemon* has been called into question as a tool for policing attempts to promote religion.[207] In the context of state action tending to undermine religion, however, two of the elements of the *Lemon* test are quite promising as a basis for evaluating such governmental attempts to suppress religion.

The first *Lemon* factor—that the state action have a secular purpose—is not likely to be important. State action lacking a secular purpose would almost certainly run afoul of the Free Exercise Clause and would presumably be dealt with on that basis. *Smith* requires religious neutrality and general applicability of state action challenged under the Free Exercise Clause.[208] Although those requirements may not in all respects be co-extensive with the secular purpose requirement, it is difficult to imagine characterizing a law with a proven anti-religious purpose as religiously neutral or generally applied.

The other two elements of the *Lemon* test are more promising. The second *Lemon* factor proscribes not only state action whose principal or primary effect is

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[201] *See supra* text accompanying note 85.

[202] Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520, 532 (1993) ("[O]ur Establishment Clause cases . . . for the most part have addressed governmental efforts to benefit religion or particular religions.").

[203] *See supra* notes 127–38 and accompanying text.

[204] *See supra* notes 139–41 and accompanying text.

[205] *See supra* note 142–44 and accompanying text.

[206] *See supra* notes 128–29 and accompanying text.

[207] See the entertaining debate on the status of *Lemon* between Justice White, writing for the Court, and Justice Scalia, writing in concurrence, in Lamb's Chapel v. Center Moriches Union Free School Dist., 508 U.S. 384, 395 n.7, 398–99 (1993).

[208] *See supra* notes 14–15 and accompanying text.

to advance religion, but also state action of that character that *inhibits* religion.[209] Inhibiting religion, of course, is precisely the point. Although the Court has not used the Establishment Clause to invalidate state action on that basis, its cases are not inconsistent with that use of the clause.[210]

Inhibition of religion, standing alone, is not sufficient, however. Otherwise, the fundamental Free Exercise Clause doctrine established by *Smith* would be undermined. The point of *Smith*, after all, is that the law *may* inhibit religious exercise—even forbid it altogether (as in the sacramental use of peyote)—if the law is neutral and generally applied.[211] Even if, as Carl Esbeck has persuasively argued, the Free Exercise Clause creates individual rights, while the Establishment Clause restrains the state from encroaching on religious organizations,[212] the First Amendment should not be construed so that the Establishment Clause routinely protects religious groups who promote conduct that, under the Free Exercise Clause, the state could prohibit.

The final part of the *Lemon* analysis—entanglement of state and religion—is a second doctrinal element that, combined with the inhibition of religion, can create a workable Establishment Clause-based doctrine for protecting religious liberty. The well-established policy of avoiding state entanglement with religion can be as relevant to attempts to restrict religion as to efforts to advance it.

The notion of entanglement has been prominent in the Supreme Court's Establishment Clauses cases at least since *Walz v. Tax Commission.*[213]

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[209] Lemon v. Kurtzman, 403 U.S. 602, 612 (1971). See also Carl H. Esbeck, *Establishment Clause on Governmental Interference with Religious Organizations*, 41 WASH. & LEE L. REV. 347, 379 n.187 (1984), for more Supreme Court cites supporting this proposition.

[210] In Tony and Susan Alamo Found. v. Sec'y of Labor, 471 U.S. 290, 305–306 (1985), the Court held that the federal Fair Labor Standards Act could be applied to a religious foundation since its record-keeping requirements were not significantly intrusive into religious affairs. The implication is that a more severe intrusion might be sufficiently inhibiting to violate the Establishment Clause. *See also* Rosenberger v. Rector of the Univ. of Va, 515 U.S. 819, 846 (1995) (stating that government action that "fosters a pervasive bias or hostility to religion . . . could undermine the very neutrality the Establishment Clause requires"); Lynch v. Donnelly, 465 U.S. 668, 673 (1984) (stating that the Constitution "affirmatively mandates accommodation, not merely tolerance, of all religions, and forbids hostility toward any"); *cf.* Ewards v. Aguillard, 482 U.S. 578, 618 (1987) (holding Louisiana's Balanced Treatment for Creation-Science and Evolution-Science in Public School Instruction Act unconstitutional because it promoted religion; but also holding the Establishment Clause would not prevent the state from acting to prevent hostility toward religion by science teachers in public schools).

[211] *See supra* notes 14–15 and accompanying text.

[212] Carl H. Esbeck, *The Establishment Clause as a Structural Restraint on Governmental Power*, 84 IOWA L. REV. 1, 9 (1998).

[213] 397 U.S. 664, 675 (1970) ("The questions [in deciding whether property tax exemptions for churches are permissible under the Establishment Clause] are whether the involvement is excessive, and whether it is a continuing one calling for official and continuing surveillance leading to an impermissible degree of entanglement.").

Entanglement officially became part of the Court's three-part Establishment Clause test in *Lemon*.[214] Its place in the *Lemon* test implied that its effect, standing alone, was sufficiently serious to trigger a finding of an Establishment Clause violation. In *Agostini v. Felton*, entanglement was demoted to an element of the "principal purpose or effect" prong of the *Lemon* test.[215] Whatever its official status, preventing excessive entanglement between religion and state has well-established credentials as an Establishment Clause value.[216]

The Supreme Court has not offered a consistent rationale for its disapproval of entanglement. Sometimes it has been seen as a self-justifying goal, essentially a means of fostering the goal of separating church and state. As the Court said in *Lemon*, "[t]he objective is to prevent, as far as possible, the intrusion of either into the precincts of the other."[217] On other occasions, the point seems to be that entanglement inevitably leads to the promotion of religion. Indeed, it was that observation that led the Court in *Agostini* to say that entanglement was best considered as part and parcel of the "principal or primary effect" prong of the *Lemon* test.[218] The Court has also noted that entanglement carries the risk of political divisiveness along religious lines.[219]

On occasion, even though the facts of the case at hand involved attempts by the state to promote religion, the Court has observed that entanglement has the capacity to oppress religion. In *Lemon* itself, for example, the Court was concerned about the intrusion and involvement that would be required to ensure that public funds supplied to religious schools were used only for secular and not religious purposes.[220] It found that relationship to be "pregnant with dangers of excessive government direction of church schools and hence of churches. . . . [W]e cannot ignore here the danger that pervasive modern governmental power will ultimately intrude on religion and thus conflict with the Religion Clauses."[221]

NLRB v. Catholic Bishop of Chicago[222] also illustrates the idea. The Court there observed that permitting the National Labor Relations Board to exercise jurisdiction over lay faculty members at Catholic schools risked entangling the Board with the religious functions of the schools.[223] The effect was likely to be that the Board would impose on the church by inquiring into assertions that certain actions taken by it were required as a matter of religious creed, or by identifying the terms and conditions of employment in a relationship permeated by religion.[224]

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[214] Lemon v. Kurtzman, 403 U.S. 602, 613 (1971).

[215] Agostini v. Felton, 521 U.S. 203, 232–33 (1997).

[216] *Id.* at 232 (1997) ("Whether a government aid program results in . . . an entanglement has consistently been an aspect of our Establishment Clause analysis.")

[217] 403 U.S. at 614.

[218] 521 U.S. at 232–33.

[219] *Lemon*, 403 U.S. at 622–23.

[220] *Id.* at 614–22.

[221] *Id.* at 620.

[222] 440 U.S. 490 (1979).

[223] *Id.* at 501–04.

[224] *Id.* at 502–03.

Significantly, *Catholic Bishop* is probably the closest the Court has come to finding state action inhibiting religion to be in violation of the Establishment Clause. The Court stopped short of a constitutionally based holding, however, ruling instead that the National Labor Relations Act should be construed so as to avoid raising the issue.[225]

In dicta, then, the Court has recognized that entanglement can play a role in state action that injures religion in violation of the Establishment Clause. Viewed from this perspective, the policy against entanglement may be understood as expressing the idea, developed by Carl Esbeck, that the Establishment Clause imposes a structural restraint on the government in relation to religious organizations. [226] That restraint becomes particularly important when state action poses not merely the risk of indirect corruption flowing from state aid or support, but of direct and intentional interference with the ability of a religious organization to define and order itself in accordance with its own beliefs.

Taken together, these two Establishment Clause policies—preventing the state from inhibiting religion and avoiding the entanglement of religion and state—form the core of a doctrine that regulates the suppression of religion. More precisely, the Establishment Clause is offended if the state seriously entangles itself in the affairs of a religious organization through action that has a primary or principal effect of inhibiting religion.[227] Defining the required nature and extent of the inhibition and the degree of entanglement will require doctrinal development, the bases for which have already been laid in Religion Clause scholarship. Professor Esbeck argues that topics that are "inherently religious" are shielded by the Establishment Clause.[228] Professor Gedicks speaks in terms of the "core" purposes of the Establishment Clause, including preventing "government control of the leadership, doctrine, and other internal matters of religious organization."[229] Whatever boundaries may be established, however, it is not difficult to see that the state court's reformation of the UEP Trust crossed the line. It enmeshed state actors with a religious organization on an ongoing basis for the purpose of marginalizing the religious element of what was an essentially religious project. The reformation thus fundamentally alters the nature of the project itself.

As is discussed in Part V, the analysis of the court's action does not end with that observation. The constitutional merits of its remedy must be gauged in light of the alternatives open to it. Faced with a problem daunting in both its practical and constitutional dimensions, the court attempted to preserve the economic benefits of

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[225] *Id.* at 507.

[226] Carl H. Esbeck, *The Establishment Clause as a Structural Restraint on Governmental Power*, 84 IOWA L. REV. 1, 2 (1998) [hereinafter Esbeck I]; Carl H. Esbeck, *Establishment Clause Limits on Governmental Interference with Religious Organizations*, 41 WASH. & LEE L. REV. 347, 348 (1984) [hereinafter Esbeck II].

[227] Under *Lemon*, a law promoting religion is unconstitutional if it fails to satisfy any of the three parts of the test. Under the approach I propose here for testing religion-suppressing state action, both inhibition and entanglement must be shown.

[228] Esbeck I, *supra* note 226, at 105.

[229] Gedicks, *supra* note 88, at 1100.

the communitarian project of the FLDS Church, while preventing further abuses by the offending trustees. Although the court avoided substantial entanglement in doctrine by eliminating doctrine from the administration of the Trust, under its reformation, a deep and continuing institutional entanglement was created in which the state will likely stay closely connected with the workings of the Church community for some time.

More importantly, the court's reformation of the Trust fundamentally alters the nature of the Church's United Effort Plan. Decisions about how members of the community enjoy their houses, businesses, and other property would be made not by ecclesiastical leaders, but by a group of individuals who are not only uncommitted to the religious culture of the community, but who are affirmatively instructed not to be bound by that culture in the administration of the Trust. The state has, in effect, remade the Trust in its own image.[230]

VI. PROTECTING THE FLDS CHURCH AND ITS TRUST UNDER THE ESTABLISHMENT CLAUSE

It is one thing to conclude, as this article has done, that the reformation of the Trust trespassed constitutional boundaries. The Utah district court, however, was faced with a serious practical problem. If secularizing the Trust was out of bounds, what should the Utah district court have done? A complete analysis of all remedial options is beyond the scope of this article, but it does offer some general observations in light of the foregoing constitutional analysis.

The court had to produce a remedy that would be effective in the real world, one that both respected constitutional requirements and took account of some difficult facts about the Church, its leaders, and members. Some of those facts are clearly established on the judicial record. Others are more a matter of public perception based on journalistic and other writings about the Church.

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[230] The 2006 Trust requires the court to appoint an initial board of directors, which eventually becomes self-perpetuating. 2006 Trust, *supra* note 55, §§ 4.1.2–.1.3. To date, however, no trustees have been appointed. Instead, at the request of the special fiduciary, the court has appointed a board of advisors. *See supra* note 187. The special fiduciary, answerable the court, remains in charge of the Trust. Although invited to do so, no practicing members of the Church have been willing to serve on the advisory board. It does include a number of former members who departed the Church under unhappy circumstances. *See* Jennifer Dobner, *Wisan: Trust Management is an Opportunity to Make a Difference*, SAN DIEGO UNION TRIB., Jan. 9, 2008, http://www.signonsandiego.com/news/nation/20080109-1302-wst-polygamytrust-wisan.html (describing the advisory board as "mostly ex-[FLDS] members"); Stephen Hunt, *Judge Appoints 3 to Trust Advisory Board*, SALT LAKE TRIB., Dec. 25, 2007 at B5 (describing the December 2007 appointment of three ex-FLDS members of the Special Fiduciary's advisory board). Although those individuals have first-hand knowledge of the community and its culture, they cannot be expected to advance the Church's mission as understood by its current leadership.

A. The Nature of the FLDS Community

One record-based fact was the close identity of Church leadership and Trust leadership. The 1998 Restatement of the Trust gave complete control over the membership, and therefore the actions, of the board of trustees to the President of the Church, Warren Jeffs.[231] The same degree of control is said to exist within the ecclesiastical organization of the Church itself. On this point there are no formal findings on record in the Trust litigation, but there are public reports that in recent years Jeffs consolidated his control over the Church by removing from its leadership those not considered sufficiently loyal to him.[232]

Another judicially established fact was that Jeffs and those he controlled had, indeed, violated their fiduciary duties under the Trust. At the very least, they had risked expensive default judgments against the Trust estate by failing to defend tort claims brought against it. They had also violated two court orders arising out of the litigation that led to the Trust's reformation.[233] That conduct amounted to violations of the duties of loyalty and of prudent administration of the Trust.[234]

In addition, it is commonly alleged that Jeffs and other Church leaders exercise extraordinary control over the rank and file membership of the Church. That control is said to arise in part from the existence of the Trust itself. The homes of Church members, at least of the majority who reside in the Short Creek community, are owned by the Trust.[235] There are numerous accounts of those who have fallen into disfavor being ejected from their homes and the community, being left with virtually no assets or social support.[236] It is not difficult to imagine that the threat of such treatment creates a strong incentive to fall in line with demands of ecclesiastical authority.

It is also alleged that Jeffs and other Church leaders exercise control over their members in other ways, such as by rearranging families. Thus, a man who is found religiously wanting may lose not only his house, but his wife—or wives—and children, as well, all of whom may be given to another man.[237] Again, the desire to

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[231] *See supra* notes 36–38, and accompanying text. Following his conviction on criminal charges, Jeffs resigned his formal position as president of the Corporation of the President of the [FLDS Church], as corporation sole. Brooke Adams, *Jeffs Quits Key FLDS Role*, SALT LAKE TRIB., Dec. 6, 2007, at B1. There is no clear evidence that his de facto authority over the Church has diminished, however. Nancy Perkins, *Resignation: Jeffs Has Dropped FLDS Position*, DESERET MORNING NEWS, Dec. 6, 2007 at A1, *available at* http://www.deseretnews.com/article/1,5143,695233701,00.html.

[232] Pam Manson & Mark Havnes, *FLDS Prophet Thins Flock*, SALT LAKE TRIB., Jan. 12, 2004, at B1.

[233] Memorandum Opinion, *supra* note 35, ¶¶ 21–22.

[234] Memorandum Opinion, *supra* note 35, ¶ 21.

[235] Interview with Bruce Wisan, *supra* note 8.

[236] For a detailed, negative portrait of the community by one of its former members, see BENJAMIN G. BISTLINE, COLORADO CITY POLYGAMISTS (2004).

[237] Brooke Adams, *Ousted FLDS Dads Stuck with Aching Stigma*, SALT LAKE TRIB., June 15, 2006, at A1.

avoid such a personally devastating event could provide a powerful incentive to conform to those leaders' wishes.

Apart from the hard facts established on the judicial record—the trustees' failure to defend the Trust or to comply with court orders—one must exercise caution in evaluating this very unflattering portrait of the FLDS Church and its leaders. Religious groups who operate at the margins of society and who refuse to abide by conventional social and moral norms typically generate fear and loathing within mainstream society. Especially when, as appears to be the case with the FLDS Church, the orthodox insiders do not actively seek to influence public opinion by telling their own story, the accounts given of them are likely to be exaggerated, distorted, or incomplete. Whatever else might be true of the FLDS Church, one should not overlook the power of genuine religious commitment as a basis for its members' loyalty to their religion and its leaders. The most powerful motivation for many Church members may be the spiritual or eternal consequences, as they perceive them, of standing firm in the faith, on the one hand, and of failing to abide by the requirements of that faith, including the demands placed upon them by their leaders, on the other.

At one level, it is unnecessary to know exactly what combination of religious commitment and fear of practical consequences motivate members of the FLDS Church. As far as this case is concerned, there is no reason to doubt that they and their Church are entitled to the benefits of the First Amendment. Indeed, the protection of unpopular religious belief and exercise is one of the most important reasons for the religion clauses. Neither the AG, any of the private litigants involved with the case, nor the court itself argued that the Church or its members were ineligible for that protection, as a general matter, even if their particular marriage practices subject them to criminal and other legal sanctions.

There are ample grounds for the State, under the auspices of its criminal laws, child protective statutes, or other legislation, to act directly against offending individuals with respect to those practices. [238] The court, however, manifestly decided not to use the UEP Trust litigation as a vehicle for regulating, deterring, or punishing such behavior, choosing instead to focus on remedying the violations of fiduciary duty on the part of the trustees. The analysis in this article takes the court at its word on that point.

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[238] Church member Rodney Holm was convicted of criminal offenses in connection with his polygamous marriage to a teenage girl. State v. Holm, 2006 UT 31, ¶¶ 104–05, 137 P.3d 726, 752. Warren Jeffs has been convicted of rape by accomplice in connection with the arranged marriage of an under-aged girl to her cousin. *See* Memorandum in Support of Motion for New Trial at 7, State v. Jeffs, No. 061500526 (D. Utah Dec. 4, 2007); *available at* http://www.utcourts.gov/media/highprofilecourtcases/archives/Memorandum%20In%20Support%20Of%20Motin%20For%20New%20Trial.%20Jeffs.pdf (moving for a new trial after his conviction because Jeffs claims that a juror was improperly replaced in the middle of his trial); *see also* Brooke Adams, *Jeffs' Attorneys Seek New Trial for Sect Leader*, SALT LAKE TRIB., Jan. 24, 2008, at B3 (discussing Jeff's request for a new trial due to a technical error). Recent actions by Texas authorities acting under that state's child protective laws are referred to in *supra* notes 4–5.

B. The Court's Remedial Options

The character of the Church and its members is highly relevant to the case on another level. In fashioning an effective remedy, the court had to take account of the realities of the FLDS community. Perhaps the most important single element of the portrait sketched out above is this fact, not expressly found by the court but very likely assumed by it: Warren Jeffs and other Church leaders would, if not prevented from doing so, wield a powerful, perhaps controlling, influence over the Church, its members, and the Trust regardless of any legal disabilities imposed upon them. If true, that fact may have had a significant and perhaps dispositive effect, on the court's choice of remedy. Consider how that fact may have influenced the options open to the court.

1. Disqualification of Existing Trustees and Minimal Reformation

In principle, the simplest remedy would be to disqualify the existing trustees from continued service, appointing other practicing members of the FLDS community in their places. Reformation of the Trust provision giving the Church president control over the trustees would be required, but otherwise the Trust could be kept essentially intact. The court would avoid entanglement with the doctrines and polity of the Church, and the beneficiaries of the Trust would continue to enjoy its benefits as part of their religious life. No serious constitutional problems with such a remedy are apparent.

Presumably the court concluded that no such trustees were to be found. That conclusion finds ample support in the refusal of any practicing Church member to cooperate with the court and the special fiduciary in any way, despite a clear invitation to do so.[239] As long as that refusal continued, this remedial approach was simply not practicable. Moreover, the likelihood that Warren Jeffs and the other disqualified trustees would continue to exercise a controlling influence over the Trust in their roles as ecclesiastical leaders would probably have led the court to dismiss that option out of hand in any event.[240]

2. State Administration of the Trust as a Religious Entity

A logical alternative would be for the court to assume control of the 1998 Trust and, through its special fiduciary, administer it as written, with reformation only to the extent needed to replace the existing Trustees with individuals selected

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[239] For example, a Minute Entry invited beneficiaries of the Trust to participate in a hearing regarding the appointment of new trustees. *In re* United Effort Plan Trust, No. 053900848 (D. Utah July 19, 2005) (minute entry).

[240] Whether that influence is itself a sufficient basis for rejecting the remedy is doubtful, however, for the reasons discussed in the text accompanying *infra* notes 244–248.

by the court.[241] Doing so would have the effect of eliminating the influence of Warren Jeffs and his colleagues. But that remedy is obviously impossible for both practical and constitutional reasons. The FLDS community would surely not cooperate. Even if it did, that remedy would require state actors to interpret and apply religious doctrine in ways thoroughly at odds with *Jones*. Appointing someone answerable to the state to administer a trust as "a spiritual step toward living the Holy United Order" and "to preserve and advance the religious doctrines and goals of the [FLDS Church]"[242] could not be consistent with any reasonable understanding of the Establishment Clause.

3. Secularizing the Trust

The court therefore chose what it may have considered to be a "third way": extensively reforming the Trust so as to turn it into an essentially secular instrument. If the paramount goal was to cut off the influence of the disqualified trustees, that remedy—if it worked—would accomplish it. Moreover, the court may have been attracted to the possibility of using the Trust's resources to preserve and improve the economic and educational standing of the FLDS community in keeping with contemporary standards.

As discussed above, that creative remedy, while avoiding direct state entanglement with Church doctrine and polity, works a major, continuing imposition on the religious life of the Church community. It places under state control, to be administered according to secular principles and priorities, a substantial body of assets that had been specifically set aside for governance according to religious principles. The conclusion of this article is that the reformation is inconsistent with the First Amendment. Even if the Free Exercise Clause fails to bar that remedy, the Establishment Clause does, especially if there is any other practicable remedy available.

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[241] Given exigent circumstances, trusts are generally subject to modification or reformation. Courts supervising the administration of a trust may interfere in the trustee's exercise of discretion when such discretion is used in an abusive manner. In more egregious cases, e.g., instances wherein the trustee commits a serious breach of trust, fails to serve the interests of the beneficiaries, or where the trustee can no longer carry out the material purpose of the trust, courts are permitted to remove the trustee and appoint a successor trustee charged with administering the trust in a more prudent manner. *See* UNIF. TRUST. CODE § 706(b) (2007). A number of states have adopted section 706, allowing for judicial removal of trustees in a limited set of circumstances. *See, e.g.*, MO. ANN. STAT. § 456.7-706 (West 2007); OR. REV. STAT. § 130.625 (2007); UTAH CODE ANN. § 75-7-706 (2007). State courts have applied this doctrine sparingly, and only in the most objectionable instances. *See, e.g.*, Cadle Co. v. D'Addario, 844 A.2d 836, 848–49, (Conn. 2004); McNeil v. Bennett, 792 A.2d 190, 220 (Del. Ch. 2001); Williams v. Duncan, 55 S.W.3d 896, 901 (Mo. Ct. App. 2001). *See generally* RESTATEMENT (SECOND) OF TRUSTS § 187 (1959) (subjecting trustee discretion to control by the court in cases of abuse); 1 SCOTT ON TRUSTS § 10 (1939).

[242] 1998 Trust, *supra* note 9, ¶ 2.

Moreover, administration of the Trust as reformed by the court cannot succeed without the cooperation of the FLDS community. Despite serious efforts by the special fiduciary to solicit applications for Trust benefits under the new regime, and to manage the Trust estate, progress has been agonizingly slow. Initial attempts to hold town meetings and otherwise to engage the community in the program envisioned by the 2006 Trust were met with silence.[243] Very limited progress has been reported recently.[244] Meanwhile, the expenses of administering the 2006 Trust, especially given the intransigence of its beneficiaries, continue to mount.[245]

4. Termination

The remaining option—termination of the Trust and distribution of its assets to the beneficiaries—was rejected summarily by the court.[246] That remedy clearly would be within the court's power.[247] It would involve some imposition on the religious practice of FLDS Church members. They would move from being participants in a communitarian economic arrangement to individual property owners or recipients of a cash payment. Given the other alternatives, termination satisfies constitutional requirements. Entanglement with the state is minimal and short-lived. As discussed below, the recipients of Trust assets would be free to reinvest their property in a successor to the United Effort Plan.

Termination is not without its own practical challenges. One surmountable problem is that termination with no reformation would send the assets of the Trust not to Church members individually, but to the Corporation of the President of the FLDS Church as the remainder beneficiary.[248] That obstacle could be overcome with a simple and discrete reformation prior to termination making the assets distributable to the beneficiaries generally, which was the pattern in the Original Trust.[249]

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[243] Interview with Bruce Wisan, *supra* note 8.

[244] Jeffrey L. Shields, attorney for the special fiduciary, reports that current Church members continue to refuse to make claims for Trust benefits or otherwise cooperate with the court-ordered management of the Trust. A number of disaffected former members of the community have applied, however. Telephone Interview with Jeffrey L. Shields, attorney, in Salt Lake City, Utah, (Dec. 11, 2007). Recently, even those former members have been at odds with the special fiduciary.

[245] Brooke Adams, *Hildale Home Sale a Milepost*, SALT LAKE TRIB., Oct. 22, 2007, at B1.

[246] It stated that "[t]he Court sees no reason why the Trust should terminate at this time," Memorandum Opinion, *supra* note 35, ¶ 54 (justifying that conclusion by reference not to the risks of termination, but to the virtues of the reformation it ordered).

[247] UTAH CODE ANN. §§ 75-7-412(1)-(2), 75-7-413(1) (2007).

[248] 1998 Trust, *supra* note 9, pt. III.

[249] Original Trust, *supra* note 36, ¶ XVII ("In the event of the termination of this trust, the then members of record shall participate in the distribution of all the properties belonging to said trust estate, and the assets shall be distributed upon the basis of share and share alike.") In contrast to the Restated, 1998 Trust, *supra* note 9, the beneficiaries of the

A second problem is that the real estate parcels on which many members' houses are located have not been subdivided into separate lots. Instead, several houses sit on a single parcel of land.[250] The necessary subdivision is ordinarily a matter for local government—which in this case is controlled by Church leadership. Subdivision has, in fact, been a thorny issue for the special fiduciary.[251] While daunting, the problem should not be insurmountable. If unreasonable obstacles are raised, the courts may facilitate the process of partition of the land held by the Trust.[252]

Termination does not resolve what may have been the court's fundamental goal of keeping the assets of the Trust beyond the influence of the disqualified trustees. If, in fact, the leaders of the FLDS Church wield the degree of influence commonly alleged, would they not simply continue directing the use of the assets as they had in the past, whether or not they used a trust instrument as the basis of that control?

They might well do so, and the court should not attempt to prevent it. The court presumably would disqualify the individual leaders from managing—directly or indirectly—the administration of any newly formed public charitable trust or private trust. But the focus should be on the members of the Church. If they desired to reunite economically with their existing leaders in some other fashion, the State should shoulder the burden of proving that the new arrangement is based on fraudulent misrepresentation, that it involves tortious constraints on members' freedom to leave the Church, or is wrongful or unlawful in some other way. Otherwise, the choice of individuals to remain loyal to the FLDS Church and its leaders should be entitled to respect, including the protection of the First Amendment.

Original Trust, were not the general class of Church members, but specifically enrolled members. Jeffs v. Stubbs, 970 P.2d 1234, 1252 (Utah 1998).

[250] Interview with Bruce Wisan, *supra* note 8.

[251] Brooke Adams, *Hildale Home Sale a Milepost*, SALT LAKE TRIB., Oct. 22, 2007, at B1.

[252] The special fiduciary is involved in efforts to partition the Trust properties, a process complicated by the fact that the community straddles the Utah-Arizona state line and actually consists of separate municipalities, Colorado City, Arizona and Hildale, Utah, each subject to the law of a different state. Litigation brought by the special fiduciary in Utah has resulted in a certificate of default against Hildale ordering it to act on a request for a subdivision of Trust properties. As of the time this article went to press, the special fiduciary, in hopes of reaching a negotiated settlement, had not yet reduced the certificate to a default judgment. Meanwhile, Colorado City, which had never had a subdivision ordinance, adopted one with expensive and onerous requirements that the special fiduciary claims are unenforceable against it. That issue has yet to be resolved by negotiation or litigation. Interview with Jeffrey L. Shields Interview, *supra* note 249. If Church members' refusal to cooperate did ultimately block the subdivision of real property and other steps needed to distribute the assets in kind, the assets could, as a last resort, sell the assets on an as-is basis for whatever price the market would bring and make the proceeds available to the beneficiaries.

It is not certain that all or most members would make that choice. They would have other options, as well. Some might choose to abandon the communitarian project altogether. For the rest, the loss of that project need not be permanent. Church members would have the choice to regroup, reform their project, or affiliate with another organization, with or without a United Effort Plan.[253] Having ownership and control of their homes, farms, and places of business would make such a choice possible. Ultimately, the scope of their freedom to act religiously would be enhanced by the freedom to act economically.[254] Given the practical and doctrinal obstacles to the other available options, termination is the preferred remedy.

Transferring Trust assets into the hands of individual beneficiaries is possible under the 2006 Trust created by the court.[255] Indeed, the special fiduciary has stated that he favors moving in that direction.[256] The unwillingness of most beneficiaries to cooperate with the special fiduciary, however, constrains his ability to do so.[257] Efficiently subdividing land, transferring title, and otherwise liquidating and distributing assets on a large scale all require basic trust and collaboration. Moreover, the framework laid out by the court contemplates a continuing, secular project radically different from the Trust's original, religious vision.[258] The malfeasance of the trustees may have made it impossible to realize that vision even in the absence of state intervention.[259] But making the admittedly difficult efforts required to put the assets of the Trust in the hands of the members of the Church whose efforts and contributions helped bring them into being is the best way to respect their freedom to pursue that vision, or any other they might choose.

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[253] There appears to be no shortage of groups operating under somewhat similar religious principles. *See* VAN WAGONER, *supra* note 2, at 200–17.

[254] The Church and some of its members and leaders apparently have substantial assets outside the Trust, as evidenced by the recent purchase of property near Eldorado, Texas, and other property in British Columbia, Canada, and Mancos, Colorado, held by the Church. *See* Brooke Adams, *FLDS Outposts*, SALT LAKE TRIB., May 13, 2007, at A1. But it appears that many rank and file members of the Church residing in the Short Creek area do not enjoy the benefit of substantial assets outside of the Trust property on which they have long resided.

[255] *See* 2006 Trust, *supra* note 55, § 5.16.

[256] He is quoted as saying he "would like to privatize the trust as much as possible. If I could, I would like to dissolve the trust." Brooke Adams, *CPA Making Few Friends as Trust Overseer*, SALT LAKE TRIB., May 28, 2007, at A1.

[257] Telephone Interview with Bruce Wisan, Special Fiduciary, United Effort Plan Trust, in Iowa City, Iowa (May 24, 2007).

[258] The special fiduciary reports, however, that in recent hearings, the court has been inclined to permit him to move toward the distribution of Trust assets. *Id.*

[259] So claims Winston Blackmore, a dissident, former member of the FLDS Church. Under the FLDS trustees, he said, "businesses were looted, retirement funds cashed in, insurance proceeds confiscated, holiday pay taken and many businesses were contributing on behalf of their reluctant employees with money that really belonged to the employee . . . The UEP as we knew and loved it is a thing of the past." *Id.*

VII. CONCLUSION

The UEP Trust litigation placed unusual and revealing demands on the Supreme Court's religion clause jurisprudence. The Utah District Court's reformation of the Trust imposed deeply on the religious exercise of the FLDS Church and its members. That imposition may well be permissible under the Free Exercise Clause, since the statute under which the court acted, and the basis for the remedy it devised thereunder, appear to have successfully navigated the relatively undemanding terrain of *Employment Division v. Smith*. The declining demands of the Free Exercise Clause brought about by *Smith*, however, disclose the Establishment Clause's constraints on state power, and, through those constraints, its capacity to protect religious liberty. Scholars have recognized that role for the Establishment Clause, and courts have occasionally paid lip service to it. But it has not routinely been pressed into service as the basis for deciding cases. The facts of the UEP Trust litigation call on the Establishment Clause to play that role.

TAX AVATARS

Bridget J. Crawford*

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I. INTRODUCTION

Anyone who has spent time in cyberspace understands the concept of an alter ego. In online games, chat rooms and on the internet generally, users select one or more avatars to represent themselves. Avatars function as the end-user's alter ego. The avatar may be a three-dimensional character in a multiplayer game or a two-dimensional icon on a bulletin board. This article uses the concept of avatars to explain the tax treatment of real-life alter egos: agents under a power of attorney. Specifically, the article discusses (1) how traditional, standard legal instruments can be used to create legal alter egos; (2) how and why these legal avatars receive

favorable transfer tax treatment; (3) how uniform laws are changing to protect legal avatars; (4) whether new legislation will increase or decrease the use of legal avatars; and (5) how scholars might use the tax treatment of legal avatars to advocate for the favorable tax treatment of relationships that arise by choice.

Part I of this article is an introduction. Part II provides an overview of how powers of attorney create legal alter egos. At its core, executing a power of attorney is like selecting an online avatar. It is a choice to make someone (or something) our representative in the real (or cyber) world. A power of attorney enables one person (called the attorney-in-fact or the agent)[1] to act on behalf of another (the principal). Part III of this article describes the favorable tax treatment that agents—legal alter egos or avatars—receive and seeks to reconcile this preferred treatment with the inconsistent approach of the Internal Revenue Service (the "Service") to fiduciary duty. Part IV explores the major reforms of the Uniform Durable Power of Attorney Act of 2006 (the "2006 Act")[2] and Part V anticipates its consequences. Standardizing the principal/agent relationship may have economic consequences that the drafters of the 2006 Act have not anticipated. Part VI of this article considers the implications of the tax treatment of legal avatars. By both inverting a critical paradigm and drawing on the model of a cyberspace avatar, powers of attorney are revealed as a vehicle for choice-based representation. Those who would like the law to recognize varied configurations of choice-based human relationships may find the tax treatment of legal avatars to be a helpful model for their efforts.

II. CREATING A LEGAL AVATAR: THE POWER OF ATTORNEY

A. Creation

A power of attorney is a legal instrument whereby one person, typically called the principal, designates one or more other persons, typically called the attorney(s)-in-fact or the agent(s), to act on his or her behalf.[3] Every jurisdiction in the United States recognizes some form of the power of attorney.[4] Depending on

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[1] To avoid confusion between the terms "attorney-at-law" and "attorney-in-fact," this Article follows the choice of the drafters of the Uniform Durable Power of Attorney Act to refer to the person appointed by the principal under a power of attorney as the "agent." *See* UNIF. POWER OF ATT'Y ACT § 102(1) (amended 2006), 8B U.L.A. 24 (Supp. 2008).

[2] *Id.*

[3] *See* BLACK'S LAW DICTIONARY 1191 (7th ed. 1999).

[4] *See, e.g.*, Karen E. Boxx, *The Durable Power of Attorney's Place in the Family of Fiduciary Relationships*, 36 GA. L. REV. 1, 12 (2001).

the jurisdiction, a principal's delegation of authority to an agent may or may not require a formal writing.[5] In those jurisdictions that require a formal writing, counselors to even the wealthiest Americans typically use standard pre-printed forms of powers of attorney because these are most likely to be recognized and accepted by banks and financial institutions.[6]

B. Scope

Powers of attorney generally fall into two categories: those that are presently exercisable[7] and those that are "springing," or effective only upon the occurrence of a certain event such as the principal's incapacity. Within each classification the power may be time limited or unlimited in duration ("durable"). The powers granted may be broad or narrow in scope.

Lawyers frequently counsel their clients who are in long-term marriages to execute presently exercisable durable powers of attorney granting each other broad powers to act as agent.[8] Such a power allows either spouse to act on the other's behalf, whether as a matter of convenience or necessity. Similarly a parent who has a close emotional and geographic relationship with an adult child may execute a general durable power of attorney in favor of the adult child.

There may be several reasons that a lawyer might counsel a client to execute a springing power instead of a general durable power. A client might view the execution of a power of attorney as diminishing his or her control, or the client may distrust family members or close friends. This client may want to postpone delegating his or her authority until it is absolutely necessary. Similarly a client may wish to designate authority to an individual for a particular transaction only. Consider the following hypothetical:

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[5] *See, e.g.*, CONN. GEN. STAT. § 47-5 (1998) (explaining that in order to use the delegated powers in conveying land the conveyance "shall be . . . [i]n writing"). The applicable South Carolina statute, S.C. CODE ANN. § 62-5-501(C) (1986), requires that a durable power of attorney that includes the power to convey real estate must be executed with all of the same formalities required for the valid execution of a Will.

[6] E-mail from James S. Sligar, Esq., Partner, Milbank, Tweed, Hadley & McCloy LLP, to Bridget J. Crawford, Associate Professor of Law, Pace University School of Law (Aug. 10, 2007, 1:27 PM EST) (on file with author).

[7] *See, e.g.*, 3 AM. JUR. 2D *Agency* § 26 (2002) (describing the function of a presently exercising durable power of attorney); LAWRENCE A. FROLIK & MELISSA C. BROWN, ADVISING THE ELDERLY OR DISABLED CLIENT ¶ 21.03[1] (2d ed. 2003), *available at* 2001 WL 642769 (2008) (providing an overview of the legal issues related to the durable power of attorney).

[8] *See, e.g.*, 45 SHARON RIVENSON MARK, N.J. PRAC. SERIES *Elder Law—Guardianships & Conservatorships* § 1.4 (2d. ed. 2007).

> **Hypothetical 1.** A is scheduled to close on her purchase of a new home, Redacre, on December 1, 2007. Unfortunately, A will be traveling out of town then and the seller is not willing to reschedule. A has several adult children whom she trusts completely, but none of them lives close enough to attend the closing of Redacre on December 1, 2007. On November 30, 2007, A executes a springing power of attorney, effective only on December 1, 2007, and with respect to the purchase of Redacre, in favor of her friend B.

Hypothetical 1 presents a classic case in which a springing, limited (or narrow) power of appointment is appropriate. A has several adult children on whom she can rely as a general matter, but these children are not able to be present for the closing of Redacre. For convenience, A grants B the authority to sign and execute all documents relating to the purchase of Redacre that A herself could and would sign if she were physically present. Because the power is time limited, it is not necessary for A to revoke the power when she returns from her trip; it expires automatically after December 1, 2007.

C. Limitations

Two issues dominate any discussion of powers of attorney. First, not everyone has one. Second, those who do have powers of attorney may not understand them. Powers of attorney are only useful if they exist. Someone who has no close family members or friends may never execute a power of attorney. Furthermore, because the typically granted powers are broad, it is likely that a principal agent or a third party could misunderstand or misinterpret the full extent of the agent's authority. Some agents may even abuse their powers to enrich themselves at the expense of the principal.[9] Historically this toxic combination of uncertainty and power has led banks and other financial institutions to be reluctant to accept powers of attorney.[10] For example, some institutions decline to accept powers because they were executed in another jurisdiction or several years prior to presentment.[11] The

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[9] *See* David M. English & Kimberly K. Wolff, *Survey Results: Use of Durable Powers*, PROB. & PROP., Jan./Feb. 1996, at 33, 33–35.

[10] *See* WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, WILLS, TRUSTS AND ESTATES, INCLUDING TAXATION AND FUTURE INTERESTS 351 (3d ed. 2004).

[11] *Id.* Some states, such as New York, have adopted penalties for institutions that refuse to accept a power of attorney executed in keeping with statutory formalities. *See* N.Y. GEN. OBLIG. LAW § 5-1504(3) (McKinney 2001) ("The failure of a financial institution to honor a properly executed statutory short form power of attorney shall be deemed unlawful.").

National Conference of Commissioners on Uniform State Laws cites the "problem of arbitrary refusals of powers of attorney by banks, brokerage houses, and insurance companies" as one of the primary reasons that the laws need to be reformed.[12] Validly executed powers have no practical use if banks and other institutions will not accept them.

III. TAXING LEGAL AVATARS

A. Estate and Gift Tax Generally

1. Overview of Gift Taxation

Current law imposes a tax on completed transfers of property by gift that otherwise are not excludible from the definition of "gift" or in some way eligible for an exemption from the gift tax.[13] This seemingly simple rule derives from several sections of the Internal Revenue Code and the related Treasury Regulations.[14] As an initial matter I.R.C. § 2501 imposes a gift tax on the transfer of property by gift by an individual.[15] To illustrate, consider a second hypothetical:

> **Hypothetical 2.** X physically transfers to Y a famous painting owned by X. X also transfers legal title to Y. X receives nothing in return. X and Y are not related in any way.

In Hypothetical 2, X has made a *transfer* of *property* to Y for gift tax purposes because she transfers the title (and possession of) the painting to Y. Contrast that with another scenario:

> **Hypothetical 3.** X invites Y to X's home to view a famous painting owned by X.

In Hypothetical 3, X does not make a *transfer* of property for gift tax purposes because X does not divest herself of ownership or control over the painting. The painting presumably hangs in X's home while X and Y gaze at it and the painting remains in X's home thereafter. Furthermore X does not make a transfer of *property* for gift tax purposes when Y comes to view the painting. X may bestow

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[12] Uniform Law Commissioners: The National Conference of Commissioners on Uniform State Laws, Summary: Uniform Power of Attorney Act (2006), http://www.nccusl.org/Update/uniformact_summaries/uniformacts-s-upoaa.asp (last visited Sept. 30, 2008) [hereinafter Uniform Power of Attorney Act Summary].

[13] *See* I.R.C. §§ 2501–2505 (2006).

[14] Unless otherwise specified all references to the Internal Revenue Code [hereinafter the "Code" or "I.R.C."] refer to the Internal Revenue Code of 1986, as amended.

[15] *Id.* § 2501(a).

on Y some psychic or emotional pleasure in inviting Y to view the painting, but such hedonic enjoyment is not *property* for gift tax purposes.

If Hypotheticals 2 and 3 suggest that one can determine with relative ease what is (and is not) a transfer of property for gift tax purposes, it is moderately more difficult to determine what constitutes a transfer of property *by gift* for gift tax purposes. I.R.C. § 2502 provides that the amount of gift tax imposed on a transfer of property by gift is the excess of the tentative tax imposed on "the aggregate sum of the taxable gifts for the taxable year and for each of the preceding calendar periods" over the tentative tax on "the aggregate sum of the taxable gifts for each of the preceding calendar periods."[16] To illustrate, consider the following hypothetical:

> **Hypothetical 4.** Prior to 2006 X never made a taxable gift. In 2006, X makes $1,000,000 in taxable gifts. X applies to these transfers the credit under I.R.C. § 2505, so X owes no gift tax with respect to this $1,000,000 of gifts. In 2007 X transfers $50,000 to Y. X makes no other taxable transfers.

To calculate the gift tax owed with respect to X's transfers in 2007, one first computes the tentative tax imposed with respect to X's gifts in 2006. One then subtracts this amount, or $345,800, from $366,300, which is the tentative tax on the aggregate sum of X's gifts in 2007 and 2006 ($1,000,000 plus $50,000, or $1,050,000).[17] Therefore, with respect to the transfer in 2007, X owes $366,300 minus $346,800 in gift tax, or $20,500.

Note that the calculation of gift tax hinges in large part on the definition of "taxable gifts."[18] But the Code does not define the term "gift." The closest one comes is in the valuation rule of I.R.C. § 2512.[19] That section provides that where a gift is made in property, its value at the date of the gift is the amount of the gift.[20] In the case of a transfer for partial consideration, the amount of the gift will be the amount by which the value of property transferred exceeds the value of property received.[21] In common parlance then, a gift occurs when one transfers more than

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[16] *Id.* § 2502(a). This rule has the effect of making each gift incrementally more "expensive" in a tax sense. *See Id.* § 2502(a)(1) (computation of tax); *id.* § 2502(a)(2) (rate schedule).

[17] *Id.* §§ 2502(a), 2001(c)(1) (rate schedule). The tentative tax on $1,050,000 is $345,800 plus 41% of the excess of such amount over $1,000,000 (or 41% of 50,000), $366,300.

[18] *Id.* §§ 2501–2502.

[19] *See id.* § 2512(a).

[20] *Id.*

[21] *Id.* § 2512(b).

one receives in return, or when—and to the extent that—one "gives" more than one "gets." To illustrate, consider this variation on Hypothetical 2.

> **Hypothetical 5.** X transfers to Y title to the famous painting owned by X. The painting has a fair market value of $5,000.[22] Y pays X only $4,000 cash.

In this case X makes a taxable gift to Y of $1,000, or the amount by which the fair market value of the painting ($5,000) exceeds the consideration received ($4,000).[23] Note that the determination of whether the transfer is a "gift" for gift tax purposes depends on a comparison of values—whether X "gave" more than X "got," not whether X intended to make a gift to Y.[24]

Apart from a difference between the value of what a taxpayer transfers and the value the taxpayer receives in return, for a transfer to be subject to gift taxation, the transfer must be *complete*. Completion occurs when "the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another."[25] The following hypothetical presents a typical case of an incomplete gift.

> **Hypothetical 6.** X transfers title to the painting to Y (whether for no consideration or for less than fair market value), [26] subject at all times to X's right to take the painting back (and the requirement that X then refund Y's money).

Because X retains the right to revoke the transfer, it is not *complete* for gift tax purposes, and no gift tax will be imposed.[27] Similarly, if X loans Y a car so that Y can go to the grocery store, then X has transferred to Y the value of the use of the car for a specific period of time,[28] but X has not make a completed transfer of

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[22] *See id.* § 2512(a).

[23] Assuming that Y is an individual, not a charity, the income tax consequences of this transaction are governed by Treas. Reg. §§ 1.1001-1(e), 1.1015-4 (as amended in 1996). The transferor's gain is the excess of amount realized over adjusted basis, provided that no loss can be recognized in a part sale/part gift transaction. Treas. Reg. § 1.1001-1(e) (as amended in 1996).

[24] This definition for gift tax purposes contrasts to the definition of a gift for income tax purposes. The income tax definition depends in large part on the transferor's intent. *See, e.g.,* Comm'r v. Duberstein, 363 U.S. 278, 286 (1960).

[25] Treas. Reg. § 25.2511-2(b) (as amended in 1999); *see also* Rev. Rul. 69-347, 1969-1 C.B. 227 (explaining that a gift pursuant to a prenuptial agreement is complete as of date of the parties' marriage).

[26] *See* I.R.C. § 2512(a).

[27] Treas. Reg. § 25.2511-2(b).

[28] *See, e.g.*, Dickman v. Comm'r, 465 U.S. 330, 338 (1984) (noting that an interest-

the entire car to Y. X cedes some amount of dominion and control over the car for the period that Y drove the car to the grocery store, but X does not make an irrevocable transfer of the car itself.

There are four major exceptions to the imposition of gift taxes under Chapter 12 of the Code. First, as illustrated in Hypothetical 4, under I.R.C. § 2505, with respect to gifts made after December 31, 2001, each citizen or resident of the United States has a credit against the gift tax equal to the amount needed to "shelter" the first $1,000,000 in taxable transfers from taxation.[29] Second, a taxpayer may exclude from the calculation of his or her taxable gifts those transfers that qualify for the annual exclusion under I.R.C. § 2503(b).[30] Third, the taxpayer may exclude from the calculation of taxable gifts any payments on behalf of any person made directly to an educational institution as tuition, or directly to a medical care provider for any person's medical expenses.[31] Fourth, a taxpayer may subtract from the amount of his or her taxable gifts the deductions permitted by Subchapter C of Chapter 12 of the Code.[32] Those deductions include transfers to or for the use of charity and transfers to a spouse.[33]

2. The Special Case of Transfers Subject to Withdrawal Rights

A transfer subject to gift tax may be direct or indirect. For example, in some contexts the right to withdraw property is the equivalent of an outright transfer for gift tax purposes. Consider this variation on Hypothetical 2:

> **Hypothetical 7.** X wants to give a painting to Y, but X is not able to attend to the details of the transfer before X leaves on a long vacation. Without receiving any consideration from Y, X places the painting in a secure local storage facility. X also places in the storage facility a binding legal instrument transferring the painting to Y. X hands Y the key to the storage facility so that Y may pick up the painting at Y's convenience.

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free loan between parents and son is a taxable gift of the "rental value" of use of the money, i.e., the foregone interest).

[29] *See* I.R.C. § 2505(a)(1).

[30] Under I.R.C. § 2503(a), "taxable gifts" are "the total amount of gifts made during the calendar year," other than certain transfers such as annual exclusion gifts made pursuant to I.R.C. § 2503(b), less the deductions permitted by subchapter C of Chapter 12 of the Internal Revenue Code (I.R.C. §§ 2522–2524).

[31] *Id.* § 2503(e).

[32] *Id.* § 2503(b). Subchapter C is found at I.R.C. §§ 2522–2524.

[33] *Id.* § 2522 (charity); *id.* § 2523(a) (spouse). The recipient must be the donor's spouse at the time of the gift. Treas. Reg. § 25.2523(a)-1(a) (as amended in 1995).

Unlike the facts of Hypothetical 2, in Hypothetical 7, X does not physically transfer the painting to Y. She places it in a storage facility and gives Y the key. Therefore Y can take possession of the painting at any time. Under the case of *Crummey v. Commissioner of Internal Revenue*, the transfers in Hypotheticals 2 and Hypothetical 7 are treated the same for gift tax purposes.[34] Y's rights with respect to the painting in the storage facility are sufficient to cause X to be treated for gift tax purposes as if she had transferred the painting directly to Y.

In the estate planning context, taxpayers frequently use the rule of *Crummey* to make tax-free transfers in trust for the benefit of family members or others.[35] In the typical "*Crummey*" trust, named after the taxpayer in whose case the court validated the technique, one or more beneficiaries with a present interest in the trust have the right to withdraw a pro rata share of property transferred to the trust.[36] As in Hypothetical 7, where Y's ability to take possession of the painting in storage is treated for gift tax purposes the same as if X physically had transferred the painting to Y, a taxpayer's contribution to a *Crummey* trust is treated for gift tax purposes like an outright transfer to a beneficiary, as long as the beneficiary has certain withdrawal rights.[37] Because such a transfer is treated as a present interest,[38] the property subject to that withdrawal right qualifies for the gift tax annual exclusion under I.R.C. § 2503.[39]

If drafted properly, a beneficiary's withdrawal rights may qualify transfers to a trust for the gift tax annual exclusion, but these rights can have other unintended tax consequences. Generally speaking, a beneficiary's withdrawal right is treated as a general power of appointment.[40] In other words, in Hypothetical 7, for estate tax purposes, Y's unrestricted right to take the painting out of storage is treated the same as actual ownership by Y. Therefore under I.R.C. § 2041, the property subject to a beneficiary's withdrawal right will be included in his or her gross estate for federal estate tax purposes.[41] Similarly, to the extent that a beneficiary's

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[34] 397 F.2d 82, 88 (9th Cir. 1968).

[35] For more information on *Crummey* trusts, see JONATHAN G. BLATTMACHR, THE COMPLETE GUIDE TO WEALTH PRESERVATION AND ESTATE PLANNING 406–09 (1999).

[36] *Crummey*, 397 F.2d 82, 87–88.

[37] Cristofani v. Comm'r, 97 T.C. 74, 79–84 (1991), *acq. in result*, 1992-1 CB 1, *action on dec.*, 1992-09 (Mar. 23, 1992). In an Action on Decision, the Service announced that it "[would] deny exclusions for powers held by individuals who either have no property interests in the trust except for *Crummey* powers, or hold only contingent remainder interests."*Id.*

[38] Gifts of future interests do not qualify for the gift tax annual exclusion. I.R.C. § 2503(b)(1) (2006).

[39] *Id.* § 2503.

[40] RICHARD B, STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 9.04[3][f] n.118 (8th ed. 2002).

[41] I.R.C. § 2041.

power lapses, that lapse is considered a release of the power under I.R.C. § 2514(e),[42] to the extent that the property subject to the power exceeds the greater of $5,000 or 5% of the aggregate trust property subject to the power.[43] The release of a power may cause the beneficiary to be deemed to have made a gift to the trust in the amount subject to the power of withdrawal.[44] Similar rules, discussed in the next section, apply for estate tax purposes.

3. Overview of Estate Taxation

Estate tax is imposed on the transfer of a decedent's "taxable estate."[45] I.R.C. § 2051 defines the taxable estate as the decedent's "gross estate" minus certain deductions.[46] The gross estate is the value of all of the decedent's property, "real or personal, tangible or intangible, wherever situated."[47] This section highlights three specific rules regarding estate tax inclusion.

First, the value of property in which the decedent had an interest is explicitly included in the decedent's gross estate.[48] Therefore in Hypothetical 3, where X invites Y to X's home to view a famous painting owned by X, if X dies during the viewing, for example, the value of the painting will be included in X's gross estate.[49] This is because X is the owner of the painting at the time of her death. X did not transfer any interest in the painting by inviting Y to view it.[50]

Second, property subject to the decedent's power to "alter, amend, revoke, or terminate" is included in a decedent's gross estate.[51] Therefore, in Hypothetical 6, where X transfers title to the painting to Y, subject to X's right to revoke the transfer, this right of revocation causes the value of the painting to be includible in X's gross estate.[52]

Third, a decedent's gross estate includes property subject to any general power of appointment held by the decedent.[53] Under I.R.C. § 2041(a), a general power of appointment is one that the power holder may exercise in favor of himself or herself, the power holder's estate, the power holder's creditors, or the

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[42] *Id.* § 2514(e).
[43] *Id.*
[44] *See Crummey*, 397 F.2d 82, 87-88; Rev. Rul. 85-88, 1985-2 C.B. 201.
[45] I.R.C. § 2001(a).
[46] *Id.* § 2051.
[47] *Id.* § 2031(a).
[48] *Id.* § 2033.
[49] *Id.*
[50] *See supra* Part III.A.1.
[51] I.R.C. § 2038(a)(1).
[52] *Id.*
[53] *Id.* § 2041(a)(2).

creditors of the power holder's estate, subject to certain limitations.[54] For estate tax purposes, it is irrelevant whether the decedent or another person creates the power of appointment. What matters is whether the decedent has the ability to direct the disposition of the appointive property so as to cause it to be treated for estate tax purposes as if it were owned outright by the decedent. Consider the following example.

> **Hypothetical 8.** X creates a trust for Y. The trust instrument provides in pertinent part that:
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> The Trustee shall manage, invest and reinvest the trust property, collect the income therefrom, and pay over or apply the net income and principal thereof, to such extent, including the whole thereof, and in such manner or manners and at such time or times, as the Trustee, in the exercise of sole and absolute discretion, may deem advisable, to or for the benefit of Y. Any net income not so paid over or applied shall be accumulated and added to principal at least annually and thereafter shall be held, administered and disposed of as a part thereof. Upon the death of Y, the principal of the trust estate, and any net income then remaining in the hands of the Trustee, shall be transferred, conveyed and paid over to such person or persons (including Y, Y's estate, the creditors of Y or creditors of Y's estate), or corporation or corporations to such extent, in such amounts or proportions, and in such lawful interests or estates, whether absolute or in trust, as Y may appoint by last will and testament.

In Hypothetical 8, Y has a testamentary power of appointment insofar as Y may appoint the trust property in his or her Will.[55] Y's power is a general power because Y may appoint the trust property to anyone, including Y, Y's estate, Y's creditors or the creditors of Y's estate. For estate tax purposes Y is treated as if Y owned the property outright.[56]

I.R.C. § 2041(b)(1) contains several exceptions to the definition of a power of appointment.[57] Under that section a power is not a general power of appointment if it is exercisable only in conjunction with the creator of the power or a person having a "substantial interest in the property . . . which is adverse to exercise of the power in favor of the decedent. . . ."[58] Although the definition of a "substantial" interest is somewhat vague—one that has a "value in relation to the total value of

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[54] *See id.* § 2041(b)(1)(A), (C).
[55] *See id.* § 2041(b)(1)(A).
[56] *See id.* § 2041(a)(3).
[57] *Id.* § 2041(b)(1).
[58] *Id.* § 2041(b)(1) (C)(iii).

the property subject to the power [that] is not insignificant"[59]—the meaning of "adverse" is clear. Examples of adverse interest holders include a taker in default of the exercise of a power and a co-holder of a power where the co-holder may appoint the trust property after the decedent's death in favor of the co-holder, the co-holder's estate, the co-holder's creditors, or the creditors of the co-holder's estate.[60] The gift tax rules are similar.[61]

After totaling all of the amounts that are included in a decedent's gross estate, to determine the value of the taxable estate, one must deduct all of the permitted items.[62] The most common deductions from the taxable estate include the value of property passing from a decedent to his or her surviving spouse[63] and contributions to or for the use of public, charitable and religious organizations.[64]

B. Why a Power of Attorney Does Not Give Rise to Wealth Transfer Taxation

If gift tax is imposed on completed transfers by gift,[65] and estate tax is imposed on the value of a decedent's gross estate,[66] one must query whether the execution of a power of attorney could give rise to a taxable gift or cause property subject to the power to be included in the agent's gross estate. If X creates a presently exercisable general durable power of attorney in favor of Y, has X made a taxable transfer to Y? If the transfer of property subject to a power holder's right to withdraw is treated the same for gift tax purposes as an outright transfer of property, then why does the principal not make a taxable gift to the agent upon execution of the power of attorney?

On the question of whether a power of attorney gives rise to a transfer, it would appear that the answer is no. After X executes a power of attorney, X is still the sole legal owner of her bank accounts, real estate and other property. As a technical matter, it is true that under the power of attorney Y has the legal ability to sell, exchange, consume or otherwise dispose of the property subject to the power. But Y *as agent* merely has certain authorities over that property. X has not *transferred* any property to Y.

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[59] Treas. Reg. § 20.2041-3(c)(2) (as amended in 1997).

[60] *Id.*

[61] *See id.* § 25.2514-3(b)(1), (2).

[62] *See* I.R.C. §§ 2051–2057.

[63] *Id.* § 2056(a) (noting that this amount may be deducted to the extent that such interest is included in the value of the gross estate).

[64] *Id.* § 2055(a)(1)-(4).

[65] *Id.* § 2001(a).

[66] *See supra* Part III.A.3.

Consider, however, the complex situation that can arise when under applicable state law or the express terms of the power of attorney itself, the agent has the ability to appoint the principal's property to the agent himself, his creditors, the agent's estate or the creditors of the agent's estate. This would seem to be the precise type of power over property that the gift and estate tax rules should make subject to the wealth transfer tax. On the one hand it could be argued that a mentally competent principal's ability to revoke the power of attorney should prevent the mere execution of a power of appointment from being treated as a completed transfer. Therefore the execution of the power would not give rise to a gift tax. If, however, the agent has the power to appoint the trust property by making gifts to himself, for example, then once the agent has done so, it would appear that the transfer to the agent (by the agent himself) becomes complete. Assuming the principal has no right to reverse a transfer if made within the scope of the agent's authority, then the principal's right of revocation alone does not prevent a taxable transfer in this case.

If a principal's ability to revoke the power, standing alone, may not be sufficient to prevent the imposition of a transfer tax on the creation of a power of appointment,[67] then two further intertwined explanations should round out the analysis. First, the agent is limited by his or her fiduciary duties to the principal to expend the property subject to the power only for the benefit of the principal.[68] For example, when X grants Y a presently exercisable general durable power of appointment with respect to X's bank account containing $1,000,000, then Y has the ability to withdraw the $1,000,000 from the account, but only for the benefit of X or if consistent with X's intent. Y may not go out and buy himself a bright red Ferrari, for example, without a specific indication that X intends Y to have that ability. Additionally an agent must "obey all reasonable instructions and directions from the principal regarding the manner of performing his or her services under the power of attorney."[69] At least one commentator has speculated that an agent's fiduciary duty could be construed to include the requirement to seek the principal's advance consent before exercising any power.[70] If this were true, then an agent under a power of attorney resembles a holder of a power of appointment who may not exercise his or her authority without the consent of another person. Under I.R.C. §§ 2041(b)(1)(C) and 2514(c)(3) an attorney-in-fact would fall explicitly outside the definition of a power of appointment.[71] Therefore, if one construes an agent's duties to require at least the implicit consent of the principal, if not her

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[67] Peter B. Tiernan, *Power of Attorney Can Inadvertently Swell Agent's Taxable Estate*, 72 PRAC. TAX STRATEGIES 4, 5 (2004).

[68] *See* RESTATEMENT (FIRST) OF AGENCY § 13 cmt. a (1933).

[69] Tiernan, *supra* note 67, at 6; *see also* 3 AM. JUR. 2D *Agency* § 218 (2002) (explaining that the agent has a duty of reasonable care with regards to safekeeping the principal's property).

[70] Tiernan, *supra* note 67, at 6.

[71] *See* I.R.C. §§ 2041(b)(1)(C), 2514(c)(3).

explicit consent, then the agent should not possess a power of appointment that would cause the property subject to the power to be subject to any wealth transfer taxes.

Construing an agent's authorities under a power of attorney to require the principal's implied or express consent interprets fiduciary duty in a tax-sensitive way. The Service,however, has not been consistently receptive to the argument that fiduciary duty functions as a meaningful limitation for wealth-transfer tax purposes. In several important cases, the Service has rejected fiduciary duty as either ineffective or illusory.

C. The Impact of Fiduciary Duty in Other Transfer Tax Contexts

The argument that fiduciary duty, however construed, limits an agent's actions under a power of attorney is particularly curious in light of the Service's position that fiduciary duty is not a meaningful constraint in some other gift and estate tax contexts. This section describes the development of the Service's position that fiduciary duty can be ignored for wealth-transfer tax purposes and suggests why that position should not apply to contracts for intimacy in the form of powers of attorney.

1. Background

In *United States v. Byrum,* the taxpayer transferred his stock in three closely held corporations to an irrevocable trust for the benefit of his descendants with a third-party bank acting as corporate trustee.[72] The corporate trustee had broad control over the trust property except that Mr. Byrum retained the right to vote any non-publicly traded shares held by the trust, to veto the sale, transfer, investment or reinvestment of trust assets and to remove the corporate trustee and appoint a successor trustee in its place.[73] Upon Mr. Byrum's death the Service sought to include in his gross estate under I.R.C. § 2036(a)(2) the value of the stock transferred to the trust.[74] The Service reasoned that the decedent retained the right to designate the beneficial enjoyment of the property.[75] The court rejected this argument, however, finding that whatever powers Mr. Byrum retained, they were not granted to him under the trust instrument itself.[76] Rather, to the extent that Mr. Byrum had any powers with respect to distributions of corporate income, they

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[72] 408 U.S. 125, 126 (1972), *reh'g denied*, 409 U.S. 898 (1972).
[73] *Id.* at 126-27.
[74] *Id.* at 131-32.
[75] *Id.* at 132.
[76] *Id.* at 132-33.

arose out of his position as a majority shareholder (because, as such, he could control the Board of Directors).[77] According to the court, Mr. Byrum was bound by his fiduciary duty as a majority shareholder "not to misuse his power by promoting his personal interests at the expense of corporate interests."[78] Furthermore, the court noted that the Directors themselves had "a fiduciary duty to promote the interests of the corporation. However great Byrum's influence may have been with the corporate directors, their legal responsibilities were to all stockholders."[79] Therefore for estate tax purposes, two levels of fiduciary constraints effectively limited Mr. Byrum's control over the transferred property.

In deciding *Byrum*, the court cited several cases in support of its holding. Two of these cases provide particular insight into the court's construction of the limitations that fiduciary duty imposes on the exercise of any rights a taxpayer may retain. For example, the *Byrum* court cited *Reinecke v. Northern Trust Co.*[80] for the proposition that "a settlor's retention of broad powers of management does not necessarily subject an *inter vivos* trust to the federal estate tax."[81] In *Reinecke*, the representative of the decedent's estate brought suit for recovery of estate tax paid with respect to certain trusts, created by the decedent during his lifetime.[82] In the case of five of those trusts, the decedent retained the right to "supervise the reinvestment of trust funds, to require the trustee to execute proxies, to his nominee, to vote any shares of stock held by the trustee, to control all leases executed by the trustee, and to appoint successor trustees."[83] The *Reinecke* court held that these powers were not sufficient to cause estate tax inclusion of the assets of any of the five trusts, reasoning that in no way had "the reserved powers of management of the trusts saved to [the] decedent any control over the economic benefits or enjoyment of the property."[84]

In *Estate of King v. Commissioner*,[85] also cited by the *Byrum* court, the decedent created three trusts, one for each of his three children.[86] Each child had the right to receive income from his or her respective trust; upon the death of the child, the trust principal was to be paid out to the children's children.[87] The decedent as grantor expressly prohibited the trustee from making any management or investment decisions except as directed by the grantor himself.[88] The Service

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[77] *Id.* at 136-37.
[78] *Id.* at 137.
[79] *Id.* at 138.
[80] 278 U.S. 339 (1929).
[81] *Byrum*, 408 U.S. at 133.
[82] *See Reinecke*, 278 U.S. 339, 343–344.
[83] *Id.* at 344.
[84] *Id.* at 346.
[85] Estate of King v. Comm'r, 37 T.C. 973 (1962).
[86] *See id.* at 974.
[87] *Id.* at 974.
[88] *Id.* at 975–76.

argued that the decedent's retained right to direct the trustee with respect to management and investment of trust assets caused the inclusion of the trust property in the grantor's gross estate under I.R.C. § 2036(a)(2).[89] The estate countered that the decedent's powers were "exercisable only in a fiduciary capacity, subject to the scrutiny of a court of equity; that . . . the grantor was under a duty to act impartially as between successive beneficiaries; [and] that, therefore, he did not retain any right to designate the persons who should possess or enjoy the property or the income therefrom."[90] Finding in favor of the taxpayer, the tax court stated that the grantor's retained power had the legal effect of making the grantor a trustee, but in doing so "he had subjected himself to those obligations of fidelity and diligence that attach to the office of trustee. . . . His discretion, however broad, did not relieve him from obedience to the great principles of equity which are the life of every trust."[91] Therefore, for estate tax purposes, the fiduciary obligations imposed on a trustee acted as effective constraints on the rights retained by the grantor.

In the years following *Byrum*, courts continued to find that fiduciary duty operated as a meaningful limitation on taxpayers' retained rights. In *Lewis G. Hutchens Non-Marital Trust v. Comm'r*,[92] the Service asserted a gift tax deficiency against the decedent's estate, on the grounds that the decedent had undervalued certain transfers to his children of stock in the family business.[93] The decedent and his wife were majority shareholders of the business, who, the Service reasoned, had the ability to control the dividends paid with respect to the stock; by failing to declare dividends, the value of the stock increased.[94] According to the Service, that increase in value constituted an additional taxable gift to the decedent's children.[95] The Tax Court disagreed.[96] In finding for the taxpayer the court held that the decedent's and his wife's fiduciary duties as majority shareholders prohibited them from promoting their personal interests over the corporation's.[97] Furthermore the court found the decision not to declare dividends was in the interest of the

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[89] *Id.* at 978.

[90] *Id.* at 979.

[91] *Id.* (quoting Carrier v. Carrier, 123 N.E. 135 (N.Y. 1919)) (internal quotations omitted). The court in King relied on *Carrier v. Carrier*, 123 N.E. 135 (N.Y. 1919), in reaching its decision. *Id.*

[92] 66 T.C.M. (CCH) 1599 (1993).

[93] *See id.* at 1617–18.

[94] *See id.* at 1602–07, 1618–20.

[95] *See id.* at 1625.

[96] *Id.*

[97] *See id.* at 1619 (citing *United States v. Byrum*, 408 U.S. 125, 137-38 (1972), *reh'g denied*, 409 U.S. 898 (1972).

corporation because it allowed the company to retain working capital for other needs.[98]

In *Daniels v. Commissioner of Internal Revenue*,[99] which was decided in 1994, the taxpayers moved for summary judgment in response to the Service's assertion of an alleged gift tax deficiency.[100] As in *Hutchens*, the Service argued that the failure to declare and pay corporate dividends constituted a taxable gift by the taxpayers to their children, who were owners of the corporation's common stock.[101] The Tax Court granted the taxpayers' motion for summary judgment, finding that the failure to declare and pay dividends did not constitute a gift to the other stockholders.[102] The court referred specifically to both *Byrum* and *Hutchens*.[103] Just as the *Byrum* and the *Hutchens* courts did, the *Daniels* court recognized the vitality of fiduciary limitations imposed on the taxpayers as members of the corporation's board of directors.[104] Furthermore, the *Daniels* court added, the taxpayers had valid business reasons for the nonpayment of dividends, so their actions were in the best interests of the corporation.[105]

2. *The Continuing Vitality of Fiduciary Duty*

In 1976 Congress responded to *Byrum* by passing an addition to I.R.C. § 2036[106] that became I.R.C. § 2036(b) in 1978.[107] Under that section, a transferor's estate includes the value of any shares of stock in a "controlled corporation" with respect to which the transferor retained the right to vote those shares.[108] The retained right to vote the shares is deemed to be a retained right to enjoy the property and therefore a trigger for estate tax inclusion.[109] Under I.R.C. § 2036(b)(2), a controlled corporation is any corporation with respect to which, during "the 3-year period ending on the date of the decedent's death, the decedent [or certain members of the decedent's] family owned . . . , or had the right . . . to

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[98] *See id.* at 1618–20.

[99] 68 T.C.M. (CCH) 1310 (1994).

[100] *See id.* at 1310.

[101] *See id.* at 1313; *see also Hutchens*, 66 T.C.M. (CCH) at 1618–20.

[102] *See Daniels*, 68 T.C.M. (CCH) at 1320.

[103] *See id.* at 1319.

[104] *Id.*

[105] *See id.* at 1320.

[106] Tax Reform Act of 1976, Pub. L. No. 94-455, §. 2009(a), 90 Stat. 1520. The proposed legislation added one sentence to I.R.C. § 2036. *Id.*

[107] Revenue Act of 1978, Pub. L. No. 95-600, § 702(i), 92 Stat. 2763, 2931, *reprinted in* 1978-3 C.B. (Vo. 1) 1, 165. This new section 2036(b) was effective with respect to transfers made after June 22, 1976, the effective date of the 1976 legislation's rule. *Id.* § 702(i)(3).

[108] I.R.C. § 2036(b) (2006).

[109] *Id.* § 2036(b)(1).

vote. . . at least 20 percent of the total combined voting power of all classes of [the corporation's] stock."[110] Scholars and practitioners typically refer to this as the "anti-*Byrum*" rule.[111]

At least one scholar has suggested that the language of I.R.C. § 2036(b) "does not impact the Supreme Court's analysis of fiduciary duty as set forth in *Byrum*."[112] Although literally true, the House Committee explained that, "[T]he voting rights are so significant with respect to corporate stock that the retention of voting rights by a donor should be treated as the retention of the enjoyment of the stock" for estate tax purposes.[113] The committee added that such treatment "is necessary to prevent the avoidance of the estate and gift taxes" and that "the capacity in which the decedent exercised the voting rights is immaterial."[114]

In one of the most significant fiduciary duty cases since *Byrum*, the United States Tax Court ruled in *Estate of Strangi v. Commissioner of Internal Revenue*[115] that the value of property transferred by a decedent during his lifetime to a family limited partnership was includible in the decedent's gross estate under I.R.C. § 2036(a).[116] In 1993 Mr. Strangi was diagnosed with a terminal illness.[117] Shortly thereafter, his son-in-law, acting as attorney-in-fact, assumed management of Mr. Strangi's affairs.[118] Approximately two months before Mr. Strangi's death, his attorney-in-fact transferred more than $9 million of Mr. Strangi's property, consisting mostly of cash and marketable securities, as well as Mr. Strangi's personal residence, to a family limited partnership in return for a 99% limited partnership interest.[119] The general partner of the partnership was a corporation

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[110] *Id.* § 2036(b)(2). The family members whose ownership will be attributed to the transferor/decedent for purposes of I.R.C. § 2036 (b) are the decedent's spouse, children, grandchildren, parents and certain partnerships, estates, trusts and corporations owned by any of the foregoing. *Id.* § 318(a)(1)-(3).

[111] Brant J. Hellwig, *Revisiting Byrum*, 23 VA. TAX REV. 275, 326 (2003).

[112] Elaine Hightower Gagliardi, *Economic Substance in the Context of the Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 MONT. L. REV. 389, 409 n.86 (2003).

[113] H.R. REP. NO. 94-1380, at 65 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3419.

[114] *Id.*

[115] 115 T.C. 478 (2000), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002), and *remanded in part*, to Estate of Strangi v. Comm'r., 85 T.C.M. (CCH) 1330 (2003) ("Strangi III"), *aff'd*, 417 F.3d 468, 2005-2 U.S. Tax Cas.

[116] *Id.* at 487–88. For a complete analysis of the *Strangi* case, see Mitchell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153 (2003).

[117] *Strangi*, 115 T.C. at 480.

[118] *Id.*

[119] *Id.* at 480–81.

whose stock was owned 47% by Mr. Strangi and 53% by Mr. Strangi's four children.[120] Mr. Strangi's attorney-in-fact was employed as the corporation's president.[121] The assets transferred to the partnership represented approximately 98% of Mr. Strangi's total wealth.[122] Prior to Mr. Strangi's death, the family limited partnership paid for a variety of Mr. Strangi's personal expenses, which included his home health care.[123]

The Service asserted a deficiency against Mr. Strangi's estate, alleging estate tax inclusion of the value of the limited partnership interests under I.R.C. 2036(a)(1) because Mr. Strangi retained the right to enjoyment of the property.[124] The Service also asserted estate tax inclusion under I.R.C. § 2036(s)(2) on the grounds that Mr. Strangi retained the right to designate enjoyment of the transferred property.[125] The tax court ruled in favor of the Service on both claims.[126]

The tax court first reasoned that the limited partnership interests were included in Mr. Strangi's gross estate because he impliedly retained "economic benefit" from the partnership.[127] The court cited the fact that Mr. Strangi transferred 98% of his wealth to the limited partnership, that he remained in his personal residence after transferring it to the partnership, and that distributions from the partnership had been made for Mr. Strangi's personal expenses.[128]

The tax court next reasoned that Mr. Strangi, in his capacity as a member of the Board of Directors of the corporate general partner, effectively retained the right to designate the enjoyment of the partnership property because he could join with the other directors to direct or withhold distributions from the partnership.[129] In other words, because of the managerial authority granted to the corporate general partner, the Tax Court found that the "decedent can act together with other [corporate] shareholders essentially to revoke the [limited partnership arrangement] and thereby to bring about or accelerate present enjoyment of the partnership assets."[130]

In response to the estate's assertion that a corporate shareholder's fiduciary duty would prevent him from joining with the other directors to revoke the partnership agreement, the tax court distinguished the *Strangi* facts from *Byrum*.[131]

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[120] *Id.* at 481.
[121] *Id.*
[122] *See id.*
[123] *Id.* at 482.
[124] *See id.* at 483, 487.
[125] *See id.*
[126] *See* Estate of Strangi v. Comm'r., 85 T.C.M. (CCH) 1331, 1335–45 (2003).
[127] *Id.* at 1337–38.
[128] *Id.* at 1338.
[129] *Id.* at 1340–41.
[130] *Id.* at 1341.
[131] *Id.* at 1342.

The tax court noted that in *Byrum,* an "independent trustee . . . alone had the ability to determine distributions from the disputed trust, notwithstanding any prior action by corporate owners or directors."[132] Furthermore, the court stated that the "dual roles" played by Mr. Strangi's attorney-in-fact, as corporate manager and attorney-in-fact for one of the shareholders, compromised any fiduciary duty.[133] Unlike in *Byrum,* the alleged fiduciary duties in the *Strangi* case were substantively limited, insofar as the fiduciary did not owe duties to "a significant number of unrelated parties" and the asserted duties had no origin in "operating businesses that would lend meaning to the standard of acting in the best interests of the entity."[134] The court stated that "[t]he rights to designate [the transferred property] traceable to decedent through [the corporate general partner] cannot be characterized as limited in any meaningful way by duties owed essentially to himself. . . . Intrafamily fiduciary duties within an investment vehicle are not equivalent in nature to the obligations created" in *Byrum.*[135]

It is important to note that in *Strangi*, the tax court, affirmed by the Court of Appeals for the Fifth Circuit, acknowledged that fiduciary duty may have some meaning for estate tax purposes.[136] But in *Strangi*, the tax court cited two facts as precluding the finding that fiduciary duty was a meaningful limitation in that case. First, any such duty would have run to Mr. Strangi himself as limited partner.[137] Second, the limited partnership was an investment vehicle, not an operating business.[138] The court left open the possibility that, with different facts before it, fiduciary duties might constitute meaningful limitations for estate tax purposes.[139]

The power of attorney presents the ideal scenario for the estate and gift tax recognition of fiduciary duties. Such contracts for intimacy arise for largely non-tax motives, such as planning for one's subsequent incapacity[140] and delegating legal authority to another to engage in a particular transaction, as in Hypothetical 1 discussed in Part II B. Therefore, like in *Byrum* and unlike in *Strangi*, the duties of an agent to a principal have legal and tax significance. The Uniform Power of Attorney Act, passed by the National Conference of Commissioners on Uniform State Laws on July 13, 2006 (the "2006 Act")[141] and discussed in the next part, is consistent with this construction of the agent as the principal's fiduciary.[142]

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[132] *Id.*
[133] *Id.*
[134] *Id.*
[135] *Id.* at 1343.
[136] *See id.* at 1342–43.
[137] *Id.*
[138] *Id.*
[139] *See id.* at 1343.
[140] *See supra* Part II.B.
[141] *See* UNIF. POWER OF ATT'Y ACT (amended 2006), 8B U.L.A. 24 (Supp. 2008); *see*

IV. PROTECTING LEGAL AVATARS

A. Overview of the Uniform Durable Power of Attorney Act

The 2006 Act provides default rules applicable to powers of attorney and recommends the use of a simple statutory form of power.[143] The 2006 Act improves on prior versions of uniform statutes concerning durable powers of attorney, namely portions of the Uniform Probate Code of 1969[144] and the Uniform Durable Power of Attorney Act of 1979, as amended through 1987.[145] As of the late 1980s,[146] some version of a uniform act had been adopted in a majority of states, albeit with significant variations between and among them.[147]

In its survey of a national group of probate and elder law attorneys, the National Conference of Commissioners found six main divergences among state laws: "1) the authority of multiple agents; 2) the authority of a later-appointed fiduciary or guardian; 3) the impact of dissolution or annulment of the principal's marriage to the agent; 4) activation of contingent powers; 5) the authority to make gifts; and 6) standards for agent conduct and liability."[148] The survey revealed that practitioners had substantial consensus about what constituted "best practices" with respect to powers of attorney, such as whether the grant of a power should include gift-giving authority (not unless the power expressly stated), what standard of care an agent owes to the principal (a fiduciary duty), and what safeguards are necessary to prevent abuse of the power of attorney (many).[149]

The 2006 Act regularizes the power of attorney in many ways. The presumption of a power of attorney's durability is one of the most important

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also Press Release, National Conference of Commissioners on Uniform State Laws, New Act Updates the Rules on Powers of Attorney (July 13, 2006), *available at* http://www.nccusl.org/Update/DesktopModules/NewsDisplay.aspx?ItemID=159.

[142] *But see* Boxx, *supra* note 4; Carolyn L. Dessin, *Acting as Agent Under a Financial Durable Power of Attorney: An Unscripted Role*, 75 NEB. L. REV. 574 (1996).

[143] *See* Uniform Power of Attorney Act Summary, *supra* note 12.

[144] *See* UNIF. PROBATE CODE §§ 5-501–505 (amended 1975), 8 U.L.A. 419–24 (1998).

[145] *See* UNIF. DURABLE POWER OF ATT'Y ACT §§ 1–9 (amended 1987), 8A U.L.A. 246–59 (1998).

[146] The National Conference of Commissioners on Uniform State Laws began its study of professional opinion in 2002. Uniform Power of Attorney Act Summary, *supra* note 12, at 1.

[147] *See* UNIF. POWER OF ATT'Y ACT, *supra* note 1, at 22–23 (prefatory note); *see also* William P. LaPiana, *The New Uniform Power of Attorney Act*, http://www.abanet.org/rppt/publications/estate/2004/2/UPOAA-LaPiana.pdf (last visited Sept. 30, 2008).

[148] *See* UNIF. POWER OF ATT'Y ACT 22 (amended 2006), 8B U.L.A. 27 (Supp. 2007) (prefatory note).

[149] *Id.* at 22–23.

changes.[150] Previously the reverse assumption applied; silence meant that the power terminated upon the principal's incapacity. A principal was required to specify if he or she wanted the agent's authority to continue beyond the principal's incapacity or incompetence.[151] Under the 2006 Act, a power is presumed to be presently exercisable "unless the principal provides in the power of attorney that it is to become effective at a future date or upon the occurrence of a future event or contingency."[152] The 2006 Act provides a model statutory form of power of attorney[153] in an effort to regularize the substantive content of these instruments and the procedures for their execution.[154] The 2006 Act attempts to address "the problem of persons that refuse to accept an agent's authority."[155] Specifically section 119 provides that a party who accepts a power of attorney in good faith will be protected from liability as long as he or she has no actual knowledge that the power of attorney has been revoked or terminated.[156] Section 120 provides for the imposition of financial and other penalties against a person who "unreasonably refuses" to accept a power of attorney.[157] A person's refusal is not unreasonable if he or she has actual knowledge of the revocation of the power of attorney[158] or the person has a reasonable belief that the offered power is invalid.[159]

In addition to rules designed to enhance the creation and use of powers of attorney, the 2006 Act specifically addresses the six noted sources of divergence among state laws.[160] With respect to the authority of multiple agents, section 111 of the 2006 Uniform Act provides that "[u]nless the power of attorney otherwise provides, each coagent may exercise its authority independently."[161] A successor agent who survives the death or resignation of his or her co-agents may continue to serve as sole agent.[162] The principal also has the ability to nominate successor agents who will have the same of authorities as the original agent.[163] The powers

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[150] *Id.* § 104.
[151] *Id.*
[152] *Id.* § 109(a).
[153] *Id.* §§ 301–302 (Article 3).
[154] The form power of attorney contemplates that the principal will initial the powers that he or she wishes to grant to the agent. *See id.*
[155] *Id.* at 23 (prefatory note).
[156] *Id.* § 119(b)–(c).
[157] *Id.* § 120.
[158] *Id.* § 120(b)(3).
[159] *Id.* § 120(b)(5).
[160] *See supra* note 156, at 125 and accompanying text.
[161] UNIF. POWER OF ATT'Y ACT § 111(a).
[162] *Id.* § 111(b)(2).
[163] *Id.* § 111(a)(2).
[163] *Id.* § 111(b).

granted to an agent either may be enumerated or a principal may incorporate them by reference to the 2006 Act.[164]

The 2006 Act clarifies the circumstances under which an agent's authorities commence and terminate. Under section 109, a power becomes effective immediately upon execution[165] and its durability shall continue unless it expressly provides that the power terminates upon the incapacity of the principal.[166] An agent's authority predictably terminates upon the principal's death,[167] revocation by the principal,[168] or termination pursuant to the terms of the instrument itself.[169] An agent's authority also will terminate if "an action is filed for the [dissolution] or annulment of the agent's marriage to the principal or their legal separation, unless the power of attorney otherwise provides."[170] Unless one of those circumstances exists, mere lapse of time does not cause the power to expire. The length of time between the date of the execution of the power and the agent's exercise of his or her authority has no relevance.[171] A power of attorney does not become "stale" by virtue of the passage of time alone.[172]

The principal expressly must grant (or restrict) certain of an agent's powers.[173] For example, in order to avoid negative tax consequences for an agent who is an ancestor, spouse, or a descendent of the principal, or a person whom the principal is legally obligated to support, that agent shall not have the right to transfer to himself or herself any interest in the principal's property, "whether by gift, right of survivorship, beneficiary designation, disclaimer, or otherwise."[174] Similarly, for an agent to have the ability to create trusts, make gifts or create property rights in others, the principal must expressly authorize the agent to do so.[175] Otherwise the 2006 Act provides that the execution of a power of attorney grants broad authorities to an agent with respect to the principal's real property;[176] tangible personal property;[177] stocks and bonds;[178] commodities and options;[179] banking and

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[164] *See id.* § 202.
[165] *Id.* §109(a).
[166] *See id.* § 109(c). The purpose of this change is to "reflect[] the view that most principals preferred their powers of attorney to be durable rather than nondurable." *Id.* at 2.
[167] *Id.* §110(a)(1).
[168] *Id.* § 110(a)(3).
[169] *Id.* § 110(a)(4).
[170] *Id.* §110(b)(3) (alteration in original).
[171] *Id.* § 110(c).
[172] *Id.*
[173] *See id.* § 201(a)–(c).
[174] *Id.* § 201(b).
[175] *Id.* § 201(a)(1)–(a)(2).
[176] *Id.* § 204.
[177] *Id.* § 205.
[178] *Id.* § 206.
[179] *Id.* § 207.

other financial transactions;[180] operation of an entity or business;[181] insurance and annuities;[182] estates, trusts, and other beneficial interests;[183] claims and litigation;[184] personal and family maintenance;[185] benefits from governmental programs;[186] retirement plans;[187] and taxes.[188] A principal may incorporate all of those powers by reference to grant an agent a wide range of authorities.[189]

For tax purposes, the Service takes the position that gifts made under a power of attorney are revocable by the principal.[190] Whether an agent under a power of attorney has the ability to make gifts of the principal's property has been the source of significant litigation.[191] Some courts have found that a broad grant of authority includes the ability of the agent to make gifts,[192] but other precedent suggests that gift-giving authority must be granted specifically.[193] Therefore the best practice is for a principal to state specifically whether the agent may make gifts of the principal's property.[194]

If an agent has the ability to make gifts, whether as a matter of state law or under the terms of the durable power of attorney, some courts (and the Service) take the view that the agent has no ability to make such gifts to himself or herself.[195] The 2006 Act attempts to "strike[] a balance between the need for

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[180] *Id.* at § 208.
[181] *Id.* at § 209.
[182] *Id.* § 210.
[183] *Id.* at § 211.
[184] *Id.* at § 212.
[185] *Id.* § 213.
[186] *Id.* § 214.
[187] *Id.* § 215.
[188] *Id.* § 216.
[189] *Id.* § 203.
[190] Estate of Casey v. Comm'r, 948 F.2d 895, 896 (4th Cir. 1991).
[191] In the absence of a specific grant of a gift-giving authority, courts often turn to state law for a determination of whether silence in a power of attorney includes the ability to make gifts. *See, e.g.*, Estate of Ridenour v. Comm'r, 65 T.C.M. (CCH) 1850, 1850-51 (1993) (applying Virginia law to gifts made by attorney-in-fact).
[192] *See id.*
[193] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 950934 (Dec. 4, 1995) (stating that a power of attorney must expressly grant gift-giving authority to agent). *But see Ridenour*, 65 T.C.M. at *8 (holding that attorney-in-fact had power to grant gifts "in accordance with decedent's personal lifetime gift-giving history" under Virginia law).
[194] *See* MYRON KOVE & JAMES M. KOSAKOW, 1 HANDLING FEDERAL ESTATE & GIFT TAXES § 2:160 (6th ed. 2008) ("The power of attorney should be durable so that it survives the principal's incompetency, and should contain a specific power authorizing gifts to family members").
[195] *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 314 (1958).

flexibility and acceptance of an agent's authority and the need to prevent . . . abuse."[196] Section 217 contains three significant provisions that apply to an agent who has been granted a broad gift-giving authority. First, the agent may make an unlimited number of annual exclusion gifts, so long as the value of each gift does not exceed the per-donee limit established by I.R.C. § 2503(b)(1).[197] Second, those gifts may be made outright or in trust or to a college tuition savings program under I.R.C. § 529.[198] Finally, all gifts by an agent must be "consistent with the principal's objectives if actually known by the agent and, if unknown, as the agent determines is consistent with the principal's best interest based on all relevant factors."[199] Therefore the 2006 Act creates boundaries that limit the power of an agent who is generally authorized by a power of attorney to make gifts.[200] In all cases an agent is required to act consistently with the principal's known objectives or best interests.[201] In other parts of the 2006 Act, this standard for decision making is more fully articulated as a fiduciary duty, as discussed in the next section.

B. Agents as Fiduciaries Under the Durable Power of Attorney Act

Generally speaking, fiduciary duty arises out of the constellation of the "duties of loyalty, prudence, and a host of subsidiary rules that reinforce the duties of loyalty and prudence."[202] In 1927, Justice Benjamin Cardozo, Chief Judge of the New York Court of Appeals, famously described fiduciary duty as a standard "stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[203] A fiduciary is a person with responsibilities to others and whose behavior is held to the highest standard.

Consider a trustee of a lifetime or a testamentary trust. The trustee's duty of loyalty requires the trustee to administer the trust assets for the benefit of the

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[196] UNIF. POWER OF ATT'Y ACT 2 (amended 2006), 8B U.L.A. 27 (Supp. 2007) (prefatory note).

[197] *Id.* § 217(b)(1). The provision for excluding gifts from taxable income is set forth at I.R.C. § 2503(b)(1) (2000). Originally the exclusion amount was $10,000 but was adjusted to $12,000 beginning in the 2006 tax year. *See* Rev. Proc. 2005-70, 2005-2 C.B. 979, 984.

[198] *See* UNIF. POWER OF ATT'Y ACT § 217(a).

[199] *Id.* § 217(a).

[200] *See id.* § 217. Note however that a power of attorney can provide the agent with greater powers. *Id.* § 217(b) (stating that the boundaries of the act apply "[u]nless the power of attorney otherwise provides").

[201] *Id.* § 217(c).

[202] JESSE DUKEMINIER ET AL., WILLS, TRUSTS, AND ESTATES 772 (7th ed. 2005) (emphasis omitted).

[203] Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

beneficiaries alone.[204] Without court approval, the trustee may not buy trust assets or sell them to himself, borrow trust funds, loan funds to the trust, profit (except through compensation) from serving as trustee, commingle the trustee's and trust assets, or indirectly engage in any of the foregoing.[205] Similarly the duty of prudence[206] requires a trustee to act in accordance with "the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another."[207]

The 2006 Act imposes most of the traditional duties of a fiduciary (such as trustee) on an agent acting under a power of attorney.[208] Section 114(b) of the 2006 Act enumerates nine specific duties,[209] each of which can be characterized as a duty of loyalty, a duty of prudence, or a derivative thereof. First in the list is the agent's duty to act "loyally for the principal's benefit."[210] The agent must act within the scope of the authority granted to him or her[211] and in a manner that is "in accordance with the principal's reasonable expectations," if known, or if not, then in the principal's "best interest."[212] The agent may not create a conflict of interest that would prevent the agent from acting in the principal's best interest.[213] The agent must cooperate with any person named as the principal's agent for health-care decision making.[214]

The agent's duty of prudence is articulated as the duty to "act with the care, competence, and diligence ordinarily exercised by agents in similar circumstances."[215] Interestingly, although the 2006 Act refers to the behavior of "agents in similar circumstances" as the touchstone against which an agent will be measured, this standard falls somewhat short of the traditional articulation of the

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[204] *See In re* Gleeson's Will, 124 N.E.2d 624, 627 (Ill. App. Ct. 1955) (describing how trustee's lease of trust land to himself constituted a breach of fiduciary duty); Hartman v. Hartle, 122 A. 615, 615 (N.J. Ch. 1923) (describing how trustee breached fiduciary duty when he purchased estate property in wife's name).

[205] GEORGE GLEASON BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543(rev. 2d ed. 1993 & Supp. 2007).

[206] *See* UNIF. TRUST CODE § 804 (2005).

[207] UNIF. PROB. CODE § 7-302 (1993).

[208] *See generally* UNIF. POWER OF ATTORNEY ACT § 114 (amended 2006), 8B U.L.A. 27 (Supp. 2007) (detailing the fiduciary duties of an agent notwithstanding the provision in the power of attorney).

[209] *Id.* §114(a), (b).

[210] *Id.* § 114(b)(1).

[211] *Id.* § 114(a)(3).

[212] *Id.* § 114(a)(1).

[213] *Id.* § 114(b)(2).

[214] *Id.* § 114(b)(5).

[215] *Id.* § 114(b)(3).

duty of prudence—that is, "the standards in dealing with [property] that would be observed by a prudent man dealing with the property of another."[216] Therefore agents under powers of attorney are compared with other agents, not necessarily the prudent person, although one hopes that the average agent is prudent. If not, the average agent's behavior remains the measurement under the 2006 Act. An agent is required, as part of the duty of prudence, to "attempt to preserve the principal's estate plan," if both known by the agent and "consistent with the principal's best interest."[217] The agent must keep complete records of his or her actions.[218]

Even though the 2006 Act embraces the duties of loyalty, prudence and their derivatives, the 2006 Act also specifically permits the agent to engage in limited self-dealing transactions. An agent under a power of attorney may benefit from a transaction with the principal as long as the agent acts with "care, competence, and diligence for the best interests of the principal."[219] Evaluation of the agent's "care, competence, and diligence" necessarily will take into account the agent's individual skills and expertise.[220] To the extent that an agent is permitted to self deal without court approval at all suggests that the duties of an agent under a durable power of attorney are somewhat less rigorous than a trustee's duties to trust beneficiaries, for example.[221]

From a policy perspective, the somewhat modified fiduciary duty of an agent to a principal under a power of attorney reflects at least in part the uniqueness of the principal-agent relationship. In many cases, the person acting as agent will be a natural object of the principal's bounty. A family member may be chosen as agent, for example, precisely because the principal has a close relationship with him or her. That close relationship, combined with the competent principal's ability to revoke the power of attorney, functions as some protection against an agent's acting in a manner that is inconsistent with the principal's directions or best interests. In the trustee-beneficiary scenario, trust beneficiaries typically have no ability to remove the trustee.[222] Also the trust's grantor, not the beneficiaries, selects the initial trustee, who may be a stranger to the beneficiaries. And even if the initial trustee were a person or institution known to the initial trust beneficiaries, as more time passes, it is less likely that a successor trustee and trust beneficiaries have any personal relationship.

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[216] *See supra* note 207.

[217] UNIF. POWER OF ATT'Y ACT § 114(b)(6).

[218] *Id.* § 114(b)(4).

[219] *Id.* § 114(d).

[220] *Id.* § 114(e).

[221] *See, e.g.*, *In re* Estate of Hegel, 668 N.E.2d 474, 478 (Ohio 1996) (stating that courts are not required to approve acts of agent under power of attorney); *see also supra* notes 72–74 and accompanying text (describing fiduciary duties).

[222] *But see* Stewart E. Sterk, *Trust Protectors, Agency Costs, and Fiduciary Duty*, 27 CARDOZO L. REV. 2761 (2006) (discussing the use of trust protectors to enforce principals' intent).

C. Fiduciary Duties Are Meaningful Limitations for Tax Purposes

Fiduciary duty is the most commonly asserted explanation for why the creation of a durable power of attorney does not give rise to negative wealth transfer tax consequences.[223] Even under a law such as the 2006 Act, which grants an agent the ability to appoint the principal's property to himself or herself,[224] the agent's power is limited to the annual exclusion amount.[225] The agent is constrained by his or her duty of loyalty to the principal from applying the trust property in a manner that is inconsistent with the best interests of the principal.[226] An agent under a power of attorney has a slightly different fiduciary duty from a trustee. That difference arises out of the unique nature of the principal-agent relationship.

Fiduciary duty in the power of attorney context has an estate and gift tax impact that it does not have in other contexts.[227] At its core, a power of attorney is a contract for intimacy. More people have created these contracts for intimacy than have established a trust.[228] According to one survey of adults age 50 and over, 23% of that population have created one or more lifetime trusts,[229] but 45% have executed a durable power of attorney.[230] Among the age 75 to 79 subgroup, about 30% have created a trust[231] but 60% have executed a durable power of attorney.[232]

Contracts for legal intimacy of the principal-agent variety are popular because they are easy to create without a lawyer. In fact, the power of attorney forms that are available in stationery stores and on the internet[233] are often identical to those

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[223] *See supra* Part III.B.

[224] *See supra* Part III.C.

[225] *See supra* note 207 and accompanying text.

[226] *See supra* Part IV.B.

[227] *See supra* Part III.

[228] AARP Research Group, Where There is a Will...: Legal Documents Among the 50+ Population: Findings from an AARP Survey (Apr. 2000), http://assets.aarp.org/rgcenter/econ/will.pdf.

[229] *Id.* at 5.

[230] *Id.*

[231] *Id.* at fig.7.

[232] *Id.* Other commentators estimate that approximately 70 percent of people over the age of seventy have executed powers of attorney. MCGOVERN & KURTZ, *supra* note 10, at 300 (citing Thomas J. Begley, Jr. & Andrew H. Hook, *The Elder Law Durable Power of Attorney*, 29 EST. PLAN. 538 (2002)).

[233] *See, e.g.*, Statutory Durable Power of Attorney Form (listing a variety of powers which may be denied by crossing them out), *available at* http://www.texasprobate.com/forms/poa.htm (last visited July 2, 2008).

used by expensive law firms.[234] Additionally, power of attorney forms, unlike many will and trust forms, require minimal customization. Therefore it is likely that a layperson can prepare and execute a power of attorney form without making legally significant mistakes; problems with will and trust forms, in contrast, give rise to well-known litigation.[235]

Durable powers of attorney are also appealing because they enable a principal to share or delegate power over his or her property without relinquishing full control over it. For those who are reluctant to acknowledge that they have lost the interest, ability, or energy to manage their property, the power of attorney may be a particularly desirable arrangement. Unlike a court-appointed guardianship, a contract for intimacy is a private arrangement that need be known only to the principal, agent, and the person requested to accept the durable power of attorney as evidence of the agent's authority. The contract for intimacy allows for a level of privacy that a guardianship does not.

V. THE FUTURE OF LEGAL AVATARS

A. For Taxpayers with Limited Traditional Family Ties

The 2006 Act standardizes the contract for legal intimacy that arises between a principal and agent under a durable power of attorney.[236] The 2006 Act clearly defines the agent's duties to the principal. From a business perspective, one can anticipate a shift in the practices of certain banks and trust companies. Just as some institutions now offer professional executor or trustee services, these institutions could expand their fiduciary business to include professional attorney-in-fact services. This potential shift to a commodified, professional fiduciary relationship would have no impact on the very rich (who can pay a bank or trust company to act in this capacity) or the very poor (who will not be able to afford professional fiduciary services at any cost). The United States middle class, however, may benefit from being able to obtain professional fiduciary services at a standardized rate.

Many Americans live more than two hours from their closest family members. These people would be the target market for professional fiduciary services under a power of attorney. Even those who do live close to family members may prefer a professional fiduciary; not everyone has a trusted family member who is willing and able to take care of his or her financial and personal matters. The divorce rate for first marriages hovered at 3.6 per 1,000 of the

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[234] *See supra* note 6.

[235] *See, e.g.*, *In re* Estate of Mulkins, 496 P.2d 605, 607 (Ariz. Ct. App. 1972) (holding that the text of the will form itself was "surplusage," but that the remainder formed a valid holographic will).

[236] *See supra* Part IV.A.

population in 2005.[237] Marriage rates occur at a rate of 7.5 per 1,000 of the total population.[238] Of the 105.5 million households surveyed in the 2000 Census, 68.1% were "family households" (households containing at least one person related to the head of household by birth, marriage or adoption).[239] 31.9% were "non-family households" (not containing at least one person related to the head of the household by birth marriage or adoption).[240] More and more often people live far away from family members; they live alone or with others to whom they are bound together by affective ties, but not genetic or legal ones.

B. For Taxpayers of Varying Levels of Wealth

The regularization of the principal-agent relationship by the 2006 Act may lead to its commodification. If so, then those who do not have a family member or close associate willing or able to fulfill that function will be able to engage a professional to do so at presumably competitive prices. Four factors would encourage positive performances by a professional agent at a relatively low cost. First, there are very low barriers to entry. One need not have specialized training or knowledge to act as an agent under a power of attorney. Second, a professional fiduciary will want to maintain a good reputation in the community, or risk losing existing business. Third, a professional fiduciary will want to enhance his, her or its good reputation in the community in order to increase business. If a professional fiduciary abuses his, her or its authority under a power of attorney, the fiduciary will have difficulty maintaining existing business and attracting new business. Fourth, a professional fiduciary has an incentive to act within the scope of its authority because it will be a repeat player who both proffers and receives powers of attorney in the financial marketplace.

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[237] BIRTH, MARRIAGES, DIVORCES, AND DEATHS: PROVISIONAL DATA FOR 2005, NAT'L. VITAL STATISTICS REPORT 54 (2) (July 21, 2006), http://www.cdc.gov/nchs/data/nvsr/nvsr54/nvsr54_20.pdf.

[238] *Id.*

[239] Tavia Simmons and Grace O'Neill, Households and Families: 2000 Census Brief (Sept. 2001), Table 1, http://www.census.gov/prod/2001pubs/c2kbr01-8.pdf.

[240] *Id.*

To illustrate, consider two neighborhood banks, Bank X and Bank Y, both of which offer professional services as agents under powers of attorney. Bank X will want to act within the scope of its authority under a power of attorney presented to Bank Y, for example, because Bank X will want Bank Y to act similarly with respect to any power of attorney presented to Bank X. Furthermore, if Bank X imposes significant transaction costs (such as delay) every time Bank Y presents a power of attorney, then Bank Y will impose significant transaction costs every time Bank X presents a power of attorney. Neither would be able to carry out its duties in a timely fashion. Market incentives would encourage the two banks to act appropriately.

As a practical matter, however, professional fiduciaries may not appeal even to taxpayers who can afford them. A professional might do a "better" job as agent than would a friend or family member, but a professional fiduciary might feel less obligated to act in conformity with a principal's previously expressed wishes or unique needs. Acting as agent will be cost ineffective for the professional fiduciary if too much customized work is required. One hopes that an individual nominated as agent would feel at least some moral duty to act consistently with the principal's wishes, no matter how idiosyncratic, because of his or her personal connection to the principal. An institutional relationship by its nature is less likely to carry with it such a moral or behavioral obligation.

If a professional fiduciary business does develop in response to the Act, most taxpayers will remain in the same position in which they were before the Act. Wealthy people, who have always had the ability to hire a professional fiduciary, will continue to be able to afford one. They may even benefit from cost reductions due to the regularization of the principal-agent relationship. Of course a person may not need to engage a professional fiduciary, if a willing child, for example, will perform those services.

In contrast, moderate-income or low-income taxpayers who historically have not employed professional fiduciaries may still not be able to afford them, regardless of how low the fees become. Even a commodified principal-agent relationship may be too costly for many taxpayers; the Act does nothing to help these taxpayers contract for intimacy. Yet the regularization of these types of contracts suggests the possible recognition of other choice-based human relationships, discussed in the next part.

VI. TAX AVATARS, ALTER EGOS AND CHOICE-BASED RELATIONSHIPS

A. How Legal Avatars Benefit the Economy

Critical scholars who share an anti-subordination agenda have two reasons to engage in a deep analysis of the tax treatment of powers of attorney. First, if the tax and other aspects of powers of attorney are well understood, the value of an agent's services will be able to be measured accurately. Second, a regularized principal-agent relationship should be understood in historical context; it conforms to the cultural practice of outsourcing activities that one is not willing or able to do for oneself (or find a family member to do).

Commodification of the fiduciary relationship under a power of attorney will permit scholars to measure more accurately the economic value of this work.[241] The overwhelming majority of caregivers for the elderly are female.[242] In a study of elderly people's choice of a health care proxy, i.e., someone to make medical decisions in the event of the individual's incapacity, "in selecting a surrogate decision maker, elders tend to look at those they see as caregivers. The spouses of elderly persons are commonly elderly as well and therefore may have physical or cognitive deficits that limit their ability to engage in effective caregiving."[243] Therefore if women are most likely to be caretakers, and caretakers are likely to be the surrogate decision makers, it is not unreasonable to assume that women are more likely than men to serve as agents under a power of attorney.

For feminist legal scholars in particular, making women's caretaking work visible historically has been an important project.[244] For example, Martha Fineman has highlighted the secondary economic effects of women's caretaking activities. Fineman points to women's "derivative dependency": "[T]hose who care for others

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[241] In the international development context, Lourdes Benería has suggested that much of women's work is not accounted for in economic studies because it is unregulated or not generally visible in the marketplace. *See* LOURDES BENERÍA, GENDER, DEVELOPMENT AND GLOBILIZATION: ECONOMICS AS IF ALL PEOPLE MATTERED 136 (2003) (describing the role of women in the informal sector and the difficulty of gathering systemic information from this informal sector).

[242] For a breakdown of the demographics of formal and informal caregivers, see Jeannette Takamura & Bob Williams, Informal Caregiving: Compassion in Action 5–12, http://aspe.hhs.gov/daltcp/reports/carebro2.pdf (last visited July 2, 2008).

[243] Nina A. Kohn, *Elder Empowerment As a Strategy for Curbing the Abuse of Durable Powers of Attorney*, 59 RUTGERS L.REV. 1, 9 (2006).

[244] *See, e.g.*, MARTHA ALBERTSON FINEMAN, THE NEUTERED MOTHER, THE SEXUAL FAMILY, AND OTHER TWENTIETH CENTURY TRAGEDIES 9 (1995) (framing her argument in terms of "burden[ing] those who would caretake with ideological and actual impediments that make their tasks more difficult").

are themselves dependent on resources in order to undertake that care. Caretakers have a need for monetary or material resources. They also need recourse to institutional supports and accommodation, a need for structural arrangements that facilitate caretaking."[245] In a similar vein, Katharine Silbaugh has emphasized the importance of understanding the economic value of women's unpaid caretaking and household work.[246] She says, "[h]ome labor as an area of significant concern to women's working lives does not appear to be temporary. . . . [I]t is critical to push for the equality of treatment of that work with paid work, and not just to seek the equality of treatment of both men and women in the paid labor force."[247] A crucial step toward gender equality, then, is measuring the economic value of women's unpaid work. If even a small professional fiduciary service business arises from the regularized principal-agent relationship created under the 2006 Act, then the market itself will set the value for this "caretaking" work.

If it is true that more women than men do the caretaking work of agents under a power of attorney, then the shift to a market in professional fiduciaries mirrors other cultural practices of outsourcing work traditionally performed by women. The influx of women into paid "market" work created a secondary workforce of women engaged in paid child-care and housekeeping. Some scholars have suggested that women's work outside the home has perpetuated a hierarchy in which "market" (outside-the-home) work is more important than "non-market" (inside-the-home) work, even if both are compensated.[248] Additionally, critics claim that women's paid employment outside the home reifies a racialized economic stratification of women in which (the typically white) women who work outside the home employ women (typically of color) to work inside the (typically white) women's homes.[249] Yet in the power of attorney context, the shift of one woman's responsibilities onto another is not likely to involve outsourcing to a party with a lesser bargaining position. A professional fiduciary, such as a bank or trust company, will be able to charge a market rate for its services and will offer

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[245] Martha Albertson Fineman, *Cracking the Foundational Myths: Independence, Autonomy and Self-Sufficiency*, 8 AM. U. J. GENDER SOC. POL'Y & L. 13, 20 (1999).

[246] Katharine Silbaugh, *Commodification and Women's Household Labor*, 9 YALE J.L. & FEMINISM 81 (1997).

[247] *Id.* at 101.

[248] MARY ROMERO, MAID IN THE U.S.A. 98 (1992) ("[e]mployed middle- and upper-middle class women escaped the double day syndrome by hiring poor women of color to perform housework and child care, and this was characterized as progress. Some feminists defined domestic service as progress . . . . However this definition neglects the inescapable fact that when women hire other women at low wages to do housework, both employees and employers remain women").

[249] Rosa Lopez, *Christopher Darden and Me*, in CRITICAL RACE FEMINISM: A READER (Adrien Katharine Wing ed., 2d ed. 2003); Taunya Lovel Banks, *Toward a Global Critical Feminsit Vision: Domestic Wor, and the Nanny Tax Debate*, 3 J. Gender, Race & Justice 1, 31 nn. 139–40 (1999).

professional agent services only if they are remunerative. In contrast, at least with childcare and housekeeping, the women to whom the work is "outsourced" often earn minimum wage and have limited economic mobility.[250] In this way, the projected outsourcing of professional agent work avoids some of the traditional critiques of other outsourcing of women's work.

B. How Legal Avatars Benefit Diverse Human Relationships

Another reason that scholars need to understand the tax treatment of powers of attorney is that the Service's recognition of contractual intimacy in this context may suggest the possibility of formal recognition in the tax law of other relationships that arise by individual choice. Affective family-like relationships have achieved some level of legal recognition in other, more fundamental areas of the law. For example, in response to a decision by the New Jersey Supreme Court in 2006,[251] the New Jersey state legislature passed "An Act Concerning Marriage and Civil Unions" granting to same-sex partners to a civil union "all the rights and benefits that married heterosexual couples enjoy."[252] But the vast majority of opposite-sex New Jersey couples must marry in order to receive these rights and benefits.[253] As a policy matter, New Jersey law gives its imprimatur to certain relationships through formal labels of "marriage" and "civil union."[254]

In contrast to the New Jersey rule, the Netherlands has a rule that permits any two people to choose to be treated as "married," but for the limited purposes of tax reporting and paying:

> These partners are permitted to share joint income (e.g., their taxable income from an owner-occupied dwelling, splitting mortgage interest deduction, child care expenses, taxable income from substantial participation, and the personal allowance) between them for their tax return. Of course, the law demands some conditions to be fulfilled . . . .

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[250] This may be due to language status, educational status, economic status or a variety of other factors. *See, e.g., id.*

[251] Lewis v. Harris, 908 A.2d 196, 206 (N.J. 2006) (holding that same-sex couples have no fundamental or constitutional right to be married under New Jersey law; they do have a right to the "benefits and privileges afforded to married heterosexual couples").

[252] *See* N.J. STAT. ANN. § 37:1-28 (West Supp. 2008).

[253] *See* Domestic Partnership Act, N.J . STAT. ANN. § 26:8A (West 2007 & Supp. 2008). New Jersey makes an exception for opposite sex couples, where both of the parties are age 62 or older. *See id.* § 26:8A4(b)(5). These couples can register their domestic partnership and receive certain state benefits. *See id.* §26:8A.

[254] *See* N.J. STAT. ANN. § 37:1-1 (West 2007) (prohibiting certain marriages or civil unions).

> The most important conditions are having a joint household and having lived together for at least six months. . . . [S]ame-sex (homosexual) couples[,] . . . a parent and an adult child or . . . other siblings or non-siblings who share one household . . . can opt to be partners for tax purposes.[255]

By permitting these types of elective "family" registrations, the Netherlands consciously recognizes and grants privileges to those relationships that have certain qualities of most marriages (a physically shared residence and some economic pooling). Dutch law gives greater latitude, at least in a tax sense, to many types of relationships that arise by choice, not just those relationships that are eligible for official state recognition as "marriage" or a "civil union," which labels depend on the gender of the parties and the presumed existence of a sexual relation between them.

Like the New Jersey law and unlike the Dutch law, the U.S. federal laws of wealth transfer taxation generally are selective in what types of relationships between taxpayers are eligible for favorable treatment.[256] For example, a taxpayer may make unlimited tax-free transfers to his or her U.S. citizen-spouse.[257] Some death-time transfers to family members receive favorable estate tax treatment compared to transfers of the same property to non-family members.[258] The estate and gift tax treatment of the power of attorney is an important exception to the preferential treatment for married, heterosexual couples and certain family members. The fact that creating a power of attorney triggers no taxable gift by the principal or estate tax inclusion for the agent[259] is true regardless of the presence or absence of a genetic or other legal relationship between the principal and agent.[260] Thus, at least in the power of attorney context, the U.S. federal estate and gift tax laws permit the recognition of all intimate relationships that arise by contract.

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[255] J.L.M. Gribnau & R.H. Happé, *Restricting the Legislative Power to Tax*, 11. 1 ELEC. J. OF COMP. L. 1, 21 (May 2007), http://www.ejcl.org/111/art111-11.pdf ; *see also* Henry Ordower, *Comparative Law Observations on Taxation of Same-Sex Couples*, 111 TAX NOTES 229, 230 (Apr. 10, 2006) (stating that "the Netherlands . . . permit[s] same-sex, civil marriages").

[256] *See, e.g.*, Bridget J. Crawford, *One Flesh, Two Taxpayers: A New Approach To Marriage and Wealth Transfer Taxation*, 6 FLA. TAX REV. 757, 759 (2004) (advocating for abandonment of marital gift and estate tax deductions).

[257] *See* I.R.C. §§ 2056, 2523 (2006) (setting the estate tax marital deduction and the gift tax marital deduction).

[258] *See, e.g.*, Bridget J. Crawford, *The Profits and Penalties of Kinship: Conflicting Meanings of Family in Estate Tax Law*, 3 PITT. TAX REV. 1, 18 (2005) (discussing how distribution of certain types of real property to family members may affect the property's valuation for estate tax purposes).

[259] *See supra* Part III.B.

[260] *See supra* Part III.B.

The law's recognition of contracts can be the source of power and rights for members of disenfranchised groups. Consider, for example, Professor Patricia Williams' description of her apartment search and how it differed from her white male colleague's search:

> In my rush to show good faith and trustworthiness, I signed a detailed, lengthily negotiated, finely printed lease firmly establishing me as the ideal arm's-length transactor . . . . [Peter and I] could not reconcile our very different relations to the tonalities of law. Peter, for example, appeared to be extremely self-conscious of his power potential (either real or imagistic) as white or male or lawyer authority figure. He seemed to go some lengths to overcome the wall that image might impose . . . . On the other hand, I was raised to be acutely conscious of the likelihood that no matter what degree of professional I am, people will greet and dismiss my black femaleness as unreliable, untrustworthy, hostile, angry, powerless, irrational and probably destitute . . . . [T]o show that I can speak the language of lease is my way of enhancing trust of me in my business affairs.[261]

For Williams, a contract evidences legal personhood and secures rights. Only those in positions of power (the "white or male or lawyer authority figure") eschew the contract. But those whom society has regarded as "unreliable, untrustworthy, hostile" or otherwise outsiders are the ones who can benefit most from the formalized rights and recognition inherent in a contract. Favorable estate and gift tax treatment of contractual intimacy then can read as recognition of the rights (and responsibilities) that the parties to the contract have. For those with relationships that are already favored, because of marital status or otherwise, the commodification of the principal-agent relationship may have no cultural significance. But for members of out-groups, legal recognition and protection for their relationships are crucial steps toward meaningful rights.

If the wealth transfer tax laws give a favorable tax treatment to contracts for intimacy that arise under a power of attorney, then the law has the capacity to recognize elective, non-marital relationships for other tax purposes. The Netherlands example suggests that any two people should be able to "opt in" to being treated as a single taxpaying unit. Such an "opt in" to favorable tax treatment currently exists with respect to powers of attorney.[262] Just as one can enter into a contract for intimacy in the form of a power of attorney, an individual taxpayer should be able to designate another as his or her "partner" for income tax filing

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[261] PATRICIA J. WILLIAMS, THE ALCHEMY OF RACE AND RIGHTS 147 (1991).

[262] *See supra* Part III.B.

purposes. That same "partner" could receive lifetime and death-time transfers free of any wealth transfer tax, just as spouses can.[263] Also the tax-designated "partner" could be treated as a "member of the family" of the taxpayer for purposes of eligibility for the special valuation rules under I.R.C. § 2032A among other tax benefits.[264]

These are only two illustrations of the ways that the tax law could recognize tax-designated partners. As with any benefits, a person with a tax-designated partner would be required to accept the negative consequences of that designation. For example, that tax-designated partner would be considered as a "member of the family" of the taxpayer within the meaning of I.R.C. § 318[265] for purposes of determining whether a particular corporation is a "controlled corporation" within the meaning of I.R.C. § 2036(b).[266] A full exploration of all of the possibilities for the tax recognition of contractual intimacy deserves more in-depth study, which is beyond the scope of this article. The next section outlines the theoretical implications for future critical scholarship of tax recognition of contracts for intimacy.

C. How Legal Avatars Impact Tax Scholarship

1. An Overview of Critical Tax Scholarship

The mid- to late-1990s were the halcyon days of critical tax scholarship. During this period, a small number of law professors attracted significant attention for the application of so-called "outsider" perspectives to the study of the Internal Revenue Code.[267] Their scholarship employed feminist theory, critical race theory, and LGBT perspectives to uncover bias against women, racial minorities, and gays and lesbians.

Some of the best feminist-oriented tax scholarship had the quality of intellectual archaeology. Carolyn Jones's historical work highlighted women's

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[263] *See supra* note 258 and accompanying text.

[264] Almost always, the alternate valuation under I.R.C. § 2032A will result in a lower valuation and lower estate tax bill. *See, e.g.*, Dennis I. Belcher, *Estate Planning for Family Business Owners: Section 2032A, Section 6166 and Section 303*, SH092 ALI-ABA PCW 449, 465–69 (2003) (discussing examples of special valuation and noting that it is rarely used outside of the context of farm land).

[265] *See* I.R.C. § 318(a)(1)(A) (2006) (establishing circumstances under which an individual is considered to own stock for another).

[266] *See* I.R.C. § 2036(b)(2) (valuing a life estate in stock with reference to whether the stock was owned for an individual by another under I.R.C. § 318).

[267] *See, e.g.*, Carolyn C. Jones, *Split Income and Separate Spheres: Tax Law and Gender Roles in the 1940s*, 6 LAW & HIST. REV. 259 (1994) (describing how the contributions of women were valued from a tax perspective in the 1940s).

participation in nineteenth-century tax protests.[268] Although Jones did not specifically contextualize her scholarship, her study of women's tax resistance employed the classic feminist legal method of "emphasiz[ing] women's experience."[269] Similarly Wendy Gerzog read the specialized estate and gift tax marital deduction rules from the perspective of women who survive their spouses.[270] Gerzog suggested that certain tax rules contribute to women's economic dependence and are based on traditional gender stereotypes of women.[271] Her work demonstrated the feminist legal method of exposing "male bias and male norms in rules, standards, and concepts that appear neutral or objective on their face," a classic method of feminist legal theory.[272] Also in a similar vein, Nancy Staudt undertook a study of the tax treatment of unpaid household work and argued that the "the Tax Code provides financial incentives for women to work in the home after bearing children. It is not surprising that the tax laws reflect an image of men as public actors earning a wage in the market, and that the laws assume women do not and should not have such roles."[273] By exposing the "less-than-ideal course of action" that women face,[274] Staudt employed feminist legal methodology to understand better the disparate impact of seemingly facially neutral rules.[275]

At approximately the same time that Jones's, Gerzog's, and Staudt's work appeared, three scholars in particular employed critical race theory as a lens for examining the Internal Revenue Code. Beverly Moran, William Whitford and Dorothy Brown responded explicitly to Professor Jerome Culp's challenge that

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[268] *See, e.g.,* Carolyn C. Jones, *Split Income and Separate Spheres: Tax Law and Gender Roles in the 1940s*, 6 LAW & HIST. REV. 259 (1994).

[269] MARTHA CHAMALLAS, INTRODUCTION TO FEMINIST LEGAL THEORY 4–6 (2d ed. 2003).

[270] Wendy C. Gerzog, *The Marital Deduction QTIP Provisions: Illogical and Degrading to Women*, 5 UCLA WOMEN'S L. J. 201 (1995).

[271] *Id.* at 305–06.

[272] CHAMALLAS, *supra* note 269, at 6. For a thorough discussion of "androcentrism" and "the privilegizing of males experience and the 'otherizing' of female experience," *see also* SANDRA LIPSITZ BEM, THE LENSES OF GENDER: TRANSFORMING THE DEBATE ON SEXUAL INEQUALITY 39–79, 183–91 (1993).

[273] Nancy C. Staudt, *Taxing Housework*, 84 GEO. L.J. 1571, 1571 (1996).

[274] CHAMALLAS, *supra* note 269, at 9.

[275] For other feminist tax scholarship, see, e.g., Mary Louise Fellows, *Wills and Trusts: The Kingdom of the Fathers*, 10 LAW & INEQ. J. 137 (1991) (discussing how women receive less consideration than men under facially-neutral laws) and Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 UCLA L. REV. 983 (1993) (recognizing that tax law reflects longstanding biased social models).

"[e]veryone has to do black scholarship if it is to succeed."[276] Moran and Whitford in their 1996 article, "A Black Critique of the Internal Revenue Code,"[277] declared the relevance of critical race theory to tax scholarship:

> One main thrust of critical race theory is a belief that racial subordination is everywhere, a structural aspect of all parts of American society. If this part of critical race theory has merit, then every important American institution should reflect racial subordination, even such a seemingly neutral institution as the American tax system.[278]

Similarly, Dorothy Brown has focused her research agenda on the purported neutrality of tax laws.[279] In a 1997 speech, Brown proposed a scholarly project "dedicated to forever eradicating the belief that tax law is somehow different, that it has no differing impact based upon race, ethnicity, or any other characteristic."[280] In one article, Brown exposed "how the convergence of the tax principles, employment discrimination, and differing marital rates result in black couples being more likely to pay a higher marriage penalty and white couples being more likely to receive a marriage bonus."[281] In another article, Brown demonstrated how members of some racial groups are more likely than members of other racial groups to be eligible for certain tax credits.[282] By combining sociological studies with technical understanding of tax rules, Brown exposed the racialized aspects of tax law.

Writing approximately five years after this highly publicized feminist and critical race scholarship, Anthony Infanti added another critical perspective to the study of tax law. Infanti's work engages in illustrating that tax is just one of the many areas of law that actively discriminate against lesbian and gay people.[283] He has applied critical theoretical methods to study tax expenditures and tax treaties.[284] According to Infanti, the tax law is "an area where gay and lesbian

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[276] *See* Jerome McCristal Culp, Jr., *Toward a Black Legal Scholarship: Race and Original Understandings*, 1991 DUKE L.J. 39, 105 (1991).

[277] Beverly I. Moran & William Whitford, *A Black Critique of the Internal Revenue Code*, 1996 WIS. L. REV. 751 (1996).

[278] *Id.* at 751–52 (citations omitted).

[279] Dorothy A. Brown, *Split Personalities: Tax Law and Critical Race Theory*, 19 W. NEW ENG. L. REV. 89 (1997).

[280] *Id.* at 91.

[281] *Id.* at 94.

[282] Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790, 790 (2007).

[283] Anthony C. Infanti, *The Internal Revenue Code as Sodomy Statute*, 44 SANTA CLARA L. REV. 763, 768 (2004) (describing the Internal Revenue Code as "another weapon for discrimination and oppression in society's already well-stocked arsenal").

[284] Anthony C. Infanti, *A Tax Crit Identity Crisis? Or Tax Expenditure Analysis,*

issues generally remain shrouded in darkness, forcibly banished to the invisibility of the closet."[285] His scholarship invites consideration of how tax rules impact individuals whose relationships are not recognized for federal tax purposes.[286]

The reaction of traditional tax scholars to feminist, critical race, and LGBT perspectives has not been positive. Critical tax scholarship has been criticized as inaccurate and unhelpful. Lawrence Zelenak suggests that critical scholarship displays "an overeagerness to accuse the tax laws of hostility to women."[287] Both Zelenak and Joseph Dodge have dismissed critical scholarship as failing to articulate a positive agenda for legal reform.[288] Their critique is accurate in part, to the extent that critical tax scholarship does not take as its primary task a detailed rewriting of tax rules, nor does it emphasize the ways in which the tax law actually could favor disenfranchised groups.[289] But to suggest that it should develop a positive agenda fundamentally misunderstands the critical project as a whole. Critical tax scholarship uncovers, reveals, and exposes bias in the face of arguments that the tax laws are value neutral.

2. Opportunities for Critical Tax Scholarship

This article shares the normative assumptions of critical tax scholarship.[290] It accepts the proposition that the tax laws are biased in favor of certain groups.[291] It argues that the tax laws should recognize a wider range of human relationships

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Deconstruction, and the Rethinking of a Collective Identity, 26 WHITTIER L. REV. 707 (2005).

[285] Anthony C. Infanti, *Tax Protest, "a Homosexual," and Frivolity: a Deconstructionist Meditation*, 24 ST. LOUIS U. PUB. L. REV. 21, 21–22 (2005).

[286] *See generally id.* (discussing the legal implications of same-sex married couples filing either single and joint tax returns).

[287] Lawrence Zelenak, *Taking Critical Tax Theory Seriously*, 76 N.C. L. REV. 1521, 1523 (1998).

[288] *Id.* at 1524 ("The most serious problem [with critical tax scholarship] is the failure to think through proposed solutions with sufficient care."); Joseph M. Dodge, *A Feminist Perspective on the QTIP Trust and the Unlimited Marital Deduction*, 76 N.C. L. REV. 1729, 1729 (1998) (stating that critical tax scholarship is "weak on plausible solutions").

[289] *But see* Theodore P. Seto, *The Assumption of Selfishness in the Internal Revenue Code: Reframing the Unintended Tax Advantages of Gay Marriage* (April 2007). Loyola-LA Legal Studies Paper No. 2005-33 (arguing that tax treatment of familial relationships relying on traditional legal definitions may benefit same-sex spouses), http://ssrn.com/abstract=850645.

[290] *See supra* Part V.

[291] *Id.*

than they currently do.[292] Where this work departs from critical tax scholarship, however, is in its methodology. Instead of centering the critique on ways in which the existing tax rules are discriminatory (at worst) or misguided (at best), the article focuses on how the current tax law suggests the possibility for broader recognition of alternative family structures and choice-based human relationships. Through a detailed analysis of the estate and gift tax treatment of powers of attorney, one can see how the existing tax structure accommodates and privileges contracts for intimacy. Similar choice-based relationships could receive favorable treatment in other tax contexts.[293] By focusing more on the positive aspects of existing tax rules, critical tax scholars have the opportunity to use the current legal framework to subvert restrictive and discriminatory social structures and to achieve recognition and protection for those who experience discrimination or disadvantage.

Writing about feminism in particular, Janet Halley has warned about the constraining theoretical consequences of a movement's failure to embrace its own power.[294] In particular, Halley suggests that feminism has taken on a tyrannical quality; it wields "actual, real-world and theoretical power."[295] Halley calls power-wielding, moralistic feminism "governance feminism."[296] One of the main theoretical missteps of governance feminism according to Halley is feminism's persistence in believing itself to be powerless:

> [A]cknowledging [some feminist work] to be a governance project has a dark side, and it is important to face it. That dark side includes its vanquished, its prisoners of war, the interests that pay the taxes it has levied and owe the rents it has imposed. Feminism with blood on its hands. . . .
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> . . . .
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> . . .[W]hen governance feminism/feminist theory pretends it is always the underdog, and when feminists insist that the prodigals must be converged back into feminism *or feminism will die*, it wages power without owning it. . . .
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> . . . When feminist theory refuses to own its will to power, when it insists that prodigals must be converged back into feminism, it commits itself to

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[292] *Id.*

[293] *See supra* Part V.B.

[294] JANET HALLEY, SPLIT DECISIONS: HOW AND WHY TO TAKE A BREAK FROM FEMINISM 10 (2006) ("[W]e can't make decisions about what to do with legal power . . . without taking into account as many interests, constituencies and uncertainties as we can acknowledge.").

[295] *Id.* at 32.

[296] *See id.* at 20–22.

> a theoretical stance that makes it hard for feminists to see around corners of their own construction.[297]

One need not agree with Halley's proposal to "take a break from feminism" to appreciate her claim that feminist theory is constrained by negative perceptions of feminists. Instead of pronouncing itself an "underdog" perspective, feminism needs to acknowledge its power.[298] So, too, should critical tax scholars be willing to move away—at least temporarily—from a critical perspective. Some existing tax rules, such as the wealth transfer tax rules applicable to powers of attorney, work in favor of the larger project of creating a tax system that is free from bias of any kind.

VII. CONCLUSION

As avatars stand for the internet's end users, agents under a power of attorney act on behalf of the appointing principal. Both an avatar and an agent under a power of attorney are kinds of alter egos. The favorable wealth transfer tax treatment that legal avatars receive suggests their utility as a model for how the tax law could be expanded to recognize other choice-based relationships. In his novel *The Partners*, author and lawyer Louis Auchincloss wrote that "[e]verything today is taxes. . . . What better seat on the grandstand of life can I offer you than that of tax counsel?"[299] Understanding the tax treatment of legal avatars is the foundation for a grandstand for seeing the potential diversity of preference-based relationships that the law could embrace.

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[297] *Id.* at 32–33.

[298] Young women who proclaim a "third wave" of feminism adopt a similar posture, claiming a feminism that embraces power and fluid identities. *See, e.g.*, Lillian S. Robinson, *Subject/Position, in* "BAD GIRLS"/"GOOD GIRLS": WOMEN, SEX, AND POWER IN THE NINETIES 177, 182–83 (Nan Bauer Maglin & Donna Marie Perry eds. 1996).

[299] LOUIS AUCHINCLOSS, THE PARTNERS 29 (1974).

PATENT-MEDIATED STANDARDS IN GENETIC TESTING

Eileen M. Kane*

Genetic testing can be used to identify disease susceptibility, establish diagnostic status, and design therapeutic regimens in medical care. Two legal realities shape the genetic testing environment in the United States. First, most genetic tests are not subject to premarket review by the Food and Drug Administration (FDA). Second, many DNA sequences and genetic testing methods are patented. The lack of FDA oversight of most genetic testing has consequences for patent-related aspects of genetic testing, and patent management, conversely, has consequences for the peer evaluation that compensates for minimal official oversight. Where exclusive control of the relevant patent portfolio for a particular disease field is used to frustrate a competitive genetic testing environment, the patent holder is able to set de facto clinical testing standards, rather than the professional community. The clinical standard then becomes a function of the marketplace, rather than the laboratory.

Restrictive management of gene patents with critical diagnostic significance limits peer assessment, and lessens the available testing options for patients. If the sole commercial provider of a particular genetic test does not offer a comprehensive genetic analysis, the test will not provide the most accurate assessment of genetic status, and compensatory genetic testing to correct deficiencies may be prohibited by the patent holder. The actual genetic testing field will then be defined by a divergence between the theoretically optimal and the commercially available. An artificially constrained genetic testing climate can result in patients receiving incomplete test results that cannot be relied on for medical decision making. As an example, limitations on commercial genetic testing for the BRCA1 and BRCA2 genes to determine the risk of hereditary breast and ovarian cancer have been maintained by the dominant patent holder in the field, and similar circumstances could develop for other genetic tests.

There are potential patent infringement conflicts that could arise if compensatory genetic testing is offered to patients who are underserved by the patent-mediated limitations in genetic tests. This article identifies doctrinal strategies in patent law to address scenarios where patent management poses risks to public health. It analyzes the prospects for compensatory genetic testing in view of the scope of dominant patents, the infringement evaluation, and the remedies determination, noting that future oversight of genetic testing by the FDA might also allow researchers to invoke a statutory research exemption to improve peer assessment. From the perspective of public health, it is necessary to consider all of these available mechanisms to relieve the patent-imposed obstacles to full

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exploitation of genetic testing for predictive, diagnostic, and therapeutic applications in medical care.

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I. INTRODUCTION

The advancement of genetic science is now marked by significant milestones, such as the sequencing of a consensus human genome[1] and the completion of an individual human DNA sequence.[2] The goal of genomic science is to understand consensus genomic structure as well as individual human variation.[3] The precise dissection of the human DNA sequence allows for the characterization of the geography of the genome: its genes, its regulatory regions, and its "junk DNA."[4]

The specific identification of genes, which are discrete segments of DNA that encode one or more proteins, has occurred rapidly over the last decade, allowing for estimations of total gene number (around 25,000)[5] and the localization of genes to specific genomic locations. The functional characterization of genes, in which a gene is matched with the proteins it encodes, can be rapidly achieved by laboratory-based in vitro expression methods or computer-based analysis of DNA sequences using bioinformatics methods.[6] The rapid adoption of bioinformatics

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[1] S.G. Gregory et al., *The DNA Sequence and Biological Annotation of Human Chromosome 1*, 441 NATURE 315 (2006) (publishing the final chromosome sequence). The genome is the full DNA sequence of an organism.

[2] Nicholas Wade, *Genome of DNA Discoverer is Deciphered*, N.Y. TIMES, June 1, 2007, at A19 (describing the sequencing of the genome of James D. Watson, who elucidated the structure of DNA with Francis Crick).

[3] Genomics is defined as the field which studies the genome through the full complement of individual genes as well as their expression patterns. NATIONAL RESEARCH COUNCIL OF THE NATIONAL ACADEMIES, REAPING THE BENEFITS OF GENOMIC AND PROTEOMIC RESEARCH 40 (2006) [hereinafter NAS REPORT].

[4] The ENCODE Project Consortium, *Identification and Analysis of Functional Elements in 1% of the Human Genome by the ENCODE Pilot Project*, 447 NATURE 799, 799 (2007) (noting that extensive genomic stretches are transcribed although not protein-coding, and illustrating the complexity of genomic segments).

[5] International Human Genome Sequencing Consortium, *Finishing the Euchromatic Sequence of the Human Genome*, 431 NATURE 931, 931, 943 (2004).

[6] *See generally* BRYAN BERGERON, BIOINFORMATICS COMPUTING (2003).

methods in gene characterization has been aided by consensus adoption of software formats and sequence databases that have become standard research tools for the field.[7]

A genomics-based medicine is likely to accelerate the identification of molecular targets for therapeutic treatment, resulting in greater clinical precision, cost-effectiveness, and efficiency in drug development.[8] One of the most important applications of expanding genetic knowledge is to correlate the genetic profile of an individual to clinically significant facts. Understanding the link between genetics and medicine precedes the age of molecular biology, traditionally relying on the use of family history, linkage analysis and population studies, but the arrival of genomic science has offered more precise techniques for establishing correlations between genetic profile and clinical status through molecular genetic testing.[9]

Genetic testing can serve a number of objectives: predictive testing of an asymptomatic individual whose family history suggests an inherited risk of a particular disease, diagnostic testing of a symptomatic individual to confirm the presence of genetic correlates to a specific disease, and genetic testing of diagnosed individuals to optimize drug therapy in pharmacogenomic applications.[10] The validity of such testing originates from scientific research that demonstrates the connection between genetic status and clinical assessment. Fundamentally, the underlying science asks whether a gene has sustained mutations or other perturbations in its sequence, whether such pathology is inherited as a germline mutation or arises from somatic mutation, and how the

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[7] *See* Helen M. Berman & Rochelle C. Dreyfuss, *Reflections on the Science and Law of Structural Biology, Genomics, and Drug Development*, 53 UCLA L. REV. 871, 881 (2006) (noting the widespread reliance on the gene sequence databanks of GenBank, DNA Data Bank of Japan (DDBJ), and the European Molecular Biology Laboratory Nucleotide Sequence Database).

[8] *See* Arti K. Rai, *The Information Revolution Reaches Pharmaceuticals: Balancing Innovation Incentives, Cost, and Access in the Post-Genomics Era*, 2001 U. ILL. L. REV. 173, 189–92 (describing the advantages of genomics-based strategies for drug development and clinical testing).

[9] Genetic testing is defined as "the analysis of human DNA, RNA, chromosomes, proteins, and certain metabolites in order to detect heritable disease-related genotypes, mutations, phenotypes or karyotypes for clinical purposes. Such purposes include predicting risk of disease, identifying carriers and establishing prenatal and clinical diagnosis or prognosis." TASK FORCE ON GENETIC TESTING, NAT'L INSTS. OF HEALTH-DEP'T OF ENERGY WORKING GROUP ON ETHICAL, LEGAL AND SOC. IMPLICATIONS OF HUMAN GENOME RESEARCH, PROMOTING SAFE AND EFFECTIVE GENETIC TESTING IN THE UNITED STATES, (Neil A. Holtzman & Michael S. Watson, eds., 1997), *available at* http://www.genome.gov/10001733.

[10] SEC'Y'S ADVISORY COMM. ON GENETIC TESTING, NAT'L INSTS. OF HEALTH, ENHANCING THE OVERSIGHT OF GENETIC TESTS: RECOMMENDATIONS OF THE SACGT 2 (2000), *available at* http://www4.od.nih.gov/oba/sacgt/reports/oversight_report.pdf [hereinafter SACGT REPORT]. The other general classes of testing are for carrier, prenatal, preimplantation, and newborn screening.

genomic sequence correlates with clinical observations in an individual.[11] The molecular classification of disease-causing genetic alterations in the human genome includes single nucleotide polymorphisms (SNPs), small insertions or deletions, and more complex derangements, such as large insertions and deletions, copy number changes, repeat variations, translocations and rearrangements.[12] It is the derangement in the genetic sequence that has possible clinical consequences, from production of an errant protein to a missing protein.[13] Genetic testing can also be divided into screening for known mutations and scanning for unknown mutations.[14] In another approach that invokes a genomic sensibility, an analysis of gene expression patterns can reveal distinct molecular signatures that correlate with clinical outcome.[15] The development of such knowledge has proceeded rapidly; an example is the field of molecular oncology, in which an estimated 1% of human genes have now been associated with particular cancers.[16]

The accumulation of knowledge linking genetics with medical possibility and outcomes has created a demand for genetic testing that can deliver on the promise of genomic-based medicine. However, difficult questions relating to the quality of genetic tests and the ownership of genetic testing resources complicate the adoption of and reliance on such tests for medical decision making. The rapid progress in scientific development has not been matched by the establishment of official regulatory capacity that can determine the scientific and clinical value of most commercially available genetic tests.[17] Separately, the patenting of many materials and methods required for genetic testing has introduced considerations of access and availability that strain the operation of the peer assessment mechanisms that are especially necessary for the field of genetic testing. The convergence of these two legal realities creates some unique points of conflict, with consequences for the integrity of the scientific field and for the quality of patient services. This article addresses patent-mediated standard-setting in clinical genetic testing, surveying points of leverage in patent law doctrine that might be used to ease

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[11] *See* BRUCE ALBERTS ET AL., MOLECULAR BIOLOGY OF THE CELL 237 (4th ed. 2002).

[12] CARL T. WITTWER & NORKIO KUSUKAWA, *Genomes and Nucleic Acid Alterations*, *in* FUNDAMENTALS OF MOLECULAR DIAGNOSTICS 17, 19 (David E. Bruns et al., eds., 2006).

[13] *Id.*

[14] MEGAN J. SMITH-ZAGONE ET AL., *Molecular Pathology Methods*, *in* MOLECULAR PATHOLOGY IN CLINICAL PRACTICE 15, 30 (Debra G.B. Leonard et al., eds., 2007).

[15] *See, e.g.*, Soonmyung Paik et al., *A Multigene Assay to Predict Recurrence of Tamoxifen-Treated, Node-Negative Breast Cancer*, 351 NEW ENGL. J. MED. 2817, 2820–24 (2005).

[16] *See* P. Andrew Futreal et al., *A Census of Human Cancer Genes*, 4 NATURE REV. CANCER 177, 178 (2004). The federally-funded Cancer Genome Atlas is a project focusing on determining the full genomic spectrum of specific cancers. *See* The Cancer Genome Atlas, http://cancergenome.nih.gov/index.asp (last visited Sept. 10, 2008).

[17] SACGT REPORT, *supra* note 10, at 26 ("Based on the rapidly evolving nature of genetic tests, their anticipated widespread use, and extensive concerns expressed by the public about their potential for misuse or misinterpretation, additional oversight is warranted for all genetic tests."); *see infra* Part II.

patent-imposed restrictions on the full delivery of genetic testing services. Part II discusses the current status of genetic testing in the U.S. and the regulatory climate. Part III introduces the patent-related aspects of genetic testing that have complicated delivery and access to these services, with a particular focus on the scenario where a single patent holder dominates a specific disease testing field and is able to set de facto clinical standards as a result of patent management decisions, leading, in some cases, to the establishment of suboptimal standards for the field. In these cases, complete determination of genetic status can only be obtained if compensatory genetic testing is available to counteract the deficiencies set by the patent holder. In view of this scenario, and in the absence of field-wide solutions regarding the patents on diagnostic materials and methods, can compensatory genetic testing be offered in view of the patents that could be asserted against such efforts? Part IV considers how the existence of compensatory genetic testing could impact the validity analysis of the relevant genetic testing-related patents. Part V considers the infringement theories that capture the relations between the patent holder and the improver who offers compensatory genetic testing. Part VI addresses the remedies analysis that would attach to an adjudicated infringement resulting from compensatory genetic testing. This article concludes that measures to compensate for the suboptimal clinical standards set by a patent holder in a genetic testing field can be theoretically accounted for using existing patent law doctrines, with outcomes that are favorable for the establishment of a genetic testing environment that enhances public health.

II. GENETIC TESTING AND ITS REGULATION

Genetic tests have proliferated rapidly, with tests currently offered for the diagnosis of genetic risk in over 1600 diseases.[18] Genetic testing can occur as part of a research program (research testing) or can be offered to patients for their medical decision-making (clinical testing).[19] Clinical genetic tests are available as commercially marketed kits or as laboratory-offered clinical services. The difference is significant: the Food and Drug Administration (FDA) requires pre-market approval for genetic tests that are packaged and marketed as kits, classifying them as in-vitro diagnostics (IVD), a category of medical device under the Federal Food, Drugs, and Cosmetic Act (FDCA).[20] However, most commercial genetic tests are offered as in-house clinical laboratory services (home-brews), in contrast to the few that are packaged as kits for public sale.[21] The regulatory

[18] GeneTests, http://www.geneclinics.org (last visited Sept. 10, 2008) (displaying number of diseases as of that date). GeneTests is a NIH-funded reference site for genetic testing. *Id.*

[19] *Id.*

[20] 21 U.S.C. §§ 301–397 (2006).

[21] Gail H. Javitt et al., *Direct-to-Consumer Genetic Tests, Government Oversight, and the First Amendment: What the Government Can (And Can't) Do to Protect the Public's Health*, 57 OKLA. L. REV. 251, 272–73 (2004) (describing regulatory measures that could establish official review of the genetic testing field).

climate for these laboratory-based genetic tests is determined by the Clinical Laboratory Improvement Amendments of 1988 (CLIA), which set standards for laboratories that perform clinical testing.[22] CLIA certification is test-neutral, evaluating a laboratory for general proficiency, although clinical tests are classified by complexity.[23] Molecular diagnostic tests are classified as high-complexity tests, requiring an elevated level of review.[24] There is no specific specialty for genetic testing, although such a CLIA classification has been considered.[25] CLIA certification is based on inspections by professional, non-profit organizations with expertise in the field.[26] CLIA compliance, however, does not constitute a thorough evaluation of any specific genetic test that would be used to provide information to patients in health decision making.[27]

The FDA regulates certain discrete aspects of genetic testing as part of its default regulation of medical devices. Since 1997, the FDA has regulated the sale of analyte-specific reagents (ASR), which are the discrete active ingredients (such as an antibody) in a particular test.[28] In 2007, the FDA published guidelines relating to the development of a particularly complex diagnostic test, known as an in vitro diagnostic multivariate index assay (IVDMIA), which combines an assay and an algorithm in the assessment of clinical status.[29] The FDA has stated that it

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[22] 42 U.S.C. §§ 263, 263a (2006).

[23] *See* HENNA RENNERT & DEBRA G.B. LEONARD, *Molecular Pathology Laboratory Management*, *in* MOLECULAR PATHOLOGY IN CLINICAL PRACTICE 553, 556 (Debra G.B. Leonard et al., eds., 2007).

[24] *Id.* at 557 (noting the requirements relating to "qualification of personnel performing and overseeing the testing, procedure manual specifications, method verification of performance specifications, proficiency testing, quality assurance, patient test management, and inspection").

[25] For example, CLIA does recognize a laboratory specialization related to cytogenetics, which invites technology-specific criteria. Javitt et al., *supra* note 21, at 270.

[26] For example, most molecular pathology laboratories are reviewed by the College of American Pathologists. RENNERT & LEONARD, *supra* note 23, at 557.

[27] SACGT REPORT, *supra* note 10, at 9 ("CLIA does not address additional aspects of oversight that are critical to the appropriate use of genetic tests, such *clinical validity* including clinical sensitivity and clinical specificity, *clinical utility*, . . . and issues related to informed consent and genetic counseling."). A clinical laboratory test can be evaluated for scientific validity (whether the test adequately detects the relevant clinical marker), clinical validity (whether the marker has a meaningful correlation to a clinical condition), and clinical utility (whether the test offers enough clinical benefit to justify its use). SACGT REPORT, *supra* note 10, at 15–18.

[28] Medical Devices; Classification/Reclassification; Restricted Devices; Analyte Specific Reagants, 62 Fed. Reg. 62,243, 62,244–46 (Nov. 21, 1997) (codified at 21 C.F.R. pts. 809, 864). The manufacturers are reviewed for "general controls," in contrast to rigorous premarket approval for each particular product. SACGT Report, *supra* note 10, at 10.

[29] FOOD AND DRUG ADMIN., U.S. DEPT. OF HEALTH AND HUMAN SERVS., DRAFT GUIDANCE FOR INDUSTRY, CLINICAL LABORATORIES, AND FDA STAFF: IN VITRO DIAGNOSTIC MULTIVARIATE INDEX ASSAYS (2007), *available at* http://www.fda.gov/cdrh/oivd/guidance/1610.pdf.

will begin to gather data relevant to the approval of pharmacogenomic treatments, which rely on genetic status to determine optimal therapeutic regimens.[30] While these categorical review decisions by the FDA improve oversight of some aspects of the genetic testing field, they should not be mistaken for a mandate that all commercially available genetic tests undergo premarket review.

The CLIA oversight of the laboratory-developed tests that dominate the genetic testing field is administered by the Centers for Medicare and Medicaid Services (CMS), an agency under the jurisdiction of the Department of Health and Human Services (DHHS).[31] The Secretary of the DHHS has convened two professional panels to consider all aspects of genetic testing—the Secretary's Advisory Committee on Genetic Testing (SACGT) and the Secretary's Advisory Committee on Genetics, Health and Society (SACGHS).[32] A pressing concern for both committees has been whether genetic testing has accelerated to the point that more specific regulatory attention is warranted.[33] In 2000, the SACGT recommended that the FDA should regulate all genetic testing.[34] It should be noted that the FDA has not disputed that it possessed regulatory authority; rather, the FDA has stated that it lacks "resources" to adequately supervise the rapidly developing field.[35] General agreement regarding the inadequacy of regulation is widespread.[36] It has been suggested that FDA hesitation may originate in the fact that genetic tests can be characterized as both medical products and medical services, and the FDA does not regulate medical practice.[37]

The development of direct-to-consumer (DTC) marketing of genetic tests also shapes the climate in which individual patients seek genetic testing. The first such DTC advertising campaign was that of Myriad Genetics (Myriad), which initially

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[30] FOOD AND DRUG ADMIN., U.S. DEPT. OF HEALTH AND HUMAN SERVS., GUIDANCE FOR INDUSTRY, PHARMACOGENOMIC DATA SUBMISSIONS (2005), *available at* http://www.fda.gov/cber/gdlns/pharmdtasub.pdf. These are nonbinding recommendations.

[31] Javitt et al., *supra* note 21, at 269.

[32] The Secretary's Advisory Committee on Genetic Testing (SACGT) was established in 1998. This committee was followed by the establishment of the Secretary's Advisory Committee on Genetics, Health and Society (SACGHS) in 2002. Javitt et al., *supra* note 21, at 251 n.2.

[33] *See* SACGT REPORT, *supra* note 10, at 1, 4; Javitt et al., *supra* note 21, at 251–52.

[34] SACGT REPORT, *supra* note 10, at 27.

[35] "However, at a future date, the agency may reevaluate whether additional controls over the in-house tests developed by such laboratories may be needed to provide an appropriate level of consumer protection." Medical Devices; Classification / Reclassification; Restricted Devices; Analyte-Specific Reagants, 61 Fed. Reg.10,484, 10,484 (Mar. 14, 1996) (codified as pts. 809 and 864).

[36] Javitt et al., *supra* note 21, at 273 ("[N]otwithstanding some involvement by FDA and CMS, little federal regulatory oversight of genetic tests exists in the United States. More specifically, there is no governmental review of whether tests work or the claims made for them are accurate.").

[37] *See* Barbara J. Evans, *What Will It Take to Reap the Clinical Benefits of Pharmacogenomics?*, 61 FOOD & DRUG L.J. 753, 775 (2006) (describing the traditional orientation of the FDA toward product regulation).

marketed its BRAC*Analysis*® test for the determination of breast and ovarian cancer risk in 2002 through advertising in popular media.[38] Such direct appeals have been criticized because of the concern that consumers may not appreciate when genetic testing would be warranted, as well as concerns regarding the sufficiency of informed consent to such tests.[39] A Myriad advertising campaign for BRCA1 and BRCA2 genetic testing was relaunched in 2007.[40]

Most commercially available genetic tests do not encounter the level of government oversight that accompanies, for example, the introduction of pharmaceuticals into the marketplace.[41] In the absence of government review, therefore, peer assessment of genetic tests by scientific and medical colleagues operates to perform validation studies.[42] Effective peer assessment may require access to patented genetic materials and methods that relate to a particular test. Where genetic testing-related patents are managed in a restricted manner, widespread peer evaluation may be impossible. Thus, a restrictive gene patenting scenario can converge with the lax regulatory climate so that a genetic test may not receive optimal peer assessment.

Despite the official segregation of regulatory jurisdiction (or because of it), it is essential that controversies at the intersection of genetics and the law consider the trans-regulatory context applicable to particular technologies. Historically, the patent system does not take note of the wider regulatory climate in which an invention operates. For example, the decision to grant a patent does not translate into an official approval for the invention as a clinical product or endorsement of the invention as a socially desirable advancement.[43] The lack of FDA oversight of

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[38] Press Release, Myriad Genetics, Myriad Genetics Launches Direct to Consumer Advertising Campaign For Breast Cancer Test (Sept. 12, 2002), *available at* http://www.myriad.com/news/release/333030.

[39] The Centers for Disease Control (CDC) surveyed women to determine the influence of the marketing campaign, and to evaluate both patient and provider knowledge regarding such tests. The CDC concluded that the campaign resulted in more requests for BRCA1 and BRCA 2 testing, but that providers were not knowledgeable about the tests and their interpretation. CENTERS FOR DISEASE CONTROL AND PREVENTION, GENETIC TESTING FOR BREAST AND OVARIAN CANCER SUSCEPTIBILITY: EVALUATING DIRECT-TO-CONSUMER MARKETING, http://www.cdc.gov/mmwr/preview/mmwrhtml/mm5327a1.htm (last visited Sept. 15, 2008).

[40] Andrew Pollack, *A Genetic Test That Very Few Need, Marketed to the Masses*, N.Y. TIMES, Sept. 11, 2007 (describing the media campaign to market the Myriad Genetics breast and ovarian cancer genetic tests).

[41] Pharmaceutical review by the FDA requires extensive clinical testing of the proposed product to demonstrate safety and efficacy in order to win approval. *See* JOHN R. THOMAS, PHARMACEUTICAL PATENT LAW 302–26 (2005).

[42] Debra G.B. Leonard, M.D., Ph.D., Coll. of Am. Pathologists, Gene Patents: A Physician's Perspective, http://www7.nationalacademies.org/step/Leonard_presentation_October_proteomics.ppt (last visited Sept. 15, 2008).

[43] *See* Diamond v. Chakrabarty, 447 U.S. 303, 314–15 (1980) (noting that a patent grant does not endorse controversial technologies that Congress may choose to regulate); Juicy Whip, Inc. v. Orange Bang, Inc., 292 F.3d 728, 745–46 (Fed. Cir. 2002) (rejecting

most genetic testing, however, does have consequences for patent-related aspects of genetic testing, and patent management, conversely, has consequences for the peer evaluation that compensates for the minimal official oversight. Some contrasts can be noted between the patent environment related to genetic testing and the pharmaceutical patent context.[44] First, the availability of patent-related notice differs between FDA-approved or home-brew genetic tests and pharmaceuticals. FDA-approved pharmaceuticals are required to be listed in the Orange Book, which is a compilation of the patents relevant to a particular product.[45] This collection provides notice to the relevant stakeholders regarding potential patent conflicts. Those in the genetic testing field have no comparable resource. Second, the pharmaceutical patent regime uniquely provides for the availability of authorized experimental uses, because of interplay between FDA regulation and the patent statute.[46] The statutory experimental use provision in patent law, provided by the Hatch-Waxman Act, as recently interpreted by the Supreme Court in *Merck KGAA v. Integra Lifesciences I, Ltd.*,[47] "extends to all uses of patented inventions that are reasonably related to the development and submission of *any* information under the FDCA."[48] It might be argued that the development of ASRs and IVDs could allow some genetic testing-related research to qualify under the current exemption because they encounter FDA review, an interpretation consonant with the Supreme Court's inclusion of medical devices in 35 U.S.C. § 271(e)(1) in *Eli Lilly and Co. v. Medtronic, Inc.*.[49] However, such an interpretation will not allow most gene test providers to rely on this statutory research exemption in order to provide clinical services. A laboratory that provides clinical genetic testing services, which are defined as those that inform a patient

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any PTO role in filtering out inventions that may deceive consumers, which the FTC can prohibit); *In re* Brana, 51 F.3d 1560, 1567 (Fed. Cir. 1995) (noting that the PTO does not attend to clinical trial evaluation of patented products that are overseen by the FDA); *see also* Margo A. Bagley, *Patent First, Ask Questions Later: Morality and Biotechnology in Patent Law*, 45 WM. & MARY L. REV. 469, 546 (2004) (noting the inability of the patent system to accommodate larger questions of morality or social consensus).

[44] For an examination of the evolution of patent issues that accompany the transition from traditional pharmaceutical science to biotechnology, see Eileen M. Kane, *Molecules and Conflict: Cancer, Patents and Women's Health*, 15 J. GENDER, SOC. POL'Y & L. 305 (2006).

[45] *See* 21 U.S.C. § 355(j)(7)(A). The Orange Book was established by the Hatch-Waxman Act, enacted to expedite the development of generic alternatives to brand name pharmaceuticals. *See* Electronic Orange Book, http://www.fda.gov/cder/ob/ (last visited Sept. 15, 2008).

[46] *See* Rebecca S. Eisenberg, *The Role of the FDA in Innovation Policy*, 13 MICH. TELECOMM. & TECH. L. REV. 345, 361 (2007) (identifying the dimension of FDA policy regarding its data-generating mandates which has the effect of stimulating innovation as well as enhancing patient safety).

[47] 545 U.S. 193 (2005).

[48] *Id.* at 202.

[49] 496 U.S. 661, 665–66 (1990) (holding that research exemption to infringement provided by 35 U.S.C. § 271(e)(1) extends to patented medical devices as well as drugs).

regarding testing status, must be certified under CLIA.[50] In contrast, research laboratories that offer genetic testing for their own research purposes are not required to obtain CLIA approval, but it is unlikely that the research activities pursuant to offering clinical services that later seek CLIA approval could invoke the protection of the statutory research exemption.[51]

Molecular genetic testing, while conceptually simple, requires complex laboratory protocols, state of the art instrumentation, and skilled personnel.[52] The foundational observation that DNA sequence deviation between a normal gene (wild-type) and a mutant gene gives rise to clinical risk or disadvantage relies on the use of sophisticated technologies. This molecular heterogeneity requires that a robust set of testing options be available in order to accurately capture the genetic sequence of interest. For example, single point mutations are known to be implicated in a number of diseases and can be detected with polymerase chain reaction (PCR)-mediated direct sequencing.[53] However, direct sequencing cannot detect certain genomic rearrangements.[54] Thus, the thoroughness of a genetic test for an individual facing genetic risk will be related to the technical breadth of the services offered.

Research demonstrates that the repertoire of genetic mutations that can be observed in a gene of interest expands over time, as more investigators scan more patients, utilizing technical advances that offer more sophisticated detection.[55] A field can develop to the point where professional guidelines emerge to recommend the screening regimen for a particular population, i.e., the mutations that have been shown to have clinical significance.[56] Optimal clinical implementation occurs when research observations and professional consensus combine to identify the full spectrum of genetic testing that is appropriate for a particular clinical field. The actual testing environment, however, will be shaped by the landscape of patent rights related to genetic testing materials and methods, leading, in some cases, to a divergence between the theoretically optimal and the actually available.

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[50] SACGT REPORT, *supra* note 10, at 9.

[51] An argument that CLIA-directed research could invoke the statutory research exemption to infringement would have to rely on the text of 35 U.S.C. § 271(e)(1), which authorizes the research exemption for activities "reasonably related to the development and submission of information under a Federal law which regulates the manufacture, use, or sale of drugs or veterinary biological products."

[52] *See* RENNERT & LEONARD, *supra* note 23, at 553.

[53] WITTWER & KUSUKAWA, *supra* note 12, at 56.

[54] *Id.* at 57.

[55] *See* Christopher Greenman et al., *Patterns of Somatic Mutation in Human Cancer Genomes*, 446 NATURE 153, 157 (2007).

[56] *See* AM. COLL. OF MED. GENETICS, TECHNICAL STANDARDS AND GUIDELINES FOR CFTR MUTATION TESTING § CF 3.3.1 (2006), http://www.acmg.net/Pages/ACMG_Activities/stds-2002/cf.htm (offering, for example, a Minimum Mutation Panel for Population-Based Carrier Screening).

III. GENETIC TESTING AND RELATED PATENTS

A patent issues after an examination in the U.S. Patent and Trademark Office (PTO) to ensure that the patent application complies with the requirements for patentable subject matter,[57] utility,[58] novelty,[59] non-obviousness,[60] and disclosure requirements.[61] An issued patent is presumed to be valid.[62]

Intellectual property rights that control access to the resources needed for genetic testing can involve the following general kinds of patent claims: claims to specific full-length DNA genes[63] or to particular mutations (SNPs)[64] as compositions of matter, claims to methods for comparing a wild-type gene sequence to the gene sequence in a specimen of interest,[65] or to kits which contain the pertinent materials for testing.[66] More recent patenting extends to the protection of gene expression profiles or methods for their use, which capture how a defined set of genes are expressed in a particular patient at a particular time, allowing for an expression pattern to form a diagnostic or prognostic indicator, or serve as a pharmacogenomic marker.[67] Practically, most clinicians operating in the shadow of

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[57] 35 U.S.C. § 101 (2006).

[58] *Id.*

[59] 35 U.S.C. § 102 (2006).

[60] 35 U.S.C. § 103 (2006).

[61] 35 U.S.C. § 112 (2006).

[62] 35 U.S.C. § 282 (2006).

[63] *See, e.g.*, U.S. Patent No. 5,747,282 (filed June 7, 1995) (claiming "[a]n isolated DNA coding for a BRCA1 polypeptide, said polypeptide having the amino acid sequence set forth in SEQ ID NO:2").

[64] *See, e.g.*, U.S. Patent No. 5,693,473 (filed June 7, 1995) (claiming "[a]n isolated DNA comprising an altered BRCA1 DNA having at least one of the alterations set forth in Tables 12A, 14, 18 or 19 with the proviso that the alteration is not a deletion of four nucleotides corresponding to base numbers 4184-4187 in SEQ. ID. NO:1").

[65] *See, e.g.*, U.S. Patent No. 5,710,001 (filed June 7, 1995) (claiming "[a] method for screening a tumor sample from a human subject for a somatic alteration in a BRCA1 gene in said tumor which comprises gene comparing a first sequence selected from the group consisting of a BRCA1 gene from said tumor sample, BRCA1 RNA from said tumor sample and BRCA1 cDNA made from mRNA from said tumor sample with a second sequence selected from the group consisting of BRCA1 gene from a nontumor sample of said subject, BRCA1 RNA from said nontumor sample and BRCA1 cDNA made from mRNA from said nontumor sample, wherein a difference in the sequence of the BRCA1 gene, BRCA1 RNA or BRCA1 cDNA from said tumor sample from the sequence of the BRCA1 gene, BRCA1 RNA or BRCA1 cDNA from said nontumor sample indicates a somatic alteration in the BRCA1 gene in said tumor sample").

[66] *See, e.g.*, U.S. Patent No. 5,747,282 (filed June 7, 1995) (claiming "[a] kit for detecting mutations in the BRCA1 gene resulting in a susceptibility to breast and ovarian cancers comprising at least one oligonucleotide prime specific for a BRCA1 gene mutation and instructions relatiing [sic] to detecting mutations in the BRCA1 gene").

[67] *See, e.g.*, U.S. Patent No. 7,171,311 (filed January 15, 2003) (claiming "[a] method of assigning treatment to a breast cancer patient, wherein said breast cancer patient is a human breast cancer patient, comprising: (a) classifying said breast cancer patient as

genetic testing-related patents will confront composition of matter claims to the DNA gene sequences or to particular genetic mutations (SNPs), or method claims to the use of the nucleic acid or techniques for sequence comparison between the test sample and the reference nucleic acid. In the context of the home-brew genetic tests which dominate clinical genetic testing, patent claims to diagnostic kits are less relevant.

There has been extensive public concern regarding the management of patents to genomic inventions,[68] which is evidenced by empirical assessment of patenting practices[69] as well as official investigations. For example, the National Institutes of Health (NIH) issued a Best Practices for the Licensing of Genomic Inventions in 2005, urging patent holders to utilize non-exclusive licensing of such patents.[70] In 2006, a committee established by the National Academy of Sciences (NAS) investigated patenting trends in genomic and proteomic inventions, concluding that, although aggregate DNA patenting appeared to be declining, the specific management of patents covering the use of genetic sequences for diagnostic

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having a prognosis selected from the group consisting of a first prognosis, a second prognosis, and a third prognosis on the basis of a first expression profile comprising the nucleic acid levels of expression of at least five genes listed in Table 5 in a clinically relevant cell sample from said breast cancer patient by a method comprising (a1) determining the similarity between said first expression profile and a first good prognosis expression profile comprising the nucleic acid levels of expression of said at least five genes to obtain a patient similarity value, wherein said nucleic acid levels of expression in said first good prognosis expression profile represent the nucleic acid levels of expression of said genes in patients having no distant metastases within five years of initial diagnosis; and (a2) classifying said breast cancer patient as having said first prognosis if said patient similarity value exceeds a second similarity threshold value, said second prognosis if said patient similarity value exceeds a first similarity threshold value but does not exceed said second similarity threshold value, and said third prognosis if said patient similarity value does not exceed said first similarity threshold value, wherein said second similarity threshold indicates greater similarity to said first good prognosis expression profile than does said first similarity threshold; and (b) assigning said breast cancer patient a treatment without adjuvant chemotherapy if the breast cancer patient is lymph node negative and is classified as having said first prognosis or said second prognosis, or assigning said breast cancer patient a treatment with adjuvant chemotherapy if said breast cancer patient (b1) is lymph node positive and is classified as having said first prognosis, said second prognosis, or said third prognosis, or (b2) is lymph node negative and is classified as having said third prognosis").

[68] *See* NAS REPORT, *supra* note 3, at 20-22.

[69] *See, e.g.*, Kyle Jensen & Fiona Murray, *Intellectual Property Landscape of the Human Genome*, 310 SCIENCE 239 (2005) (reporting the U.S. patenting of nearly 20% of human genes).

[70] Best Practices for the Licensing of Genomic Inventions: Final Notice, 70 Fed. Reg. 18413 (April 11, 2005) (recommending careful consideration of where incentives are required and therefore when genomic inventions should be patented, and recommending non-exclusive licensing of any such patents in order to facilitate full access to DNA sequences).

genetic testing continued to raise concern.[71] The committee report presented a spectrum of patent management scenarios relating to gene sequences with diagnostic application, ranging from the most restrictive (Myriad as the sole provider of clinical genetic testing related to its holding of the BRCA1 and BRCA2 patents), to litigation-driven compromises (the Canavan gene patent management by Miami Children's Hospital and subsequent involvement of the Canavan Disease Foundation to increase access) and relatively unrestricted access (the Huntington's disease gene patent and the willingness of patent holder Massachusetts General Hospital to license widely, facilitating multiple testing sites and methods, and lower cost).[72] Other scholars reach the same conclusion as the NAS Report with respect to the particularly difficult patent issues that attach to diagnostic gene patenting.[73]

The official panels convened by DHHS to review the status of genetic testing in the United States have included patent-related issues in their deliberations regarding the state of the field. The Secretary's Advisory Committee on Genetic Testing (SACGT) panel expressed official concern over the impact of gene patenting on the availability of resources for researchers and patients,[74] and, more recently, the later-convened Secretary's Advisory Committee on Genetics, Health, and Society (SACGHS) has been investigating where gene patenting impacts the development of the field and the delivery of clinical services.[75]

An exclusive holder of the patent portfolio for genetic testing in a particular field can make a strategic decision to limit licensing of the patents which are essential for research and clinical services, and decide to become the sole provider

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[71] *See* NAS REPORT, *supra* note 3, at 62–69.

[72] *Id.*

[73] *See, e.g.*, John H. Barton, *Emerging Issues in Patent Diagnostics*, 24 NATURE BIOTECHNOL. 939, 941 (2006) (noting that the diagnostic gene patent issues impact a range of applications, including single-gene testing, microarray technologies, and pharmacogenomic applications); Timothy Caulfield et al., *Evidence and Anecdotes: An Analysis of Human Gene Patenting Controversies*, 24 NATURE BIOTECHNOL. 1091, 1093 (2006) (noting "one important exception" to the general absence of anticommons effects in gene patenting is "the area of gene patents that cover a diagnostic test"). Note that although many commentaries cite "diagnostic" gene patents as objects of concern, the actual focus is wider, and technically includes the use of genes for predictive as well as prognostic purposes. For simplicity, the Article uses "diagnostic gene patent" as inclusive of the other types of patents.

[74] *See* Letter from Edward R.B. McCabe, Chair, SACGT, to The Honorable Donna E. Shalala, Sec'y of Health and Human Servs., U.S. Dep't of Health and Human Servs. (Nov. 17, 2000), *available at* http://www4.od.nih.gov/oba/sacgt/10-17-00.htm ("Given the importance of gene patents and licenses, we believe that current concerns and questions about possible adverse effects on access should be assessed more fully.").

[75] The SACGHS has convened a task force on gene patents and licensing practices. *See* JAMES P. EVANS, CHAIR, SACGHS TASK FORCE ON GENE PATENTS AND LICENSING PRACTICES, REPORT FROM THE SACGHS TASK FORCE ON GENE PATENTS AND LICENSING PRACTICES (2006) *available at* http://www4.od.nih.gov/oba/SACGHS/meetings/Nov2006/Evans.pdf.

of genetic testing by offering "home-brew" laboratory services which can be marketed to physicians and patients. The existence of a sole provider of clinical genetic testing for a particular disease raises concerns about data exclusivity and mutation prevalence analysis, in addition to any technical shortcomings in the laboratory services.[76] The preconditions that are most likely to engender patent-mediated obstacles to full development of the field will occur when the critical patents are held by one particular holder, and the disease testing requires the detection of multiple kinds of genomic mutations in the gene(s) of interest.[77] Recall that the full scope of genetic testing can detect any number of distinct genomic derangements.[78] Any decision to offer less than the full complement of testing techniques will necessarily limit the kinds of mutations that can be detected. As a result, mutations that may exist in the genes of some patients will not be detected if the necessary testing methods are not commercially available. What happens when a researcher is able to determine that some individuals in the population screened by the patent holder, who have tested "negative" for the presence of deleterious mutations in a gene, do in fact carry mutations which can be detected by other analytic techniques, but the patent holder does not offer such clinical testing and will not permit others to offer such clinical services?

This is not an abstract question. Such a clinical scenario has occurred and can be used as a paradigmatic illustration of the general problem. A large patent portfolio which dominates the genetic testing field for the BRCA1 and BRCA2 genes related to hereditary breast and ovarian cancer[79] is held by Myriad Genetics, based in Salt Lake City, Utah.[80] Clinical genetic testing for the BRCA1 and BRCA2 genes in the U.S. is only available as an in-house laboratory service performed at Myriad, for patients who present a physician referral. These currently available commercial tests offer full sequencing of the BRCA1 and BRCA2 genes,

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[76] Jon F. Merz, *Disease Gene Patents: Overcoming Unethical Constraints on Clinical Laboratory Medicine*, 45 CLIN. CHEM. 324, 326 (1999).

[77] *Id.* at 326–27. For example, Athena Diagnostics, Inc., holds the exclusive license to a number of patents for genes to neurodegenerative diseases (e.g., spinocerebellar ataxia, SCA1) and is the sole provider of genetic testing for mutations in these genes. *See* Leonard, *supra* note 42.

[78] WITTWER & KUSUKAWA, *supra* note 12, at 19.

[79] Mutations in the BRCA1 and BRCA2 genes are associated with an elevated familial risk of breast and ovarian cancer. *See* Richard Wooster et al., *Identification of the Breast Cancer Susceptibility Gene* BRCA2, 378 NATURE 789, 790 (1995); Yoshio Miki et al., *A Strong Candidate for the Breast and Ovarian Cancer Susceptibility Gene* BRCA1, 266 SCIENCE 66, 66 (1994).

[80] Myriad holds at least 20 patents that are related to BRCA1 and BRCA2, including its own originally filed U.S. patents as well as those it licensed from OncorMed, which also included those generated by researchers at the University of California. A search of the USPTO Patent Full-Text and Image Database, http://www.uspto.gov/patft/index.html (last visited Sept. 14, 2008) for patents including "BRCA1" and "BRCA2" and assignees "Myriad" and "OncorMed" and "University of California" reveals patents issued as recently as U.S. Patent No. 6,235,263 (filed Feb. 29, 2000) and as early as U.S. Patent No. 5,654,155 (filed Feb. 12, 1996).

as well as detection of a small set of genomic rearrangements and a panel of specific point mutations.[81] The tests are ideally directed to individuals with a family history suggesting genetic predisposition to these cancers, rather than to the public at large.[82] The Myriad tests can detect some of the mutations that can occur in the BRCA1 and BRCA2 genes, but not all. A disclaimer describing the limitations of the testing accompanies the test results that are provided to a patient.[83]

Scientific reports that identify genomic arrangements in the BRCA1 and BRCA2 genes that are not detected by the Myriad testing date back at least to 2001.[84] With the ongoing advancement in the techniques of molecular diagnostics, new methods can detect a wider range of mutations in the genes of interest, and there have been a number of scientific reports of such newly discovered mutations in the breast cancer genes from laboratories outside the U.S.[85] The findings of European researchers led to significant professional concern over the Myriad European patents, and public opposition by leading medical organizations in Europe.[86] A divergence between U.S. and European patent law allowed the Myriad patents to be directly challenged in the European Patent Office, using the formal

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[81] The commercially available tests include full sequencing of the gene, screening for a panel of specific mutations that can occur in the general population and a set of mutations that predominate in the Ashkenazi Jewish population, and detection of a discrete set of genomic rearrangements. Genetic Test Results Overview, http://www.myriadtests.com/testresults.htm (last visited Sept. 15, 2008) [hereinafter Test Results Overview].

[82] U.S. PREVENTIVE SERVICES TASK FORCE, *Genetic Risk Assessment and BRCA Mutation Testing for Breast and Ovarian Cancer Susceptibility: Recommendation Statement*, 143 ANNALS OF INTERNAL MED. 376, 376 (2005) (recommending "that women whose family history is associated with an increased risk for deleterious mutations in BRCA1 or BRCA2 genes be referred for genetic counseling and evaluation for BRCA testing").

[83] *See* Test Results Overview, *supra* note 81. In addition, the BRCA1 and BRCA2 Hereditary Breast/Ovarian Cancer reference page at Gene Reviews states "[o]ther genomic rearrangements or some types of errors in RNA transcript processing will not be detected in the Myriad Genetic Laboratory protocol." NANCY PETRUCELLI ET AL., GENE REVIEWS, BRCA1 AND BRCA2 HEREDITARY BREAST/OVARIAN CANCER 4 (2007), http://www.ncbi.nlm.nih.gov/bookshelf/picrender.fcgi?book=gene&&partid=1247&blobtype=pdf.

[84] *See* Sophie Gad et al., *Identification of A Large Rearrangement of the BRCA1 Gene Using Colour Bar Code on Combed DNA in an American Breast/Ovarian Cancer Family Previously Studied by Direct Sequencing*, 38 J. MED. GENETICS 388 (2001) ("No *BRCA1* or *BRCA2* gene mutation was identified by direct DNA sequencing (BRCAnalysis™, Myriad Genetic Laboratories Inc, Salt Lake City, USA.).").

[85] *See* Frans B.L. Hogervorst et al., *Large Genomic Deletions and Duplications in the* BRCA1 *Gene Identified by A Novel Quantitative Method*, 63 CANCER RES. 1449, 1449 (2003) ("[W]e applied a new method, called MLPA, which enables us to determine the relative copy number of all of the *BRCA1* exons simultaneously with high sensitivity in a high-throughput format.") (footnotes omitted).

[86] Michael Balter, *Transatlantic War Over BRCA1 Patent*, 292 SCIENCE 1818, 1818 (2001) (noting the Institut Curie characterization of the missed mutations in the Myriad BRCA1 test as a "potential danger" to patients).

opposition procedure provided by the European Patent Convention, which permits third-party challenges to recently granted patents.[87] In contrast, U.S. patent law has no such mechanism. The oppositions filed against the Myriad European patents succeeded in revocation or amendment of the patents, sharply curtailing the company's European patent rights over diagnostic genetic testing for the BRCA1 and BRCA2 genes,[88] and, as a result, allowing a competitive testing environment to develop in Europe.[89]

In 2006, Dr. Mary-Claire King and her colleagues published a study in the Journal of the American Medical Association that determined the frequency of undetected mutations in individuals in the United States who had been given a negative test result from the Myriad BRCA1 and BRCA2 tests.[90] Access to the Myriad patented materials is available to researchers who can pay the relatively high licensing fees and who use the materials solely for research-oriented purposes.[91] The King laboratory used a technique that was not used in the clinical testing offered by Myriad, known as multiplex ligation probe amplification (MLPA), which can detect large genomic rearrangements that are missed by direct sequencing.[92] The study reported that 12% of the women who were screened

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[87] Any person may file an opposition against a newly granted EPO patent. European Patent Convention art. 99, Nov. 29, 2000 [hereinafter European Patent Convention], *available at* http://www.epo.org/patents/law/legal-texts/html/epc/1973/e/ar99.html.

[88] *See* Jordan K. Paradise, *Lessons from the European Union: The Need for a Post-Grant Mechanism for Third-Party Challenge to U.S. Patents*, 7 MINN. J. L., SCI. & TECH., 315, 320–22 (2006) (noting revocation of EP 699754, pertaining to diagnostic methods, based on sequencing errors that undermined novelty and disclosure, the amendment of EP 705902 to exclude diagnostic methods, the amendment of EP 705903 to cover only one mutation in the BRCA1 gene, and the amendment of EP 785216 to cover the use of a mutation only in the Ashkenazi Jewish population); Birgit Verbeure et al., *Analysing DNA Patents in Relation with Diagnostic Genetic Testing*, 14 EUR. J. HUM. GENETICS 26, 30 (2006). Significantly, none of the opposition decisions relied on the use of EPC art. 52(4), which excludes "diagnostic methods practised on the human or animal body" from patentable inventions. *See* European Patent Convention, *supra* note 87.

[89] *See* Jordan Paradise, *European Opposition to Exclusive Control Over Predictive Breast Cancer Testing and the Inherent Implications for U.S. Patent Law and Public Policy: A Case Study of the Myriad Genetics' BRCA Patent Controversy*, 59 FOOD & DRUG L.J. 133, 138–45 (2004) (summarizing the opposition proceedings in the EPO).

[90] *See* Tom Walsh et al., *Spectrum of Mutations in* BRCA1, BRCA2, CHEK2, *and* TP53 *in Families at High Risk of Breast Cancer*, 295 J. AM. MED. ASS'N. 1379, 1379 (2006).

[91] Myriad has entered an agreement with the National Institutes of Health allowing NIH-funded investigators to use patented materials for research purposes at lower rates than the commercial testing fee of approximately $3,000. *See* Tom Reynolds, *Gene Patent Race Speeds Ahead Amid Controversy, Concern*, 92 J. NATL. CANCER INST. 184, 185 (2000).

[92] For a discussion of the methodology employed by Dr. King and her colleagues, see Walsh et al., supra note 90. For a discussion of the MLPA technique, see Jan P. Schouten et al., *Relative Quantification of 40 Nucleic Acid Sequences by Multiplex Ligation-Dependent Probe Amplification*, 30 NUCLEIC ACIDS RES. 1 (2002).

negative by the Myriad tests in fact did have genomic rearrangements that could be detected with MLPA, particularly large deletions or duplications.[93] The investigators noted the constrained testing climate in the U.S., stating that "[G]enetic testing, as currently carried out in the United States, does not provide all available information to women at risk."[94] The results attracted widespread press coverage.[95] Despite the fact that the work of King and her colleagues did not duplicate any clinical service offered by Myriad, the company's response indicated that its patents would likely be infringed by any clinical testing based on the results from the King study.[96]

The Myriad patent-based control over commercial genetic testing options has attracted wide attention from those concerned with patent-related obstacles to genetic testing in the United States.[97] The scientific literature has consistently noted that the ongoing BRCA1 and BRCA2 patent issues must be factored into any

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[93] Walsh et al., *supra* note 90, at 1379, 1386.

[94] *Id.* at 1386.

[95] *See, e.g.*, Andrew Pollack, *Flaw Seen in Genetic Test for Breast Cancer Risk*, N.Y. TIMES, March 22, 2006, at A20; AMERICAN CANCER SOCIETY, *Genetic Tests Can Miss Breast Cancer-Causing Mutations*, March 21, 2006.

[96] In response to the King et al., report, a Myriad spokesperson responded "that would probably infringe on our patents." Erik Stokstad, *Genetic Screen Misses Mutations in Women at High Risk of Breast Cancer*, 311 SCIENCE 1847, 1847 (2006). Myriad added a new test, the BRACAnalysis® Rearrangement Test (BART), in 2006, which detects DNA rearrangements not detected by the company's other testing methods. *See* Press Release, Myriad Genetics, Inc., Myriad Introduces Enhanced BRAC*Analysis*® Test for Exceptionally High-Risk Breast Cancer Patients (Aug. 1, 2006), *available at* http://www.myriad.com/news/release/890018. The study indicated that 2.6% of patients testing negative by other means had a positive result from the BART test. *See* R. Wenstrup et al., *Molecular Genetic Testing for Large Genomic Deletion and Duplication Mutations in the BRCA1 and BRCA2 Genes for Hereditary Breast and Ovarian Cancer*, 25. J. CLIN. ONCOL. 10513, 10513 (2007). Decisions by the patent holder to expand commercial testing options (which may occur years after the tests become technically feasible) can confront previously tested patients and their genetic counselors with the possibility of recontact and retesting, as well as earlier medical decisions made on the basis of incomplete data. *See* Wendy S. Rubinstein, *Roles and Responsibilities of a Medical Geneticist*, 7 FAM. CANCER 5, 11–13 (2008) (describing the challenge of counseling patients as genetic testing options evolve over time).

[97] *See* Vural Ozdemir et al., *Shifting Emphasis from Pharmacogenomics to Theragnostics*, 24 NATURE BIOTECHNOL. 942, 943 (2006) ("[T]he *BRCA* patents give Myriad the ability to constrain research-oriented applications of *BRCA* patents and particularly head-to-head comparisons of which genotyping methodology or test product is most informative for clinical management of the susceptibility to breast cancer."). *See also* Caulfield et al., *supra* note 73, at 1093 (noting that the acutely restrictive climate created by the Myriad BRCA1 and BRCA2 patents is a "cautionary tale" for other gene patent holders).

assessment of progress in the field of genetic testing for inherited breast and ovarian cancer.[98]

The scenario described above related to testing of the BRCA1 and BRCA2 genes can be characterized as the use of patent rights to set a de facto clinical standard by controlling the repertoire of available testing options and limiting compensating alternatives to the dominant models.[99] The consequences are real for the scientific community, which must contend with limited allowances for peer validation and compensatory research, and for patients, who cannot access the full range of testing procedures that would establish a more comprehensive genetic profile for an individual on which to base medical decision making. This latter shortcoming leads to instances of false negative results for certain patients, whose genetic test results reflect not just science, but the marketplace. Although a commercial laboratory may concede its testing limitations in disclaimers to individual patients, the wider public health issue in which genetic testing operates under technical disadvantage due to patent management decisions must be addressed as a public policy matter.[100] The divergence between public health needs and patent management does not translate into an immediate patent-based solution, as the patent system is not formally burdened with any public health mandate.[101]

Field-wide solutions that recognize the need for widespread access to diagnostic gene patents are certainly desirable, and have been suggested with respect to research and the provision of clinical services. The need to consider statutory research exemptions to patent infringement is more pressing in view of the limitations to the common-law research exemption imposed by the Federal

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[98] *See, e.g.*, CINDY L. VNENCAK-JONES, *Inherited Diseases*, *in* FUNDAMENTALS OF MOLECULAR DIAGNOSTICS 125, 148 (David E. Bruns et al., eds., 2006) ("A U.S. patent has resulted in clinical testing for BRCA1 and BRCA2 being available exclusively at one location within the United States; both false-negative test results and variants of uncertain significance are possible."); Christine Sevilla et al., *Testing for BRCA1 Mutations: A Cost-Effectiveness Analysis*, 10 EUR. J. HUM. GENETICS 599, 599 (2002) ("Due to the diagnostic strategy used by the patent owner, direct DNA sequencing may become the only BRCA1/2 test procedure available, although there exist several alternative strategies.").

[99] *See* Merz, *supra* note 76, at 326 ("[D]isease gene patentees have the very real ability to prescribe nationwide medical practices and to dictate the medical standard of care.").

[100] WENDY S. RUBENSTEIN, *Inherited Breast Cancer*, *in* MOLECULAR PATHOLOGY IN CLINICAL PRACTICE 207, 208 (Debra G.B. Leonard et al., eds., 2007) ("Because the complete genetic characterization of BRCA1 and BRCA2 is an ongoing process, the technique(s) selected for mutation detection must be comprehensive in order to provide an accurate clinical result.").

[101] This observation finds support in many of the AIDS-related patent controversies, for example, both domestic and international, where allegations that patent rights impair access to pharmaceuticals have led to campaigns for compulsory licenses. For example, see the National Institutes of Health's denial of the 2004 Norvir-related march-in application. *See* Memorandum from Elias A. Zerhouni, Director, Nat'l Insts. of Health, In the Case of NORVIR®: Manufactured by Abbott Laboratories, Inc. (July 29, 2004), *available at* http://www.ott.nih.gov/policy/March-in-norvir.pdf.

Circuit in the case of *Madey v. Duke University*.[102] Proposals for legislative enactment of a research exemption for the use of diagnostic gene patents would facilitate the scientific work that is designed to assess the scientific validity and reliability of such tests, and one such proposal recently issued from a study panel of the National Academy of Sciences.[103] However, research exemptions to patent infringement cannot address the limitations on clinical services that deprive patients of full access to genetic testing services. One legislative proposal with a broader impact was introduced in Congress and would have exempted diagnostic genetic testing using patents to DNA sequences from infringement, as well as providing a research exemption,[104] but there was no enactment. The proposed field-wide solutions would alleviate the patent-generated dilemmas in the genetic testing field, but in their absence, there are doctrinal strategies in patent law that should be considered for specific and seemingly intractable controversies where patent management poses risks to public health, as, for example, in the case of the Myriad BRCA1 and BRCA2 patents.

In the absence of any formal opposition procedure in U.S. patent law that authorizes third-party challenges to existing patents, it is possible to sketch out possible outcomes when compensatory genetic research intersects with existing patent rights, leading to allegations of infringement. This article provides an overview, as a theoretical matter, of how the existence of later-developed genetic research that identifies compensatory clinical options for patients might impact the validity and scope analysis of apparently dominating patent claims (Part IV), how compensatory clinical services based on the research could be characterized in view of an infringement analysis (Part V), and how the remedial options to the patent holder who asserts patent rights against those offering compensatory clinical services might fare in view of current jurisprudential views regarding injunctive relief in patent cases (Part VI).

IV. PATENT VALIDITY IN VIEW OF COMPENSATORY GENETIC TESTING

A challenge for a patent-centered evaluation of conflicts where dominant patents related to genetic testing hinder the range of clinical testing options is that the validity of the patent itself, responsible for structuring the relations between the

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[102] 307 F.3d 1351, 1361–62 (Fed. Cir. 2002) (narrowing the availability of the exemption for most academic research).

[103] NAS REPORT, *supra* note 3, at 14, 16 (recommending that Congress consider infringement exemptions for research "on" inventions and for research providing independent verification of diagnostic genetic tests); *see also* Rochelle Dreyfuss, *Protecting the Public Domain of Science: Has the Time for an Experimental Use Defense Arrived?*, 46 ARIZ. L. REV. 457, 459, 471 (noting the particular difficulties in implementing an experimental use provision where the technology has clinical application, such as the BRCA1 and BRCA2 genes, as the most critical "experiments" will involve patients).

[104] The 2002 legislative proposal would have created a research infringement exemption for research on genetic sequence information and an infringement exemption for genetic diagnostic testing. H.R. 3967, 107th Cong. (2002).

patent holder and everyone else, is not formally evaluated with reference to any contemporaneous activities of patentee or user. At the extremes, non-use by the patent holder or infringing use by a potential defendant are not facts that formally bear on whether or not the actual patent is invalid.[105] This fact is noted, only because medical professionals and patients will often reflexively call for the invalidation of any patent that appears to curtail legitimate medical practice. But the patent must be judged on its merits.

Application of the substantive standards for patentability to patents on DNA gene sequences has generated several technology-specific controversies: whether genes should be patentable subject matter, whether the utility standard operates to frustrate early-stage patenting, and whether the standard for the obviousness of a DNA gene sequence in view of known protein composition is appropriate.[106]

A number of professional organizations involved in genetic testing, for example, oppose the classification of genes as patentable subject matter.[107] The general doctrinal considerations certainly attach to any gene patent asserted in diagnostic testing, but more specific doctrinal concerns can be identified where a researcher may have developed new approaches to genetic testing that may or may not be covered by dominant patents.

The chronology and development of a technical field are relevant to locating patent rights, which are sought and granted at particular times, against the march of technical progress in which the publicly available knowledge continuously evolves.[108] The claimed advance of an inventor is evaluated against the background of existing work, looking backward at the prior art in order to place the invention in context, and determine its novelty or non-obviousness.[109] Separately, disclosure doctrines look forward to identify the knowledge demanded from the inventor to justify the patent grant.[110]

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[105] *See* 35 U.S.C. § 282 (2006).

[106] *See* Dan L. Burk & Mark A. Lemley, *Is Patent Law Technology-Specific*, 17 BERKELEY TECH. L.J. 1155, 1173–82 (2002) (summarizing specific doctrinal issues in patent law pertaining to the field of biotechnology).

[107] Some professional organizations have taken official policy positions which oppose the granting of patents on genes. *See, e.g.*, COLLEGE OF AMERICAN PATHOLOGISTS, STATEMENT ON PATENTS AND GENE-BASED TESTS (2000), *available at* http://www.cap.org; AMERICAN COLLEGE OF MEDICAL GENETICS, POSITION STATEMENT ON GENE PATENTS AND ACCESSIBILITY OF GENE TESTING, *available at* http://www.acmg.net/StaticContent/StaticPages/Gene_Patents.pdf.

[108] *See, e.g.*, Rebecca S. Eisenberg, *Obvious to Whom? Evaluating Inventions from the Perspective of PHOSITA*, 19 BERKELEY TECH. L.J. 885, 887 (2004) (noting the time-sensitive nature of invention analysis, in which an invention made at one time may be judged at a later time, introducing possible distortion).

[109] Novelty of the invention is required by 35 U.S.C. § 102 (2006) and non-obviousness is required by 35 U.S.C. § 103 (2006). In addition to the prior art analysis during patent prosecution, a granted patent may be subject to a later reexamination at the PTO, for example, in which prior art not reviewed during prosecution is newly considered.

[110] *See* 35 U.S.C. § 112 (2006) (providing for the written description, enablement, and best mode requirements).

The intersection between a broad patent claim and later-developed technology implicates the patent law doctrine of enablement. Enablement requires that a patent adequately disclose how to make and use the invention,[111] and is judged as of its sufficiency at the time of the filing of the patent application.[112] The doctrine functions to set the limits on the patent grant, as "the scope of the claims must bear a reasonable correlation to the scope of enablement provided by the specification to persons of ordinary skill in the art."[113] Disclosure also serves a public-domain-enhancing role, ensuring that when the patent enters the public domain, the invention is ready to be made or used by a public that relies on the sufficiency of the disclosure. Those of skill in the art should not have to engage in "undue experimentation" in order to practice the claimed invention.[114] A set of analytic factors from *In re Wands* facilitates this analysis.[115] The inherent unpredictability of a technical field, a factor that cautions against broad claim scope, is particularly relevant to patents relating to biotechnology.[116]

The clinical scenario where a later researcher develops or applies techniques that may have been developed after the filing of the relevant dominating patent could suggest possible enablement issues that might bear on the scope and/or validity of patent claims that might be alleged to cover the compensatory research. The false negatives that are uncovered in the research genetic testing described in this article pose a problem not just for the patients, but might point to inherent vulnerabilities in the patents that are used to constrain testing. The interpretation of claim scope in a particular patent that may appear to dominate a genetic testing field has consequences for those who wish to operate outside the scope of the patent, whether or not they seek to patent their own work.

Claim scope is not just a limited inquiry in a particular patent infringement suit; the breadth of a patent claim has implications for the incentives that remain available to all subsequent developers in the field.[117] The scope of patent rights also dictates whether a patent holder may be able to efficiently coordinate the development of a field, as theorized in the prospect theory of patents.[118] While industries have been categorized as presenting models of cumulative or discrete

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[111] *See id.*

[112] *In re* Hogan, 559 F.2d 595, 604 (C.C.P.A. 1977).

[113] *In re* Fisher, 427 F.2d 833, 839 (C.C.P.A. 1970).

[114] *In re Wands*, 858 F.2d 731, 736–37 (Fed. Cir. 1988).

[115] *Id.* at 737.

[116] Enzo Biochem Inc. v. Calgene, 188 F.3d 1362, 1372 (Fed. Cir. 1999) (noting a particular application to the field of antisense technology).

[117] *See* Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 843 (1990) (defining a relationship between claim scope and the incentives for follow-on development).

[118] *See* Edmund W. Kitch, *The Nature and Function of the Patent System*, 20 J. L. & ECON. 265, 267–71 (1977) (suggesting that broad patent claims facilitate coordinated development of a field by the patent holder).

innovation,[119] patent claims to gene sequences and mutations *per se* and the derivative patent claims that describe methods for their use are more usefully categorized as having both discrete and cumulative features. Each foundational discovery, such as the identification of a gene linked to a clinical disease, gives rise to a predictably discrete set of related patents whose management will likely determine the development of the field and subsequent patenting efforts. That characterization may indicate that the consequences of a patent holder's restrictive management are confined to a particular field. The effects of dominant patents in the circumscribed field, however, may block subsequent research efforts, which illustrate the cumulative characteristics of genetic research. In the case of genetic testing, where a clinical phenomenon and a genetic correlation are irrefutable, each clinical field can be viewed as a zone of non-discretionary standards that are either available or not. There is no discretionary aspect to genetic science at the level of the informational uses that comprise genetic testing. From these perspectives, the discrete burden on a specific field as well as the cumulative impact on future development can both be understood.

The composition of matter claims pertaining to DNA sequences used in genetic testing could pose enablement issues depending on the scope of compounds that will be covered by a broad claim describing a gene of interest. In general, such a patent claim may describe the range of DNA compounds by reciting an end function, or by other claim strategies that use stringency hybridization or sequence identity.[120] An illustration of the Federal Circuit's restrictive view of enablement using functional claiming of a DNA gene sequence can be observed in *Amgen, Inc. v. Chugai Pharmaceutical Co.*[121] More recently, the Federal Circuit restricted the scope of a DNA gene sequence claim in *Regents of the University of California v. Eli Lilly & Co.*,[122] using the separate disclosure doctrine of written description, a doctrinal maneuver that has been criticized for its redundancy to the enablement doctrine.[123] Although a DNA gene sequence claim

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[119] *See* Merges & Nelson, *supra* note 117, at 880–82 (defining and distinguishing between discrete inventions and cumulative technology).

[120] PATENT RES. GROUP, BIOTECHNOLOGY PATENTS, LICENSING AND FDA PRACTICE I7–I14 (2002).

[121] 927 F.2d 1200, 1202–19 (Fed. Cir. 1991) (disfavoring broad claims to DNA sequences encoding erythropoietin, because of the lack of enablement regarding specific working analogs).

[122] Regents of the University of California v. Lilly, 119 F.3d 1559, 1567 (Fed. Cir. 1997) (disfavoring a wide scope for patent claims to DNA encoding insulin in multiple organisms, due to the limited exemplification in one species).

[123] *See, e.g.*, Mark D. Janis, *On Courts Herding Cats: Contending With the "Written Description" Requirement (and Other Unruly Patent Disclosure Doctrines)*; 2 WASH. U. J. L. & POL'Y 55, 69–88 (2000) (noting the incoherence of the separate patent disclosure standards, exacerbated by the *Lilly* decision); Janice M. Mueller, *The Evolving Application of the Written Description Requirement to Biotechnological Applications*, 13 BERKELEY TECH. L.J. 615 (1998) (noting the redundancy of the written description analysis in view of the enablement doctrine). Recent scholarship suggests that the *Lilly* written description doctrine has not been widely applied to restrict claim scope. *See* Christopher M. Holman, *Is*

will allow a patent holder to dominate the use of that gene in all potential applications, there is a difference between the use of a gene for therapeutic (protein-oriented) applications and the use of the gene for informational purposes in genetic testing. In the context of therapeutic proteins, there may be greater tolerance of silent and point mutations in the DNA coding sequence[124] because there are likely many functionally similar sequences that will retain therapeutic function; jurisprudence that establishes the scope of such claims can, as a practical matter, set the level of competition in the field.[125] However, these kinds of conflicts over claim scope, which dominate jurisprudence to date, are less relevant to informational use of the gene. The use of a specific DNA for diagnostic purposes can demand more fidelity to the original sequence, as the objective is to determine individual variation from this known reference sequence. With respect to patent claims to SNPs or point mutations, the same rationale applies. As a result, there is reason to be less optimistic that a narrow interpretation of composition of matter claims using the enablement doctrine would alleviate the problem of facilitating access to critical and claimed DNA gene sequences and mutations necessary for genetic testing.

There are enablement issues that could relate to the method claims related to genetic testing in this scenario. A broad patent claim to a genetic testing method that uses a particular DNA sequence will be interpreted according to the claim language, specification, and prosecution history.[126] The intended breadth of such a patent claim is generally to cover all instances whereby a test sample DNA sequence is compared to one or more recited DNA sequences in order to find mutations.[127] The specification may include one or more references to particular testing techniques, and may or may not support a genus claim encompassing multiple species.[128] The enablement-centered evaluation of scope, as noted earlier, will be judged according to what the skilled artisan is able to achieve using the disclosure without resorting to undue experimentation.[129] Cases in which the Federal Circuit has restricted the scope of broad method claims in biotechnology

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Lilly *Written Description A Paper Tiger?: A Comprehensive Assessment of the Impact of* Eli Lilly *and Its Progeny in the Courts and PTO*, 17 ALBANY L. J. SCI. TECH. 1, 26–42 (2007) (noting the actual underapplication of the Lilly standard to date in the courts).

[124] ALBERTS ET AL., *supra* note 11, at 236.

[125] A DNA compound encoding a protein for therapeutic use is observed in *Amgen, Inc.*, 927 F.2d at 1203–04 (erythropoietin) and in *Eli Lilly & Co.*, 119 F.3d at 1562–64 (insulin).

[126] *See* Vitronics Corp. v. Conceptronic, Inc., 90 F.3d 1576, 1582 (Fed. Cir. 1996).

[127] *See, e.g.*, U.S. Patent No. 5,650,281 (filed May 17, 1995) (claiming "[a] method of assessing genetic change in a tissue of a human, comprising: detecting loss of wild-type DCC (Deleted in Colorectal Cancer) gene sequences as shown in FIG. 4 from nucleotide 1 to 5168 or their expression products in an isolated first tissue suspected of being neoplastic, said loss indicating a genetic change in the tissue").

[128] A genus patent claim is a claim that encompasses multiple embodiments, known as species, which share general attributes.

[129] *In re* Wands, 858 F.2d 731, 737 (Fed. Cir. 1988).

are characterized by claims in which a method shown to work in one organism or cell type has been claimed broadly across multiple species.[130] A genetic testing claim may not have that kind of vulnerability, as the technique is generally not being claimed in non-enabled organisms, but a lesson that can be carried over from the paradigmatic cases in biotechnology is that the unpredictability of the art will work against broad construction. While the comparison of genetic sequences *per se* may not be technically novel, the interpretation of claims in the context of clinical objectives imports the uncertainty and caution that attach to the intersection of technical procedures with human physiology, a sensibility that could be imported into the interpretation of patent claims in the genetic testing field in order to apply the enablement standard in full context.

The Federal Circuit has not developed a coherent approach to later-developed technology that might fall within the scope of a generally broad claim. If the enablement evaluation is pegged to the date of filing, can a patent claim be interpreted to cover unforeseen technical advances? In *Amgen, Inc. v. Hoechst Marion Roussel, Inc.*, the Federal Circuit affirmed a broad interpretation of a composition claim to include the compound produced by later technical methods that sharply departed from the patent holder's methods.[131] In that case, the claim was written broadly, and the court adhered to the notion that limitations from the specification could not be read into the claims to give them a restricted scope.[132] In *Chiron Corp. v. Genentech, Inc.*, the Federal Circuit introduced a developmental aspect to the enablement inquiry pertaining to an invention involving monoclonal antibodies.[133] If the technology was undeveloped, enablement could not require disclosure relating to the objectively unknown.[134] However, if the technology was "nascent," meaning in its early stages, enablement became more demanding and failure to equip the skilled artisan with "a specific and useful teaching" could become an enablement defect. [135] The court also employed the written description doctrine to limit the claims to monoclonal antibodies as they were understood on the filing date.[136] In her concurrence, Judge Bryson suggested that the proper approach to the evaluation of later technology against an earlier filed claim is to match the claim interpretation to the filing date, according it a meaning that would have been understood at the time.[137] As such, the claim would exclude later, unforeseen developments.

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[130] *See, e.g.*, Enzo Biochem, Inc. v. Calgene, Inc., 188 F.3d 1362, 1374–75 (Fed. Cir. 1999) (stating that method for antisense expression could not be claimed beyond the exemplified *E. coli* cells); *In re* Vaeck, 947 F.2d 488, 495–96 (Fed. Cir. 1991) (method for fusion protein expression could not be claimed for multiple species).

[131] 314 F.3d 1313, 1358 (Fed. Cir. 2003).

[132] *Id.* at 1335.

[133] *See* 363 F.3d 1247, 1256 (Fed. Cir. 2004).

[134] *See id.*

[135] *Id.* at 1254.

[136] *Id.*

[137] *Id.* at 1263 (Bryson, J., concurring).

Where the broad method claim aims to identify genetic predisposition by sequence comparison, it should be supported by a specification that recognizes the heterogeneity of mutations and genomic arrangements that lead to clinical risk, and that recognizes the heterogeneity of testing techniques that can fully screen for all possible mutations. As discussed, the enablement must be pegged to the time that the application is filed. At the time an application was filed, the state of knowledge may have understood the theoretical heterogeneity of genetic mutations, but the state of the art did not provide the technical means to identify and thereby distinguish different classes of mutations. An apparently broad patent claim to a diagnostic method, therefore, could be construed so that it did not cover later-developed techniques that were not enabled by the application at the time of filing. Such a boundary would comport with maintaining incentives to advance the state of genetic testing for a particular field, because the later researcher can be motivated by the possibility of patenting her advance, or simply to engage in and publish such progress without the possibility of a patent infringement suit. It should also be recognized that the establishment of new mutations that are associated with clinical risk might rise to the level of "undue experimentation" that would indicate a patent claim that is potentially broader than its disclosure. The method claim may also contain limitations to compositional aspects of the testing. Where a patent method claim proposes to generally detect a "somatic alteration" or "germ line alteration," the scope of the claim should be limited to the detection of those mutations as understood at the time of filing, which means that the panel of alterations might be quite specific and limited by then-available methodologies.

There are other dimensions to the enablement inquiry. A method patent claim with apparent breadth can also be evaluated to determine whether the genus of methods is composed of some inoperative embodiments, i.e., methods that do not work as intended. The presence of some inoperative embodiments can be tolerated, if the person of skill in the art would be able to determine how to distinguish between operative and inoperative embodiments. In *Atlas Powder Co. v. E.I. Du Pont de Nemours & Co.*, the Federal Circuit established that the presence of some inoperative embodiments within the scope of the claim does not invalidate the claim unless the number becomes significant and "undue experimentation" would be required to sort the successes from the failures.[138] A broad view of a method patent claim that purports to compare a wild-type sequence to a clinical specimen might cover some methods that in fact contain technical limitations that rise to a level of inoperability. If so, the broad claim might have a number of inoperative species that cannot be foretold. As each clinical test is a unique assessment of an individual's clinical status, it is not possible to determine beforehand which technique is optimal to reveal particular genetic risk. This is a discrete kind of inoperability that can attach to patent claims that are to be interpreted in view of clinical objectives. In a genetic testing context, where the availability of multiple testing platforms would be optimal to capture most instances of clinical risk, clinical inoperability could be a technology-specific, scope-limiting mechanism to

[138] 750 F.2d 1569, 1576 (Fed. Cir. 1984).

prevent the reach of a patent claim to methods that were not enabled by the original disclosure and that augment or correct the deficiencies in the patentee's offerings.

Where a patent has clinical impact, the clinical dimensions of the patent claim should be given weight in evaluating the proper scope of the claim. Thus, broad claims should be judged according to the contemporaneous clinical context at the time of filing, which would limit a claim that apparently reads on multiple, later-derived techniques to only those techniques that were understood at the time of filing. That earlier contemporaneous context can be established by later-published references that document the state of the art at earlier times.[139] These observations regarding the use of the enablement doctrine to frame an apparent gap between the patent holder's scope of rights and an accused infringer's later-derived activities can be used to suggest testable limits on the broad patent claims in a genetic testing field that might unduly the impair the development of advances in research and clinical services.

V. INFRINGEMENT IN VIEW OF COMPENSATORY GENETIC TESTING

Despite the socially useful effects of research that can compensate for limited clinical testing options offered by the patent holder, the likelihood that such work could infringe the compound and method patent claims that dominate the field is all too real. Determining patent infringement is a two-part process: claim interpretation to determine scope, followed by a comparison of the accused product or method against the scope of the claims.[140] Claim interpretation relies on the claim language, the specification and the prosecution history.[141] Infringement can be literal, in which the accused product or method falls squarely within the boundaries of the claim, or it can rely on the doctrine of equivalents, where the patent holder is permitted to establish infringement where insubstantial equivalents of the claimed invention are at issue.[142] Despite the occurrence of literal infringement, patent doctrine can theoretically account for instances where the activities of a would-be infringer are not regarded as infringing, where a product or service offered by a potential defendant departs significantly from what may be literally covered by a patent claim. In these situations, the judicially created reverse doctrine of equivalents is available to capture these relatively rare instances of extreme departure.[143] In view of the potential for the doctrine to investigate

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[139] *See In re* Wright, 999 F.2d 1557, 1562 (Fed. Cir. 1993).

[140] *See* Markman v. Westview Instruments, Inc., 52 F.3d 967, 976 (Fed. Cir. 1995) (en banc), *aff'd*, 517 U.S. 370 (1996).

[141] *See* Vitronics Corp. v. Conceptronic, Inc., 90 F.3d 1576, 1582–83 (Fed. Cir. 1996).

[142] *See, e.g.*, Warner-Jenkinson Co. v. Hilton Davis Chemical Co., 520 U.S. 17, 25–30 (1997).

[143] "The business of the PTO is patentability, not infringement. Like the judicially-developed doctrine of equivalents, designed to protect the patentee with respect to later-developed variations of the claimed invention, the judicially-developed 'reverse doctrine of equivalents,' requiring interpretation of claims in light of the specification, may be safely

infringement by comparing the underlying features of the patented invention and the accused work, it is reasonable to consider how the provision of compensatory genetic testing might be accounted for using this approach.

The reverse doctrine of equivalents has its origins in 1899, in *Boyden Power Brake Co. v. Westinghouse*, in which the Supreme Court refused to find infringement of a patent claim where the accused brake device departed significantly from the mechanism and operation of the claimed product.[144] The doctrine can alleviate a potential impasse between two parties who hold what are known as blocking patents, where the holders of a dominant patent and a subservient patent on an improvement both depend on cross-licensing for use of the other's invention. In this scenario, the reverse doctrine of equivalents can induce a dominant patent holder to enter into a licensing arrangement with the improver rather than risk a finding of non-infringement under the doctrine.[145] The doctrine also functions as an equitable mechanism to allow the work of an improver to continue despite literal infringement, using a rationale that views the accused work as so far removed in principle from that of the patented invention that it would be unjust to shut it down.[146] It is not only useful for an impasse over sequential patents; an improver who wishes to proceed with otherwise infringing activities and has no interest in patenting can also utilize the doctrine. The doctrine has also been described as a theoretically relevant "policy lever,"[147] despite the fact that the Federal Circuit has not acquiesced in its application to date.[148]

The doctrine is only relevant to instances where literal infringement has been determined. The test is described as "whether a product has been so far changed in principle that it performs the same or similar function in a substantially different way,"[149] and the developer has been described as a "radical improver."[150] There are few instances where a court has excused infringement on the basis of this doctrine, resulting in a paucity of examples that could illuminate its application. However, there are instances where a defendant has argued non-infringement on this basis.

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relied upon to preclude improper enforcement against later developers." *In re* Hogan, 559 F.2d 595, 607 (C.C.P.A. 1977).

[144] 170 U.S. 537, 583 (1898).

[145] *See* Robert S. Merges, *Intellectual Property Rights and Bargaining Breakdown: The Case of Blocking Patents*, 62 TENN. L. REV. 75, 93–94 (1994) (noting the leverage that the reverse doctrine of equivalents provides to an accused infringer who might escape literal infringement).

[146] *Id.* at 91.

[147] Dan L. Burk & Mark A. Lemley, *Policy Levers in Patent Law,* 89 VA. L. REV. 1575, 1657–58 ("In theory, however, it serves as a vital release valve, preventing patent owners from stifling radical improvements.").

[148] Tate Access Floors, Inc. v. Interface Architectural Resources, Inc., 279 F.3d 1357, 1368 (Fed. Cir. 2002) (noting that the court has not yet agreed with its application in any case that it has considered).

[149] SRI Int'l v. Matsushita Elec. Corp. of Am., 775 F.2d 1107, 1124 (Fed. Cir. 1985).

[150] Merges, *supra* note 145, at 79; *see also* Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX. L. REV. 989, 1010 (1997).

The doctrine surfaced in several biotechnology cases at the Federal Circuit, where defendants argued that an accused product was produced by radically different means than was the claimed product.[151] In *Scripps Clinic v. Genentech, Inc.*, the Federal Circuit acknowledged that the doctrine was available, and noted that, in addition to considerations of a different production mechanism at issue, the superior qualities of the product produced—"the specific activit[y] and purity"[152]—could also support application of the doctrine.[153] In *Amgen, Inc. v. Hoechst Marion Roussel, Inc.*, the court did not endorse the use of the doctrine, despite the defendant's demonstration that the accused product was produced by substantially different means than was the claimed product.[154] In *Tate Access Floors v. Interface Architectural Resources*, the Federal Circuit panel suggested that the court had never affirmed non-infringement based on the reverse doctrine of equivalents because of the rigorous disclosure requirements in the 1952 Patent Act that obviated most foreseeable assertions of the doctrine.[155]

A majority of the cases where the reverse doctrine of equivalents has been asserted involve product patent claims.[156] Because the doctrine might permit non-infringement where there is mechanistic departure, it would most readily surface where two apparently identical products work through dissimilar mechanisms. Does this observation have any relevance to the scenario where literal infringement of a composition of matter is at issue, as in the case of potential infringement of a DNA gene patent in genetic testing? The answer is likely yes, and the Federal Circuit has noted that the reverse doctrine of equivalents, in general, poses more analytic difficulty when applied to chemical compounds.[157] As a result, the use of DNA in genetic testing does not invoke the kind of production-based dissimilarities that have formed the basis for previous applications of a reverse doctrine of equivalents analysis, making this line of argument less likely to succeed.

In order to imagine how the reverse doctrine of equivalents could be invoked where there is literal infringement of method claims related to genetic testing, it is

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[151] *See generally* Amgen, Inc. v. Hoechst Marion Roussel, Inc., 314 F.3d 1313 (Fed. Cir. 2003) (concerning erythropoietin produced from a cell through exogenous gene transformation or endogenous gene activation); Scripps Clinic & Research Found. v. Genentech, Inc., 927 F.3d 1565 (Fed. Cir. 1991) (concerning factor VIII protein produced by chromatographic separation or recombinant DNA technology).

[152] 927 F.2d at 1581.

[153] *Id.*

[154] 314 F.3d at 1351.

[155] 279 F.3d 1357, 1368 (Fed. Cir. 2002).

[156] *See, e.g., id.* at 1360–62 (floor panel); Smith Kline Diagnostics, Inc. v. Helena Labs. Corp., 859 F.2d 878, 880–82 (Fed. Cir. 1988) (specimen test slide); SRI Int'l v. Matsushita Elec. Corp. of Am., 775 F.2d 1107, 1124 (Fed. Cir. 1985) (filter and camera).

[157] U.S. Steel Corp. v. Phillips Petroleum Co., 865 F.2d 1247, 1253 n.9 (Fed. Cir. 1989) (noting the usual formulation of the doctrine as determining "function," when the notion of "principle" might be more applicable to chemical compounds, but noting that such analysis is "conceptually and linguistically difficult").

necessary to conceptualize any accused activities as representing a radical departure from a patent claim that broadly covers a genetic testing method for a particular clinical condition. As noted, there are few models in the jurisprudence for the doctrine's application to method claims. One would have to argue, nonetheless, that the methods that could be literally infringing are a sharp break from the way that the method claims are understood to work, based on the specification. As such, the accused method offers a new and radical approach to achieving the function understood in the method claims. A radically different method might be that which, by definition, will work to uncover the mutations that cannot be detected with the patented method, as it is understood to work in actual operation. It is tempting to argue that simply offering a genetic testing method that is not available at all represents a radical departure. But that would be to misconstrue the nature of an argument under the reverse doctrine of equivalents, which formally compares two kinds of methods to discern substantially different operational principles.[158] While the foregoing might appear to be an argument regarding scope of an apparently broad method claim, this is an analytically distinct approach with a comparative focus on the advancement of the defendant and the contribution of the patent holder. The validity analysis *per se* does not perform this task.

Apart from a potential use of the reverse doctrine of equivalents in cases involving literal infringement, there can be infringement under the doctrine of equivalents that could be subject to the kind of analysis offered above. Professor Merges has noted that the sensibility underlying the reverse doctrine of equivalents could shift even more attention to "the importance of the advance represented in the *accused* device" when an infringement analysis occurs under the doctrine of equivalents.[159]

The perspectives offered here regarding the suitability of finding infringement where equitable considerations might reasonably compel a different outcome should be contrasted with the observations regarding the validity of the patents that might be asserted against compensatory genetic testing.

The enablement theories offered in Part IV, *supra*, represent claim-defining strategies that might limit the apparently broad sweep of a patent claim to a general genetic testing method, but this approach should be complemented with a thorough evaluation of infringement status.[160] Professors Merges and Nelson have also noted that the reverse doctrine of equivalents could be particularly useful in instances

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[158] Reference to the patent holder's actual activities will be discussed with reference to remedies; see *infra* Part VI.

[159] Merges & Nelson, *supra* note 117, at 909.

[160] A more explicit nod toward the application of infringement theories is stated: "The courts have consistently considered subsequently existing states of the art as raising questions of infringement, but never of validity." *In re* Hogan, 559 F.2d 595, 607 (C.C.P.A. 1977).

where the patent validity analysis, particularly with respect to enablement, cannot account for the improver's contribution.[161]

Consideration of the reverse doctrine of equivalents offers a method for investigating not just the activities, but the advancement offered by an accused infringer, a sensibility that might find some resonance where the accused activities are undertaken in view of undesirable technical limitations in the field that are deliberately imposed by the patent holder, with attendant disadvantage for patients. The nature of the problem addressed in this article is, at its foundation, the fact that patients cannot access a full range of clinical genetic testing options for optimal determination of genetic status. Therefore, a theory that fully accounts for (and might actualize) all the activities of a researcher offers the most benefit for public health. The equitable considerations that underlie the reverse doctrine of equivalents, if applied to activities that comprise research and clinical services with significant departure from a patented invention, offer another strategy for approaching the problem of patent-mediated limits on research and clinical services in genetic testing.

VI. REMEDIES IN VIEW OF COMPENSATORY GENETIC TESTING

The critical role of a court in structuring the relations between a patent holder and all others is apparent when it considers whether to grant preliminary or permanent injunctive relief to a patent holder asserting the right to exclude others from use of a patented invention. The exclusionary attribute is central to the intellectual property right, which is traditionally conceptualized as protected by a property rule, rather than a liability rule.[162] As such, the practical ability to seek injunctive relief in order to exclude third parties allows the patent grant to operate as a property entitlement.[163]

This traditional understanding of a patent as a species of property has allowed a patent owner to rely on the issuance of a permanent injunction in most cases when a patent has been found to be infringed.[164] The patent statute contemplates

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[161] Merges & Nelson, *supra* note 117, at 911. ("A more liberal use of reverse equivalents would be especially valuable when the allegedly infringing improvement embodies new technology not available when the patent was issued. As long as adequacy of disclosure is measured as of the filing date, enablement doctrine will be of no help to the infringing improver.").

[162] *See* Merges, *supra* note 145, at 78 (citing the theoretical framework developed by Calabresi and Malamed identifying the distinction between liability rules, which solely provide remedies in the form of damages, and property rules, which also provide a right to exclude in the form of injunctive relief).

[163] *See* 35 U.S.C. § 261 (2006) ("[P]atents shall have the attributes of personal property.").

[164] Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405, 430 (1908).

the issuance of injunctive relief to a successful patent holder.[165] The award of damages to compensate for past infringement does not account for future encroachment of the patent in suit by an adjudicated infringer.

Recent controversies largely arising in business-method and software-related patenting have focused critical attention on the nearly automatic award of a permanent injunction following a judgment of infringement. Two circumstances of recent origin account for a renewed skepticism regarding injunctions in certain cases. First, the nature of many business-method and software-related patents has drawn criticism, questioning whether such inventions are patentable subject matter, and whether such patenting offers incentives or obstacles to the progress of many Internet-based business models and software-dependent products and services.[166] Second, a number of plaintiff-patent holders who enforce their patents in these fields are non-practicing entities, sometimes called "patent trolls."[167] In many of the high-profile cases to date, the defendant is a business that makes a product or offers a service that may infringe the patent, but that also has wide commercial and public dependence.[168] The threat of a permanent injunction in these cases could eliminate a technology with great public support; as a result, the plaintiff is in a position to seek very high licensing fees from an accused infringer who is in danger of losing the freedom to operate in the marketplace. This contrast between the "troll" and the provider has elicited an outcry against the use of patents to demand unreasonable licensing fees, or to seek an injunction to eliminate the defendant's activities.[169]

The standards for injunctive relief in patent cases were explored by the Supreme Court in the recent case of *eBay, Inc. v. MercExchange, L.L.C.*[170] The plaintiff was a non-practicing patent holder who successfully sued an Internet auction site for infringement of its patent to an online auction bidding method.[171] The district court did not award an injunction to the prevailing plaintiff, largely due

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[165] *See* 35 U.S.C § 283 (stating that "courts having jurisdiction of cases under this title may grant injunctions in accordance with the principles of equity to prevent the violation of any right secured by patent").

[166] *See, e.g.*, Jay Dratler, Jr., *Does Lord Darcy Yet Live? The Case Against Software and Business-Method Patents*, 43 SANTA CLARA L. REV. 823, 853–71(2003) (criticizing the issuance of patents on subject matter that has no technological risk component).

[167] *See, e.g.*, Mark A. Lemley, *Are Universities Patent Trolls?* 17–20 (Stanford Public Law Working Paper No. 980776, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980776 (analyzing university patenting practices in view of their identity as non-practicing entities). The patent troll is generally defined as a patent-holding entity which does not practice the invention but uses its patents to extract revenue from (or to enjoin) those that do practice the invention. *See id.* at 1 n.4.

[168] *See, e.g.*, NTP, Inc. v. Research in Motion, Ltd., 418 F.3d 1282, 1287–90 (Fed. Cir. 2005) (discussing patent related to Blackberry wireless device).

[169] Maggie Shiels, *Technology Industry Hits Out at Patent Trolls*, BBC NEWS, June 2, 2004, http://news.bbc.co.uk/1/hi/business/3722509.stm.

[170] 547 U.S. 388 (2006).

[171] *Id.* at 1839.

to the fact that it did not practice its invention.[172] The Federal Circuit reversed, using language that suggested that a permanent injunction is automatically entered for a successful plaintiff in a patent lawsuit.[173] The Supreme Court took issue with an apparently reflexive denial from the district court and a reflexive grant from the Federal Circuit.[174] The Court emphasized that the award of a permanent injunction is not automatically denied or granted in such cases, but relies on the application of the traditional four-part test established for injunctive relief to the facts of an individual patent case.[175]

The *eBay* concurrence by Justice Kennedy drew heightened attention to the role of the activities of the patentee and the character of the patent in suit in considering the merits of a permanent injunction.[176] He noted that several factors of recent origin may have altered the default assumption that an injunction would always follow a judgment of infringement.[177] Citing "the nature of the patent being enforced," Justice Kennedy noted the "potential vagueness and suspect validity of some of these patents," possibly alluding to subject matter issues and disclosure deficiencies in "patents over business methods:"[178] In reference to the patent holder, he noted the "economic function of the patent holder" had changed in some situations, where "[a]n industry has developed in which firms use patents not as a basis for producing and selling goods but, instead, primarily for obtaining licensing fees."[179] This shifting climate, in his opinion, could introduce new considerations for a court into the application of the four-part test for injunctive relief.[180]

Following the *eBay* decision, the lower courts have begun to apply the four-part test to applications for injunctive relief in patent cases. Although the cases to date are evenly divided with respect to the grant of an injunction,[181] the influence

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[172] *Id.* at 1840.

[173] The court noted "the general rule that courts will issue permanent injunctions against patent infringement absent exceptional circumstances." MercExchange, L.L.C. v. eBay, Inc., 401 F.3d 1323, 1339 (Fed. Cir. 2005).

[174] The Court noted the "categorical denial" by the district court and the "categorical grant" by the Federal Circuit as equally problematic. 547 U.S. 388, 393–94 (2006).

[175] The plaintiff must demonstrate (1) an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between plaintiff and defendant, an equity is warranted; and (4) that the public interest is not disserved by an injunction. *Id.* at 391.

[176] *See Id.* at 396–97 (Kennedy, J., concurring).

[177] *Id.*

[178] *Id.*

[179] *Id.*

[180] *Id.*

[181] *See* Andrei Uancu & W. Joss Nichols, *Balancing the Four Factors in Permanent Injunction Decisions: A Review of post-*eBay *Case Law*, 89 J. PAT. & TRADEMARK OFF. SOC'Y, 395 (2007) (describing recent post-*eBay* trial court decisions, which illustrate a mixed application of the *eBay* analysis).

of Justice Kennedy's concurrence, which identified the status of the patent holder and the nature of the patent as relevant factors, can be discerned.[182]

The specific controversy over business-method patents accounts for some of the recent hesitation from the courts regarding the award of a permanent injunction. However, historically, some courts would not issue a permanent injunction when public health needs were dependent on the invention at issue. In *Vitamin Technologists v. Wisconsin Alumni Research Foundation*, the court was concerned over an injunction that would deprive the public of a patented process in which foodstuffs were irradiated in order to produce Vitamin D, although the court ultimately decided that the patents were invalid.[183]

In *City of Milwaukee v. Activated Sludge, Inc.*, the court denied an injunction to the plaintiff, holder of a patent to a sewer purification apparatus, due to concerns that the defendant's facility provided the only waste management for the local community.[184] In those cases, the public interest factor weighed heavily against a permanent injunction that would deprive the public of an invention with proven health benefit.[185] Relying on a public interest rationale, the Federal Circuit upheld the denial of a preliminary injunction against a defendant providing diagnostic tests for cancer and hepatitis in *Hybritech Inc. v. Abbott Laboratories*.[186]

Refusals to license, as a general matter, are not considered a violation of patent or antitrust law.[187] A patent holder has a statutory right to exclude others from making, selling, or using the patent invention.[188] However, the sensibility that has taken hold in the post-*eBay* climate, where permanent injunctions to non-practicing patentees are less automatic, and where third-party reliance on adopted technologies is accorded significant weight, is certainly advantageous for health-related inventions in the biotechnology sector where medical need is an independently significant factor.

A court could be asked to consider whether an injunction should be granted in two scenarios of concern related to genetic testing. In the first instance, a defendant is offering clinical services that are not offered by the patent holder, providing a compensatory set of testing options for the general public. That scenario has been

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[182] *See, e.g.*, z4 Technologies, Inc. v. Microsoft Corp., 434 F. Supp. 2d 437, 441, 444 (E.D. Tex. 2006) (finding that a non-practicing patent holder and the reliance of the public on the software technology under patent were factors that weighed against an injunction, and noting the Kennedy concurrence in *eBay*).

[183] 146 F.2d 941, 956 (9th Cir. 1945).

[184] 69 F.2d 577, 593 (7th Cir. 1934).

[185] *Vitamin Technologist*, 146 F.2d at 944; *Activated Sludge*, 69 F.2d at 593.

[186] 849 F.2d 1446, 1459 (Fed. Cir. 1988).

[187] *See* Herbert Hovenkamp, Mark D. Janis, & Mark A. Lemley, *Unilateral Refusals to License*, 2 J. COMPETITION L. & ECON. 1, 12 (2006). Exceptions to this general rule could be invoked where an intellectual property asset controls a natural monopoly or essential facility. *Id.* at 19–21.

[188] 35 U.S.C. § 154(a)(1) (2006) (noting "the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States").

discussed with respect to potential validity and infringement issues in Parts IV and V, *supra*, respectively. How does the four-part test for injunctive relief map onto this scenario? A patent holder who has proven infringement of patented product or method claims can seek injunctive relief as well as damages. A court could consider that an injunction would deprive the public of genetic testing that they cannot access otherwise, thus weighing the public interest factor against the grant of an injunction. Furthermore, a patent holder who is not offering a particular genetic test can be characterized as a non-practicing entity with respect to those tests, or as even exhibiting trollish behavior.[189] As such, the balance of hardships might not favor the patent holder, and furthermore, it could well be the case that monetary damages are adequate to compensate for the infringement. Of course, the award of damages only, while allowing a defendant to continue otherwise infringing activities, is close to the definition of a compulsory license.[190] In a second instance, where a researcher or another party seeks to perform validation studies of existing commercial genetic tests, the courts may decide that the public interest is similarly served by the refusal to issue an injunction that would frustrate the necessary peer assessment of genetic tests. As noted earlier, the great majority of genetic tests offered in the United States do not undergo any premarket approval by the FDA, shifting the burden of assessment to the peer community.[191] Following its investigation of the issue, the NAS Report recommended that courts decline to enjoin infringement where public health needs or professional standardization make it necessary for a genomic invention to remain available.[192] With respect to Justice Kennedy's observation on the "suspect validity" of some types of patents, the designation of genes as patentable subject matter has been questioned in legal scholarship[193] and criticized by professional medical organizations in the genetic testing field.[194]

A conflict between the patent system and the norms of medical practice arose in the 1990s, following the specter of litigation involving a patent to a method of

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[189] The concept of trolling can be viewed as a verb rather than a noun. Recently, Professor Lemley has explored, for example, whether a university is a patent troll when it simply licenses its patents, shifting the focus to specific instances of conduct rather than general characterizations. *See* Lemley, *supra* note 167, at 19 ("We shouldn't focus on the question of who is per se a bad actor. In my view, troll is as troll does.").

[190] Berman & Dreyfuss, *supra* note 7, at 907.

[191] *See supra* Part II.

[192] NAS REPORT, *supra* note 3, at 16.

[193] *See* Eileen M. Kane, *Splitting the Gene: DNA Patents and the Genetic Code*, 71 TENN. L. REV. 707, 752–53 (2004) (applying the law of nature exclusion in patentable subject matter to gene patents); Arti K. Rai & Rebecca S. Eisenberg, *Bayh-Dole Reform and the Progress of Biomedicine*, 66 LAW & CONTEMP. PROBS. 289, 299 (2003) (applying the product of nature doctrine to gene patents).

[194] *See supra* note 107.

cataract surgery.[195] The history of the enactment of 35 U.S.C. § 287(c), generally limiting the remedies available in the enforcement of medical procedure patents, illustrates how parallel concerns about the effect of medically relevant patents were addressed through technology-specific legislation, in a sequence that mirrors the suggested approaches to the current problems posed by some genetic testing-related patents. The initial legislative proposal in 1995 responded to concerns over the patenting of medical and surgical methods raised by the American Medical Association and approached the problem as a patentable subject matter issue, with a bill that would have prohibited the granting of patents to medical and surgical procedures.[196] That first attempt was followed with a proposal to exempt medical personnel from infringement if their professional practice posed the possibility of creating infringing conduct.[197] When concerns were raised regarding congressional interference with substantive standards for patentability and infringement, the legislation was rewritten to limit the remedies available for such alleged infringement, declaring that patent owners would not be able to enjoin or seek damages from medical practitioners or health care entities in the performance of the medical procedure.[198] The exemption does not include the use of diagnostic methods by a medical practitioner.[199] Foreclosing remedies may practically work as a kind of patentable subject matter exclusion, because the incentives to seek such patents are categorically removed. A statutory mandate makes this approach far more certain than reliance on shifting standards for injunctive relief, and that was certainly the intent. Note that a simple research exemption would not have been sufficient to address the concerns over these patents, as the ultimate goal of medical practitioners is to provide services to the public at large, rather than just to confirm research observations or extend the technological development of the field. That necessity parallels the concerns over the genetic testing-related patents and their clinical impact, and why solutions must provide for the opportunity to conduct research as well as to provide clinical services.

An accused infringer of a genetic-testing related patent who might rely on the possibility that a court will decline to issue an injunction in the post-*eBay* environment is certainly not in the same advantageous position as the medical practitioner who is protected by the remedy-limiting provision of 35 U.S.C. § 287(c). Within the scope of 35 U.S.C. § 287(c), a physician, for example, can proceed with medical practice, assured that no infringement claims will be asserted. Those in the diagnostic testing field have no *ex ante* assurances, either for

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[195] Gerald J. Mossinghoff, *Remedies Under Patents on Medical and Surgical Procedures*, 78 J. PAT. & TRADEMARK OFF. SOC'Y. 789, 790 (1996) (documenting the history of the medical procedure patent infringement exemption).

[196] *See id.* at 789–91. This parallels a recent bill introduced in the 110th Congress, H.R. 977, the Genomic Research and Accessibility Act (2007), which would ban patents on genes.

[197] Mossinghoff, *supra* note 195, at 790. This parallels a provision in the proposed legislation relating to gene patents that was introduced in 2002. *See supra* note 104.

[198] Mossinghoff, *supra* note 195, at 794.

[199] 35 U.S.C. § 287(c) (2006).

research uses or for the provision of clinical services. Litigation is always a possibility, and should infringement be found, a defendant can still encounter an award of damages to the plaintiff, even without an injunction, that becomes the equivalent of a compulsory license to practice the invention.

It is fair to conclude, however, that recent developments in the judicial treatment of injunctive relief in patent cases are favorable in the event that the offering of compensatory clinical genetic testing services are held to infringe certain patents, as a court may well consider that public health concerns and the failure of the patent holder to provide these tests are factors that argue against enjoining these medical services. In the absence of any immediately reasonable prospect that Congress would enact a general or research infringement exemption for the use of patented DNA sequences or genetic testing methods, the shift in the jurisprudential climate is welcome.

VII. CONCLUSION

Genetic testing can be used to identify disease susceptibility, establish diagnostic status, and design therapeutic regimens in medical care. The opportunities to apply genetic knowledge to medical problems have expanded rapidly in the DNA-based era of molecular genetics. Two legal realities are also shaping the development of the genetic testing field in the U.S. First, there is no FDA premarket review of most commercially available genetic tests. Second, many DNA sequences and genetic testing methods are patented. The intersection of these two realities explains some of the clinical dilemmas that have arisen in genetic testing.

This article has described several doctrinal strategies in patent law to address the public health consequences of patent-mediated standard-setting that limits research and clinical genetic testing for particular diseases. Any patent-imposed limitations on peer assessment of genetic tests are particularly onerous in view of the fact that most commercial genetic testing in the U.S. escapes rigorous assessment by the government or professional organizations. Patent-imposed limitations on clinical services deprive patients of complete genetic testing for particular disease risks, and leave them with the possibility of false-negative results that cannot be relied upon for medical decision making. One illustration of these dilemmas occurs with respect to the management of the BRCA1 and BRCA2 patents for the determination of hereditary breast and ovarian cancer risk, where current patent management strategies by Myriad Genetics artificially constrain research and clinical care, resulting in a seemingly intractable controversy. However, the scenario can also develop in the management of patent portfolios related to other genes and clinical conditions.

This article posed a hypothetical scenario where the development of genetic testing approaches that supplement the limited clinical standard set by the dominant patent holder become the reference point for the invalidity-infringement-remedy trajectory that would characterize a dispute between a patent holder and an accused infringer. The article offered some observations regarding the validity and

scope of dominant patent claims in view of subsequent genetic research, how future clinical services based on the research could be characterized in view of an infringement analysis, and how the remedial options to the patent holder who asserts patent rights against those offering compensatory clinical services might fare in view of current jurisprudential views regarding injunctive relief in patent cases. The validity and infringement analyses framed the problem as the evaluation of later-derived research in view of particular dominant patent claims that could be used to block such work. The remedies analysis asked, in contrast, how the nature of the patent and the activities of the patent holder would be factored into a decision regarding the legitimacy of injunctive relief against an infringer performing research or offering clinical services. The particular example described in the article, where the Myriad patent portfolio has been used to establish a suboptimal clinical standard for BRCA1 and BRCA2 genetic testing, is illustrative of the danger that patent rights in the field of genetic testing can amplify to set a standard of care for an entire clinical field. The genetic testing environment becomes a product of business decisions, rather than scientific judgment.

In specific cases, one or more of the strategies discussed in this article might be optimal to alleviate any obstacles to comprehensive genetic testing that result from allegations of infringement of particular composition and/or method claims. A successful enablement challenge, which limits the scope of an overly broad method claim, for example, may need to be accompanied by the refusal of a court to issue an injunction against the use of a patented gene compound if genetic testing that is impacted by both product and method patent claims is to proceed. It is noteworthy that the post-*eBay* climate with respect to the award of patent injunctions might induce a court to be particularly protective of compensatory genetic testing that does not, by definition, duplicate any services offered by the patent holder, and that satisfies a distinct public health need for complete genetic testing.

All of the theoretical strategies for patent conflicts explored in this article are litigation focused. As such, the options are only applicable to a hypothetical patent conflict between two parties, and are not field-wide solutions. Field-wide solutions would require action from one of several federal power sources: legislative, such as research exemptions or general exemptions to infringement of certain patents; administrative, such as a compulsory license issued by the U.S. under its plenary power;[200] or use of the march-in rights maintained by the NIH for patents relying on federal funding.[201] All of those options are, of course, potentially desirable to alleviate certain patent-related obstacles where public health needs are at stake. Political realities, however, have limited the real-world availability of such approaches. The absence of any formal patent opposition procedure in U.S. patent law eliminates any preemptive evaluation of patent validity or scope before the granted rights impact a research sector. Because the prospects for field-wide solutions are unfavorable at present, this article suggested doctrinal strategies that

[200] 28 U.S.C. § 1498 (2006).

[201] *See supra* note 101.

could be applied to current, specific patent conflicts in the genetic testing field, noting that patients in the U.S. have been contending with suboptimal genetic testing options for the BRCA1 and BRCA2 genes due to the presence of the U.S. Myriad patents, in contrast to the competitive genetic testing environment in Europe.[202] A renewed advertising campaign to market the Myriad tests in the U.S. was announced in late 2007.[203] A further concern regarding the genetic testing climate in the U.S. is the chill that the Myriad BRCA1 and BRCA2 gene patents (or any other such patents on the genes underlying a genetic test) can cast over the scientific field itself, as researchers understand that they may not be able to readily translate laboratory advances into publicly available clinical services. In this sense, it is reasonable to conclude that innovation in the field has been negatively impacted by the loss of confidence in the ability to achieve market exploitation of significant advances.

Patenting concerns in biotechnology have often focused on the problem of the anticommons or patent-thicket obstacles to successful implementation of research advances. The clinical scenario, here, in contrast, is not an anticommons problem in the sense of multiple proliferating patent rights that aggregate to pose significant problems of navigation, transaction costs, and permissions.[204] It is also not a problem of multiple patent holders whose discrete permissions must be assembled to facilitate the progress of a biotechnology standard, such as a genome (*e.g.*, SARS) or a genetically engineered product (*e.g.*, Golden Rice).[205] Where a genetic testing field is marked by multiple patent holders with patents on various genetic sequences that are essential for a particular genetic testing field, any obstacles to full development of testing options could be facilitated by the establishment of a patent pool that aggregates the essential rights for efficient transactions.[206]

The uniquely dominant position of the patent holder who controls the portfolio of patents in a specific genetic testing field, which is the focus of this article, can be explained by the convergence of the essential genetic standard with the de facto technical standard. A genetic standard is the basis for the identification of medical risk, where population studies, family histories, and molecular investigation synergize to detail the link between one or more specific genes and an increased occurrence of a specific disease. Academic commentary has amply

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[202] *See supra* Part III.

[203] *See supra* note 40.

[204] *See* Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCIENCE 698, 698–99 (1998) (describing how a proliferation of patent rights in biotechnology might actually inhibit scientific development).

[205] *See* Jorge A. Goldstein, Patent Pools and Standard Setting in the Biotechnology Industry, (July 11, 2005), www.law.washington.edu/CASRIP/Summit/2005/Goldstein.ppt.

[206] Patent pools have been proposed for certain aggregate patent situations in genetic testing, where multiple patent holders control the essential patent rights for a particular field. *See* Ted J. Ebersole et al., *Patent Pools as a Solution to the Licensing Problems of Diagnostic Genetics*, 17 INTELL. PROP. TECH. L.J. 6, 9 (2005). The utility of patent pools was endorsed by the NAS REPORT, *supra* note 3, at 98.

noted the inability to invent around such genes, where the goal is the determination of genetic status for predictive, diagnostic, or prognostic uses.[207] The gene is the standard. The characterization of the anchor position of the gene patent holder as conferring a standard-setting posture is reasonable. The presence of the genetic standard amplifies the effects of the strategic decisions of the patent holder so that the clinical standard for the field is a function of patent management decisions. This is the nexus between the patent rights and the standard of care. The disproportionate influence of the patent holder obscures the standard-setting that would normally be a product of collective professional consensus based on extensive trial and error. The standard becomes a function of the marketplace, rather than the laboratory.

The intersection of patent rights and standard-setting has been discussed in legal scholarship, for example, with respect to standard-setting organizations in the electronics industries that design technical standards that rely on the availability of many component parts, protected by multiple patents.[208] In those cases, the network effects of a discretionary standard amplify the strategic advantage that can be enjoyed by any particular patent holdout in a collective licensing or pooling arrangement.[209] The behavior of the gene patent holder described here can be usefully analogized to that of the holdout in a standard-setting organization, whose inhibitory conduct is amplified due to the reliance imposed by the standard. The inhibiting influence of the gene patent holder is then viewed in the larger context of the development of a technological field—behavior imposing social costs at large in addition to specific costs to potential users. The cost exceeds the unfavorableness of a particular private transaction, and amplifies to inhibit the field as a whole. This view resonates with the scenarios of restrictive patent management in genetic testing, where this article has documented how patent strategies can limit the clinical advancement of a particular field, with consequences for researchers and patients. The urgency of resolution to these scenarios is derived from the recognition that the presence of the genetic standard removes the competitive patent incentives that can ameliorate the effect of dominant patents because there is no ability to design around the gene.

In addition to the deprivation of clinical options for patients, the patent-mediated obstacles in genetic testing are acute in view of the regulatory void in the approval of genetic tests that was described earlier, where the lack of official

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[207] Berman & Dreyfuss, *supra* note 7, at 907.

[208] *See* Mark A. Lemley, *Intellectual Property Rights and Standard-Setting Organizations*, 90 CAL. L. REV. 1889, 1896–1909 (2002) (describing standard-setting origins and the intersection of patent rights with standard implementation). A holdout is a patent holder whose intellectual property is critical to the standard and who seeks to extract maximum financial gain, using the threat that the patented invention may not be available for the standard.

[209] Mark A. Lemley, *Ten Things to Do About Patent Holdup of Standards (And One Not To)*, 48 B.C. L. REV. 149, 152 (2007) (describing mechanisms for standard-setting organizations to reduce the likelihood of holdout/holdup scenarios which delay standard implementation).

premarket approval for most genetic tests in the U.S. intensifies the need for peer assessment by professionals in the genetic testing field. To date, there is no FDA oversight of most genetic testing in the U.S. However, there are proposals to make FDA review mandatory. If FDA review is imposed on the genetic testing field, there may be significant effects on the ability of researchers to engage in research on genetic testing, as they may be able to invoke the protection of 35 U.S.C. § 271(e)(1) for activities that could be framed as "reasonably related" to FDA approval. As a further illustration of the nexus between food and drug law and patent law, future FDA oversight would be an example of an apparently unrelated decision involving the regulatory review of genetic testing to improve the ability of researchers to work around existing patent rights. Increased oversight, while certainly desirable from the viewpoint of patient safety, could also create legal opportunities for research experimentation that do not currently exist.

The oft-cited promise of genomic medicine relies on the intersection of scientific research and clinical practice, which must proceed in tandem to identify the optimal uses of molecular insights into disease processes. It is critical that the patent system, charged with providing incentives that contribute to the expansion of scientific knowledge, remains a source of encouragement for the application of that knowledge to medicine.

DEFAMATION CLAIMS BASED ON PARODY AND OTHER FANCIFUL COMMUNICATIONS NOT INTENDED TO BE UNDERSTOOD AS FACT

Joseph H. King*

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I. INTRODUCTION: THE PARODY PROBLEM

In some types of communication, the author contends that the statements were not intended to be understood as fact—in other words that they were not intended to represent that the depicted events actually occurred. Such communications

 UTK and Walter W. Bussart Distinguished Professor of Law, University of Tennessee College of Law. Research for this Article was supported by a generous summer research stipend from the College of Law. I am also indebted to Brittian Sexton, my former research assistant, for his able help with reference material for this Article.

commonly take the form of parodies, cartoons, caricatures, or similar types of fanciful communications. Sometimes parodies and similar types of speech are the bases for claims for defamation. This article considers the question of how courts should decide whether a statement should be actionable despite the defendant's contention that it was not intended to be interpreted as representing that the portrayed event actually occurred. More specifically, I will address the matter of deciding when such statements should be deemed *protected opinion*[1] rather than potentially liability-supporting statements of *fact*.

Parody is a humorous or, less often, serious "imitation of a specific artistic work, person, idea, or historical period."[2] More broadly defined, it "includes any cultural practice which makes a relatively polemical allusive imitation of another cultural production or practice,"[3] characterized by "ironic inversion."[4] The concept of parody has been bedeviled by disagreement over its definition[5] and even its etymology.[6] Parody is most commonly conceived as a form of imitation created for the purposes of ridicule, mockery, or satire.[7] Thus, the predominant modern usage defines it as "any humorous, satirical, or burlesque imitation, as of a person,"[8] although at least one authority suggests that the definition need not necessarily

[1] I use the phrase "protected" opinion to mean that the statement was not sufficiently factual to be actionable as defamation as required by constitutional law or state law. Thus, protected opinion may not be sufficiently factual because it does not contain a provably false factual connotation; it cannot reasonably be understood as suggesting the occurrence of actual events; it consists of rhetorical hyperbole or an obvious epithet; or it does not express or imply undisclosed, unassumed, or unknown defamatory facts. *See* discussion *infra* Part II.F (summarizing the derivation of these four rules).

[2] MARY ANN RISHEL, WRITING HUMOR: CREATIVITY AND THE COMIC MIND 201 (2002).

[3] SIMON DENTITH, PARODY, 37 (2000).

[4] LINDA HUTCHEON, A THEORY OF PARODY: THE TEACHINGS OF TWENTIETH-CENTURY ART FORMS 6 (1985). Hutcheon elaborates: "Parody, then, in its ironic 'trans-contextualization' and inversion, is repetition with difference. A critical distance is implied between the backgrounded text being parodied and the new incorporating work, a distance usually signaled by irony." *Id.* at 32.

[5] *See* DENTITH, *supra* note 3, at 9, 193.

[6] *See* MARGARET A. ROSE, PARODY: ANCIENT, MODERN, AND POST-MODERN 6 (1993).

[7] DENTITH, *supra* note 3, at 193–94; *see* THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, (4th ed. 2006), *available at* http://dictionary.reference.com/cite.html?qh=parody&ia=luna (defining parody as "[a] literary or artistic work that imitates the characteristic style of an author or a work for comic effect or ridicule"). Dentith comments broadly that parody consists of a "range of cultural practices, all of which are imitative of other cultural forms, with varying degrees of mockery or humour." DENTITH, *supra* note 3, at 193.

[8] Dictionary.com, 10 Results for: *Parody*, http://dictionary.reference.com/browse/parody (last visited on June 14, 2008).

include ridicule.[9] The term 'parody' is usually traced etymologically to the Greek noun *parodia*, which means, 'counter-song.'[10] It has been around at least since ancient times, and probably since human beings began to communicate pictorially or verbally.[11] Its force derives from its emotional impact. For present purposes, parody will refer to a fanciful or fictitious imitation of the characteristics, conduct, or work product of another for the purposes of ridicule or comedic incongruous effect, one that typically contains signals of its parodic nature.[12]

Quite a few defamation claims have been based on parodies. The problem is that while a parody may often exact a severe emotional toll on its victim, it may or may not adversely affect the victim's reputation. There is "a history in all men's lives,"[13] and a person's reputation is a reflection of others' perception of that person's life history. It follows, then, that for one's reputation to be harmed, misinformation must negatively distort the person's life history—his reputation. A defamatory statement thus must register on recipients by *expressly* depicting defamatory events, or by *implying* the existence of defamatory events indirectly. A victim's reputation can be harmed only if falsely depicted or implied events change the recipients' perception of the events that make up the victim's life history.

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[9] Hutcheon suggests that, at least based on its Greek derivation, "[t]here is nothing in *parodia* that necessitates the inclusion of a concept of ridicule." HUTCHEON, *supra* note 4, at 32. For detailed discussion of the ancient and early etymology of parody, see ROSE, *supra* note 6, at 6–19.

[10] HUTCHEON, *supra* note 4, at 32.

[11] The early Egyptians, for example, "parod[ied] politicians in their stone drawings of anthropomorphic figures." RISHEL, *supra* note 2, at 203.

[12] *See* ROSE, *supra* note 6, at 45. Rose offers a useful definition (albeit in the literary context):

> [P]arody in its broadest sense and application may be described as first imitating and then changing either, and sometimes both, the "form" and "content", [sic] or style and subject-matter, or syntax and meaning of another work, or, most simply, its vocabulary. In addition to, and at the same time as the preceding, most successful parodies may be said to produce from the comic incongruity between the original and its parody some comic, amusing, or humorous effect, which, together with the changes made by the parodist to the original by the rewriting of the old text, or juxtaposition of it with the new text in which it is embedded, may act as "signals" of the parodic nature of the parody work for its reader.

Id.; *see also* Campbell v. Acuff-Rose Music, Inc., 510 U.S. 569, 580 (1994) (stating "[m]odern dictionaries . . . describe a parody as a 'literary or artistic work that imitates the characteristic style of an author or a work for comic effect or ridicule,' or as a 'composition in prose or verse in which the characteristic turns of thought and phrase in an author or class of authors are imitated in such a way as to make them appear ridiculous.'" (citation omitted)).

[13] WILLIAM SHAKESPEARE, THE SECOND PART OF HENRY FOURTH act 3, sc. 1.

Whether parodies should be potentially actionable as defamation depends on whether the statement is deemed factual and thus potentially actionable, or is a matter of protected opinion and not actionable. [14] Although plagued by confusion and lack of consensus, under the prevailing trends of constitutional law and/or state substantive defamation law principles, four core bases have emerged for classifying a statement as protected opinion: (a) it did "not contain a provably false factual connotation;"[15] (b) it "cannot 'reasonably [be] interpreted as stating actual facts;'"[16] (c) it consists merely of "rhetorical hyperbole, a vigorous epithet,"[17] or "imaginative expression;"[18] or (d) it does not state or imply undisclosed, unassumed, or unknown defamatory facts.[19]

In addressing defamation claims arising from parodies, courts usually consider the entire article and publication and its full context in their assessment of the fact versus protected opinion question. [20] Moreover, in assessing specific statements, the courts also consider the effect of the overall article and publication on how the specific statements will be understood.[21] The problem is that a number of courts sometimes go further by following a monolithic analysis, and also frequently apply a one-dimensional approach. Their analysis may be monolithic in that they seem to reason that if the overall tenor of an article is deemed a parody, then they seem to assume *ipso facto* that they need not consider whether some of the events depicted could reasonably be interpreted as having actually occurred.[22] By one-dimensional I mean that the courts usually seem to focus on simply whether or not the events expressly depicted in the parody were reasonably understandable as suggesting that those described events actually happened as depicted. While such an analysis may be appropriate as far as it goes, it may be incomplete when a parody, even if not believable as representing the actual occurrence of the expressly depicted events, nevertheless may have reasonably implied that there were other defamatory events that did occur. Compounding such monolithic and one-dimensional analyses, if they conclude that the language in question could reasonably be interpreted as parody, some courts state that parody and defamation are mutually exclusive—that "parody cannot constitute a false statement of fact and cannot support a defamation claim."[23] This may overlook the possibility that even if the overall tenor of the parody is not believable as actual

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[14] RESTATEMENT (SECOND) OF TORTS § 565 (1977); *see also infra* notes 15–19.

[15] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990).

[16] *Id.* at 21 (quoting Hustler Magazine v. Falwell, 485 U.S. 45, 50 (1988)).

[17] Greenbelt Coop. Publ'g Ass'n v. Bresler, 398 U.S. 6, 13–14 (1970); *see also Milkovich*, 497 U.S. at 17.

[18] *Milkovich*, 497 U.S. at 20 (quoting *Hustler*, 485 U.S. at 53–55).

[19] *See infra* Part II.D.

[20] *See* Cianci v. New Times Publishing Co., 639 F.2d 54, 61 (2d Cir. 1980) (examining entire article as a whole).

[21] *See id.* at 60.

[22] *See infra* Part III.A. (discussing this type of analysis).

[23] Hamilton v. Prewett, 860 N.E.2d 1234, 1247 (Ind. Ct. App. 2007).

events, there may be *some depicted events* that are reasonably believable or the parody may *imply other events or conduct* that are believable as actual facts.

The incompleteness of the typical judicial analysis can be illustrated by the recent case of *Hamilton v. Prewett*.[24] The plaintiff was in the water conditioning business. He discovered a Website entitled "Paul Hamilten—The World's Smartest Man."[25] The Website was written from the perspective of a "Hamilten,"[26] a person in the water conditioning business.[27] It allegedly portrayed "Hamilten" as "a manipulative individual both personally and professionally."[28]

The Website stated in part:

> I am known for my ability to seduce women with my quick wit. I have several methods of attracting women as well as socializing skills, which are in the book I am writing . . . .
>
> . . . .
>
> When my employees are installing a unit at a place where their [sic] is a woman at home, I like to get the target alone and tell her that she doesn't have to "pay for this." A couple of winks and boom, you have another sucker hooked. Please note that this only works on women that have half a brain, the more intelligent ones.[29]

The plaintiff claimed that the Website defamed him and his business. The defendant argued that the Website was protected as "a form of comedy, parody, or satire."[30]

Affirming a summary judgment for the defendant, the court of appeals held that "the Website taken as a whole is not subject to a defamatory interpretation," reasoning that it was "a parody because no reasonable person could believe its claims to be true."[31] The court pointed to the tongue-in-cheek "Customer Testimonials"[32] to illustrate the Website's facetious nature, noting that "[i]t is not reasonable to believe that merely drinking a specific kind of water can attract women, cure severe facial disfigurement, or raise a low intelligence quotient to the

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[24] *Id.*

[25] *Id.* at 1238.

[26] There was a one-letter difference between the spelling of the name of the plaintiff, Paul Hamilton, and the name of the person on the Website, "Paul Hamilten" ("Hamilten"). The defendant-Prewett "never denied that he was the author of the Website or represented that the Website was not a reference to Hamilton or Hamilton Water Conditioning." *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.* at 1238–39.

[30] *Id.* at 1238.

[31] *Id.* at 1247.

[32] *Id.* at 1238.

level of a rocket scientist."[33] According to the court, the plaintiff's defamation claim must fail "because parody cannot constitute a false statement of fact and cannot support a defamation claim."[34] The court anchored its analysis on "the proposition that defamation and parody are mutually exclusive."[35] I believe that its analysis was incomplete. It may not have been obvious to a reasonable reader upon what frame of reference the defendant based his parody—in other words, whether or what potential undisclosed factual events may have inspired or precipitated the parody. If so, a legitimate question may have remained whether the parody, even if not reasonably understandable as indicating that the events described actually happened as depicted, may nevertheless have implied that there were other defamatory events that actually did occur. Specifically, should the statements about sexual seduction[36] be something potentially actionable?

In Part II, I will discuss the evolution of the traditional distinction between fact and protected opinion in general, particularly the *Restatement* formulations and the principal Supreme Court decisions addressing the constitutional dimensions. In Part III, I will discuss some of the parody cases and explain why I believe the analytical approach commonly applied is incomplete. Then, I will suggest a framework and methodology for addressing defamation claims based on parodies. I believe that an allegedly defamatory statement should be deemed protected opinion if it falls within one or more of the following four core categories under First Amendment or state substantive tort law principles that define the parameters of protected opinion: (a) it did not convey a provably false factual imputation; (b) it could not reasonably be understood as representing actual events; (c) it consists merely of so-called rhetorical hyperboles, epithets, or fanciful or imaginary expressions; or (d) it does not state or imply undisclosed, unassumed, or unknown defamatory facts. Then, with this four-pronged grid or framework, I propose that the courts examine both of the potentially defamatory dimensions of parodies.

First, with respect to the *specific events expressly described in the parody*, the court should determine whether the allegedly defamatory events expressly depicted in the parody were protected opinion. This inquiry will focus on whether the parody reasonably suggested that at least some of the defamatory events expressly described actually occurred. Thus, even if the overall tenor of the piece is deemed a parody, the court should nevertheless still consider whether, giving due consideration to the full context and the fact that the overall piece is a parody, there nevertheless are selected events depicted that are reasonably believable as describing actual events and that do not fall within any of the categories of protected opinion. Secondly, and irrespective of the outcome on the first step, the

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[33] *Id.* at 1246. The court also noted that the Website not only contained a disclaimer, but that it was clearly meant to be parody. *Id.*

[34] *Id.* at 1247.

[35] *Id.* at 1244 (citing Browning v. Clinton, 292 F.3d 235, 248 (D.C. Cir. 2002)).

[36] *See supra* note 29 and accompanying text.

court should also examine the possibility that imbedded defamatory facts were *implied in the parody*. Furthermore, the outcome under both steps should not depend conclusively on whether or not the overall tenor of the writing conveys to a reasonable reader that it is parody rather than a depiction of actual events. Finally, I briefly comment on whether potential liability for tortious interference based on the use of parody for the undisclosed ulterior purpose of interfering with the prospective economic relations of the plaintiff in order to benefit a competitor should be precluded solely because the parody might be deemed protected opinion for defamation purposes.

II. EVOLUTION OF THE FACT-OPINION DISTINCTION

A. Overview

One may be subject to liability for defamation for communicating a statement that injures a victim's reputation.[37] The required elements include: a communication; defamatory meaning; publication; reference to the plaintiff; causal connection between the defamation and the harm to the plaintiff's reputation; liability-supporting state of mind of the defendant with respect to the truth or falsity of the statement and its defamatory character; special damages (in some jurisdictions); falsity; and a communication of fact rather than protected opinion.[38] The element most discretely implicated in defamation claims based on publication of parodies is the requirement that the statement be of fact rather than protected opinion. Accordingly, the fact-rather-than-protected-opinion requirement is the most commonly invoked and most appropriate element for addressing whether a parody is potentially actionable as defamation.[39] A few cases, however, address one of the fact/protected opinion tests—whether the parody could "reasonably [be] interpreted as stating actual facts"[40]—in terms of the defamatory meaning element that asks whether the statement carried a defamatory meaning.[41] Nevertheless, the test seems to be expressed in the same terms irrespective of which element the court ties its rule to. For the sake of simplicity, I will develop my analysis within the fact/protected opinion element for present purposes. It should also be noted that some courts have developed special formulations for the state of mind requirement

[37] *See* RESTATEMENT (SECOND) OF TORTS §§ 558, 559 (1977).

[38] The list of elements was adapted from Joseph H. King, *Defining the Internal Context for Communications Containing Allegedly Defamatory Headline Language*, 71 U. CIN. L. REV. 863, 869–70 (2003). Even when all of the elements are satisfied, recovery may still be constitutionally limited to actual damages for defamatory statements involving matters of public concern, at least in the absence of proof of defendant's knowledge of, or reckless disregard with respect to, the falsity of the communication. *Id.* at 870.

[39] *See infra* note 233 and accompanying text.

[40] *Milkovich*, 497 U.S. at 20 (quoting Hustler Magazine v. Falwell, 485 U.S. 46, 50 (1988)).

[41] *See infra* note 235 and accompanying text.

in cases of parody, satire, and similar fanciful communications.[42] I will not, however, examine that aspect of the parody question here.

The place of opinion in the law of defamation has always been problematic. That said, one can still generalize about the status of opinion in defamation law at least to say that there have always been limitations, albeit variable and shifting ones, on defamation liability for statements of "opinion." The devil, of course, lurks in the details. It is useful to think of reputation as a reification of a person's life history. In order for that life history to be denigrated by defamation, a defendant's statement must have falsely depicted events that are understood to constitute that history. From this core (though seldom articulated) premise comes the distinction between misstatements of events, "facts which may change the perception of a person's life history in the eyes of others," and "opinion," which does not change the perception of historical events.

Defamation law regarding liability for statements of "opinion" has been a dynamic area,[43] and is still a work in progress. I have organized a summary of the evolution of the fact-opinion distinction into roughly four phases: the pre-1964 period before the introduction by the Supreme Court of constitutional limitations on defamation liability; the formative Supreme Court cases; the *Second Restatement* and pre-1990 state and lower federal cases; and, finally, the *Milkovich* case and its aftermath.

I must add a caveat here. In addition to the inherent arbitrariness of categorization, attempting to subdivide the developments on the fact-opinion distinction is complicated by two factors. First, the law has been influenced and driven by three forces: state substantive tort law; formulations of the *Restatement of Torts*; and Supreme Court decisions developing constitutional limitations on the potential defamation liability. And, second, these forces are intertwined. Since 1964, and especially since 1974, the dates of bedrock Supreme Court decisions constitutionally overlying much of defamation law, the state court decisions, the lower federal court decisions, and the *Restatement* have all evolved to a significant extent in response to a perception that the First Amendment compelled the protection of non-factual "opinions" from defamation liability.

It is not the purpose of this article to definitely explore the respective purviews of the constitutionally-based, as opposed to the state-law-based, rules governing the protection of opinion. Nor is it to attempt to straighten the meandering (and maddening) twists and incarnations of the various lower court opinions both before and after the relevant Supreme Court cases. Rather, my goal is to suggest architecture for addressing the fact-opinion dichotomy in the context

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[42] *See infra* notes 238–240 and accompanying text.

[43] For background on the evolution, with emphasis on defamation in the workplace, *see generally* John Bruce Lewis & Gregory V. Mersol, *Opinion and Rhetorical Hyperbole in Workplace Defamation Actions: The Continuing Quest for Meaningful Standards,* 52 DEPAUL L. REV. 19, 23–28, 36–43 (2002).

of parodies, and let the courts apply the constitutional and state-law rules within that framework.

B. Pre-1964 Lower Court Decisions and the First Restatement of Torts

The early substantive tort rules on liability for opinions were somewhat ambivalent. This can be illustrated by the initial *Restatement* position. On the one hand, the *First Restatement of Torts* provided that "[a] defamatory communication may consist of a statement of opinion based upon facts known or assumed by both parties to the communication."[44] Comment a explains that "the defamation may consist of a comment upon some act or omission of another which is accurately stated by the person making the comment or which, because of its notoriety or otherwise, is known to the recipient."[45] At the same time, an exception to this rule was recognized for the privilege of fair comment.[46] The fair comment privilege, however, was limited to "matters of public concern," according to the *Restatement*.[47]

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[44] RESTATEMENT (FIRST) OF TORTS § 566 (1938). Comment a. elaborates that "a defamatory communication may be made by derogatory adjectives or epithets as well as by statements of fact. Thus, it is defamatory to add to an accurate statement of another's innocent conduct, an adjective or epithet which characterizes it as reprehensible." *Id.* at cmt. a. For an example of a case applying the First Restatement rule, see Owens v. Scott Pub. Co., 284 P.2d 296 (Wash. 1955). The court stated that while "[i]t is well settled that truth is a complete defense . . . a publication may still be actionable as libel, even though based on true facts, if it contains criticism or comment which tend to expose a living person to hatred, contempt." *Id.* at 302. Of course, the state, like most others, now follows the Second Restatement version of section 566, affording extensive protection to statements of opinion. *See, e.g.*, Ammons v. N. Pac. Union Conf. of Seventh-Day Adventist, No. 17674-6-III, 2000 WL 1879053, at *5 (Wash. Ct. App. Dec. 28, 2000) (stating that "[o]pinions are only actionable if they imply the allegation of undisclosed defamatory facts as the basis for the opinion" (citing Dunlap v. Wayne, 716 P.2d 842 (Wash. 1986) (adopting section 566 of the Restatement (Second) of Torts (1977)))).

[45] RESTATEMENT (FIRST) OF TORTS § 566 cmt. a (1938).

[46] *Id.* ("If such comment expresses a sufficiently derogatory opinion as to the conduct in question, it is defamatory and, *unless it is privileged as fair comment* (*see* § 606), is actionable." (emphasis added)). On the background of the common law privilege of fair comment, *see generally* 1 RODNEY A. SMOLLA, LAW OF DEFAMATION §§ 6:4–:8 (2007); Alfred Hill, *Defamation and Privacy under the First Amendment*, 76 COLUM. L. REV. 1205, 1227–45 (1976).

[47] RESTATEMENT (FIRST) OF TORTS § 606 cmt. a (1938) (outlining matters of public concern under the fair comment privilege). Section 606 provides in part:

> (1) Criticism of so much of another's activities as are matters of public concern is privileged if the criticism, although defamatory,
>
> (a) is upon,
>
> (i) a true or privileged statement of fact, or
>
> (ii) upon facts otherwise known or available to the recipient as a member

Notwithstanding the *Restatement*, there was significant variation among the states regarding the fair comment privilege. A majority of states required that the privilege be based on facts already revealed.[48] Some states, in addition, required that the comment also be "fair."[49] And, a minority position may have existed that sometimes protected comment on false or undisclosed facts.[50] In addition to the fair comment privilege, some cases declined to impose defamation liability for "abusive words, name-calling, and hyperbole."[51]

C. The Interregnum—Formative Supreme Court Opinion Cases

There have been seven core United States Supreme Court cases that have developed the constitutional underpinnings of the fact-protected opinion dichotomy in defamation. The process has been a gradual one under which the constitutional and state law doctrines have gravitated closer together, and have sometimes begun to coalesce. In this subsection, I will briefly explore the first six of these cases, those that were decided during the interregnum between the *New York Times* and the 1990 *Milkovich* case, a generation later. In the next subsection I will address the *Milkovich* decision, the Supreme Court case that has most directly addressed the constitutional underpinnings and scope of protected opinion.

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of the public, and

(b) represents the actual opinion of the critic, and

(c) is not made solely for the purpose of causing harm to the other.

Id. § 606. The comments to the current version section 566 described the fair comment privilege prior to the approval of the Restatement (Second) version:

> If the expression of opinion was on a matter of public concern, it was a form of privileged criticism, customarily known by the name of fair comment. The privilege extended to an expression of opinion on a matter of public concern so long as it was the actual opinion of the critic and was not made solely for the purpose of causing harm to the person about whom the comment was made, regardless of whether the opinion was reasonable or not. According to the majority rule, the privilege of fair comment applied only to an expression of opinion and not to a false statement of fact, whether it was expressly stated or implied from an expression of opinion.

RESTATEMENT (SECOND) OF TORTS § 566 cmt. a (1977).

[48] SMOLLA, *supra* note 46, § 6.6 (stating that "[t]he traditional majority position was that the fair comment privilege existed only if based on facts 'truly stated'"); *see* Hill, *supra* note 46, at 1229.

[49] SMOLLA, *supra* note 47, § 6.6; Hill, *supra* note 46, at 1230–33 (quotation omitted).

[50] SMOLLA, *supra* note 46, § 6.6.

[51] Lewis & Mersol, *supra* note 43, at 25 (referring to "the American rule that abusive words, name-calling, and hyperbole were not actionable").

1. New York Times Co. v. Sullivan

In the landmark case of *New York Times Co. v. Sullivan*,[52] the Court imposed First Amendment limitations on state defamation law, holding that constitutional guarantees of freedom of speech and press prohibit recovery by a public official for a defamatory statement relating to his official conduct unless a plaintiff proves that the statement was made with knowledge of its falsity or with reckless disregard of its truth or falsity.[53] Thus, the public[54] plaintiff must satisfy both elements state tort law requires and the state of mind requirement of *New York Times*. Tucked away in a footnote was the following intriguing statement: "Since the Fourteenth Amendment requires recognition of the conditional privilege for honest misstatements of fact, it follows that a defense of fair comment must be afforded for honest expression of opinion based upon privileged, as well as true, statements of fact."[55] This largely overlooked language was the earliest intimation by the Court suggesting that the protection of statements of "opinion" may be compelled by the First Amendment.[56] The language also represents one of the four prongs that have emerged under constitutional law, state law, or both that define the parameters of protected opinion.[57]

2. Greenbelt Cooperative Publishing Association v. Bresler

The plaintiff in *Greenbelt Cooperative Publishing Association. v. Bresler*[58] was a prominent local real estate developer and builder. The defendants were publishers of a small weekly newspaper. The plaintiff was negotiating with the city council to obtain zoning variances to allow construction of high-density housing on his land. The city was at the same time trying to acquire other land owned by the plaintiff to construct a new high school. The concurrent negotiations afforded both parties "considerable bargaining leverage,"[59] were controversial, and were addressed at several tumultuous city council meetings. In reporting on the

[52] 376 U.S. 254 (1964). For a critical look at the *sequelae* of the *Times* case, see Joseph H. King, *Deus ex Machina and the Unfulfilled Promise of* N.Y. Times v. Sullivan*: Applying the* Times *for All Seasons*, 95 KY. L.J. 649 (2007).

[53] *Id.* at 279–80.

[54] The *Times* requirement has been also extended to public figures. *See* Curtis Publ'g v. Butts, 388 U.S. 130 (1967).

[55] *New York Times*, 376 U.S. at 292 n.30.

[56] *Id.* It was here that the Court "first hinted that the First Amendment provides some manner of protection for statements of opinion." Milkovich v. Lorain Journal Co., 497 U.S. 1, 23 & n.1 (1990) (Brennan, J., dissenting).

[57] This reading of the language received explicit support more than four decades later in Justice Brennan's dissent in *Milkovich*. *Id.* at 23–36; *see also infra* Part II.E.

[58] 398 U.S. 6 (1970).

[59] *Id.* at 7.

meetings, two news articles in the paper said that at the public meetings some people had characterized the plaintiff's negotiating position as "blackmail."[60]

The plaintiff contended that "the speakers at the meeting, in using the word 'blackmail,' and the petitioners in reporting the use of that word in the newspaper articles, were charging [the plaintiff] with the crime of blackmail."[61] The Court rejected that argument, holding "that the imposition of liability on such a basis was constitutionally impermissible—that as a matter of constitutional law, the word 'blackmail' in these circumstances was not slander when spoken, and not libel when reported in the Greenbelt News Review."[62]

There seemed to be two rationales[63] for the Court's holding: first, the Court reasoned that the paper had reported the debates at the city council meetings as "full and accurate," including the plaintiff's proposal and the statement of some people there referring to the proposal as blackmail.[64] The Court emphasized that it was the plaintiff's "public and wholly legal negotiating proposals that were being criticized."[65] This seemed to imply a constitutional First Amendment consecration of a rule that anticipated the test later adopted by the *Second Restatement*.[66] Second, the Court stated:

> No reader could have thought that either the speakers at the meetings or the newspaper articles reporting their words were charging Bresler with the commission of a criminal offense. On the contrary, even the most careless reader must have perceived that the word was no more than rhetorical hyperbole, a vigorous epithet used by those who considered Bresler's negotiating position extremely unreasonable.[67]

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[60] *Id.* at 7–8. "The word appeared in print several times, both with and without quotation marks, and was used once as a subheading a news story." *Id.*

[61] *Id.* at 13.

[62] *Id.*

[63] For a more recent example of a similar two-rationale analysis, see Horsley v. Feldt, 304 F.3d 1125, 1132–33 (11th Cir. 2002) (discussing the "rhetorical hyperbole" rationale, and what the court called "constitutionally protected comment" rather than implying that the defendant "had access to any facts, beyond those that were undisputed").

[64] Greenbelt Coop. Publ'g Ass'n v. Bresler, 398 U.S. 6, 13 (1970). The newspaper report had described the plaintiff's position to the effect that "[s]ome time ago, it became known that the developer would agree on the price, provided the city would help him obtain higher density rezoning for two of his tracts (Parcels 1 and 2, totaling 230 acres) near the center of Greenbelt. If the city refused, he threatened to delay the school site acquisition as long as possible through the courts." *Id.* at app. 15.

[65] *Id.* at 14.

[66] *See infra* Part II.D.

[67] *Greenbelt*, 398 U.S. at 14. For evidence of the coalescence with state law, see, for example, Horsley v. Rivera, 292 F.3d 695, 702–03 & n.2 (11th Cir. 2002) (stating in connection with holding that defendant's speech was "protected by the First Amendment as non-literal rhetorical hyperbole," that "[i]n addition to enjoying First Amendment protection, Rivera's statement was also protected as hyperbolic expression under Georgia

3. Gertz v. Robert Welch, Inc.

In *Gertz v. Robert Welch, Inc.*,[68] the Supreme Court held that so long as the states do not impose liability without fault, they may define the appropriate standard of liability for a defendant accused of defaming a private plaintiff,[69] and no presumed or punitive damages may be awarded, at least in the absence of knowledge or reckless disregard.[70] Damages in such cases are limited to "actual injury."[71] The significance of *Gertz* for present purposes of the fact-protected opinion dichotomy lies in the following three sentences:

> Under the First Amendment there is no such thing as a false idea. However pernicious an opinion may seem, we depend for its correction not on the conscience of judges and juries but on the competition of other ideas. But there is no constitutional value in false statements of fact.[72]

This *Gertz* dicta spurred the recognition of a constitutionally-mandated protection of statements deemed matters of "opinion." Judge Sack observed: "[p]erhaps because of the insufficiency and difficulties inherent in the common-law rules, courts and the second *Restatement* latched onto that statement as the seed for new, constitutional protection for opinion."[73] The *Gertz* language had "become the opening salvo in all arguments for protection from defamation actions on the ground of opinion, even though the case did not remotely concern the question."[74] As will be discussed, eventually the Court decided that this language from *Gertz* did not single-handedly herald a wholesale constitutionalization of parameters of the fact-protected opinion dichotomy. Rather, "the fair meaning of the passage is to equate the word 'opinion' in the second sentence with the word 'idea' in the first sentence," and thus "the language was merely a reiteration of Justice Holmes' classic 'marketplace of ideas' concept."[75]

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law, which similarly provides that the pivotal question in a defamation action is whether the challenged statement(s) can reasonably be interpreted as stating or implying defamatory facts").

[68] 418 U.S. 323 (1974).

[69] *Id.* at 346–47.

[70] *Id.* at 349.

[71] *Id.*

[72] *Id.* at 339–40.

[73] 1 ROBERT D. SACK, SACK ON DEFAMATION: LIBEL, SLANDER & RELATED PROBLEMS § 1.8 (3d ed. 2008).

[74] Milkovich v. Lorain Journal Co., 497 U.S. 1, 18 (1990) (quoting Cianci v. New Times Publ'g Co., 639 F.2d 54, 61 (2d Cir. 1980)).

[75] *Id.* at 18. In *Milkovich* the Court "appeared to erase, in one sentence, the entire foundation for the widening constitutional umbrella." SACK, *supra* note 73, § 1.8.

4. Old Dominion Branch No. 496 v. Austin

In *Old Dominion Branch No. 496 v. Austin*,[76] the Court adapted the constitutional requirements for defamation claims by public officials to labor disputes from *New York Times*.[77] Specifically, the Court reaffirmed that as a matter of statutory construction "libel actions under state law were pre-empted by the federal labor laws to the extent that the State sought to make actionable defamatory statements in labor disputes which were published without knowledge of their falsity or reckless disregard for the truth."[78] Thus, an actual malice standard was required in defamation claims arising in context of a labor dispute, but that otherwise, such defamation claims were not preempted by the National Labor Relations Act ("NLRA"). Although the Court employed concepts developed in the context of and driven by the First Amendment concerns, technically the Court's holding here was not directly mandated by the First Amendment, but rather by federal labor law.[79] Importantly for present purposes, the Court did not stop with the actual malice standard, but went on to examine the specific communication at issue in the case.

The defendant allegedly published a newsletter in which the plaintiffs, who were nonunion letter carriers, were accused of being "scabs."[80] The defendant's monthly newsletter thereafter published a "List of Scabs" that included the plaintiffs.[81] It also had a definition of "scabs," that stated that "'a SCAB is a traitor to his God, his country, his family and his class.'"[82] The plaintiffs essentially argued for a literal interpretation of this definition. The Court, anticipating the later analysis of *Milkovich*, began with the bedrock principle that before a plaintiff can prove the knowing or reckless falsity, "there must be a false statement of fact."[83] The Court then held that "[t]he definition's use of words like 'traitor' cannot be construed as representations of fact," and therefore, was not a basis for a defamation action under federal labor laws.[84] It explained that the phrase was used "in a loose, figurative sense"[85] and was "merely rhetorical hyperbole, a lusty and imaginative expression of the contempt felt by union members"[86] and "exaggerated rhetoric"[87] not meant to be taken seriously.[88]

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[76] 418 U.S. 264 (1974).

[77] *Id.* at 272–73.

[78] *Id.*

[79] *See id.* at 273. Here "the relevant federal law [was an] Executive Order . . . rather than the NLRA." *Id.*

[80] *Id.* at 267.

[81] *Id.*

[82] *Id.* at 268 (quoting the postal branch's monthly newsletter).

[83] *Id.* at 284 (citing Gertz v. Welsh, 418 U.S. 323, 339–40 (1974)).

[84] *Id.*

[85] *Id.*

[86] *Id.* at 285–86.

[87] *Id.* at 286.

5. Philadelphia Newspapers, Inc. v. Hepps

In *Philadelphia Newspapers, Inc. v. Hepps,*[89] the Court held that "at least where a newspaper publishes speech of public concern, a private-figure plaintiff cannot recover damages without also showing that the statements at issue are false."[90] The Court articulated its rule as a "constitutional requirement that the plaintiff bear the burden of showing falsity, as well as fault, before recovering damages."[91] Although the Court's focus was on the burden of proving falsity, one unanticipated consequence of the Court's holding came four years later in *Milkovich.* There the Court anointed *Hepps* (and pointedly not *Gertz*) as the "keystone"[92] of the constitutional protection from defamation liability of statements that do not contain "a provably false factual connotation."[93]

6. Hustler Magazine, Inc. v. Falwell

The litigation in *Hustler Magazine, Inc. v. Falwell*[94] arose after *Hustler Magazine* published a parody that featured the plaintiff, Jerry Falwell, a well-known minister and player in public affairs. The parody was modeled after an actual advertisement for Campari Liqueur.[95] It "contained the name and picture of the [plaintiff], and was entitled 'Jerry Falwell talks about his first time.'"[96] The regular Campari advertisements "included interviews with various celebrities about their 'first times.'" Although it was apparent by the end of each interview that "the subject was the first time the celebrity had tried Campari, the ads also played on the double entendre of sexual 'first times.'"[97] By "[c]opying the form and layout of these Campari ads, [the defendant's] editors chose [Falwell] as the featured celebrity and drafted an alleged 'interview' with him" in which he was portrayed as stating that his "'first time' was 'during a drunken incestuous rendezvous with

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[88] *Id.*

[89] 475 U.S. 767 (1986).

[90] *Id.* at 768–69. The Court also noted that "a public-figure plaintiff must show the falsity of the statements at issue in order to prevail in a suit for defamation." *Id.* at 775.

[91] *Id.* at 776.

[92] SACK, *supra* note 73, § 1.8.

[93] Milkovich v. Lorain Journal Co., 497 U.S. 1, 19–20 (1990) ("Foremost, we think *Hepps* stands for the proposition that a statement on matters of public concern must be provable as false before there can be liability under state defamation law, at least in situations, like the present, where a media defendants involved.").

[94] 485 U.S. 46 (1988).

[95] *Id.* at 48.

[96] *Id.*

[97] *Id.*

his mother in an outhouse,'"[98] and portrays them as "drunk and immoral, and suggests that Falwell was a hypocrite, [and] preaches only when he is drunk."[99]

The plaintiff alleged, inter alia, that the parody constituted libel and intentional infliction of emotional distress.[100] A jury rendered a verdict for the defendants on the libel allegation, but a verdict for the plaintiff for intentional infliction of emotional distress.[101] The Court of Appeals affirmed. The Supreme Court noted that "the jury . . . found against respondent on [his] libel claim" when it decided that the Hustler "ad parody could not 'reasonably be understood as describing actual facts about Falwell or actual events in which [he] participated,'"[102] and that the Court of Appeals interpreted the jury's finding to be that the parody "'was not reasonably believable.'"[103] By accepting these findings and holding that the plaintiff's appeal must rise or fall on his intentional infliction claim, the Court clearly suggested that opinion in the form of parody that "could not reasonably have been interpreted as . . . actual facts"[104] was not actionable as defamation. The Court reaffirmed that protection of statements of "opinion" may be compelled by the First Amendment.[105] Specifically, the Court extended First Amendment protection to speech that "could not reasonably have been interpreted as stating actual facts about the public figure involved,"[106] even if that speech were "patently offensive and . . . intended to inflict emotional injury."[107] In so doing, the Court endorsed as a matter of constitutional law one of the four constituent prongs that have emerged to define the parameters of protected opinion—namely that protected opinion includes statements that were not reasonably believable as describing actual facts or events.[108]

With respect to the claim for intentional infliction of emotional distress, the plaintiff had argued that "so long as the utterance was intended to inflict emotional distress . . . it is of no constitutional import whether the statement was a fact or an opinion."[109] Not so, held the Court: "public figures and officials may not recover for . . . intentional infliction of emotional distress by reason of publications such as the one here at issue without showing in addition that the publication contains a

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[98] *Id.*

[99] *Id.*

[100] *Id.* at 48–49. Defendants included Hustler Magazine, Inc., Larry C. Flynt, and Flynt Distributing Co., Inc. *Id.* at 48.

[101] With respect to defendant, Flynt Distributing Co., however, the jury found no liability on the intentional infliction claim. *Id.* at 49 n.2.

[102] *Id.* at 49.

[103] *Id.* at 57 (quoting Falwell v. Flynt, 797 F.2d 1270, 1278 (1986)).

[104] *Id.* at 50.

[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *See infra* Part II.F.

[109] *Hustler*, 485 U.S. at 52–53.

false statement of fact"[110] that defendant published with knowledge or reckless disregard of whether it was true or false.[111] The opinion arguably leaves open the question of the scope of the constitutional rule with respect to private plaintiffs,[112] and also with respect to matters outside "the area of public debate about public figures."[113]

D. The Second Restatement and Pre-1990 State and Lower Federal Cases

The 1977 approval of a revised section 566 in the *Second Restatement* represented a marked change from the prior version of section 566. The *Second Restatement* construct also formalized the general tendency toward broader protection of opinions from defamation liability. The later *Restatement* language also subsumed the prior rule for fair comment, essentially obviating the need for it.[114] Section 566 now provides that "[a] defamatory communication may consist of a statement in the form of an opinion, but a statement of this nature is actionable

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[110] *Id.* at 56.

[111] *Id.*

[112] The scope of the constitutional rule remains somewhat unsettled with respect to a private person suing for intentional infliction. *Compare* Esposito-Hilder v. SFX Broad., Inc., 665 N.Y.S.2d 697, 699 (N.Y. 1997) (allowing the claim against owners and operators of radio station and disc jockeys employed at that station for allegedly making derogatory and disparaging comments about the plaintiff's appearance and inviting their listeners to do likewise in connection with a routine known as the "Ugliest Bride" contest), *with* Pring v. Penthouse Int'l, 695 F.2d 438, 442 (10th Cir. 1982) (stating that the "outrageous conduct" doctrine was subject to the same First Amendment considerations as defamation), and Winter v. DC Comics, 121 Cal. Rptr. 2d 431, 439 (Cal. Ct. App. 2002) (holding with respect to comic book series that allegedly depicted and falsely portrayed plaintiffs that parody that was protected opinion for defamation purposes would also not be actionable as intentional infliction), *rev'd in part on different claim and grounds*, 69 P.3d 473 (Cal. 2003), and Walko v. Kean Coll., 561 A.2d 680, 686 (N.J. Super. Ct. Law Div. 1988) (holding that "when a publication about a private person is held not to be defamatory as a matter of law because it involves no (false) statement of fact, then there can be no recovery for intentional infliction of emotional distress"). Some courts do not even mention a constitutional dimension. *See, e.g.*, Netzer v. Continuity Graphic Assoc., Inc., 963 F. Supp. 1308, 1327 (S.D.N.Y. 1997) (holding in connection with a comic book that allegedly named a fictional terrorist after the plaintiff that "the use of the Names in connection with a clearly fictional character in a comic book is not objectively so outrageous as to exceed all possible bounds of decency").

[113] *Hustler*, 485 U.S. at 53. There is also a question of whether *Hustler* is limited to matters of public concern. *See* Dworkin v. Hustler Magazine, Inc., 867 F.2d 1188, 1197 (9th Cir. 1989) (discussing the issue, and in dicta interpreting *Hustler* as applying even if the statements were not a matter of public concern); King, *supra* note 52, at 694–98.

[114] *See* RESTATEMENT (SECOND) OF TORTS § 566 cmt. b (1977).

only if it implies the allegation of undisclosed defamatory facts as the basis for the opinion."[115]

The comments explain the rule in terms of a distinction between "pure" (protected) and "mixed" (not protected) opinions. The pure type "occurs when the maker of the comment states the facts on which he bases his opinion of the plaintiff and then expresses a comment as to the plaintiff's conduct, qualifications or character,"[116] or "when both parties to the communication know the facts or assume their existence and the comment is clearly based on those assumed facts and does not imply the existence of other facts in order to justify the comment."[117] The so called mixed type may be an "opinion in form or context, [but] is apparently based on facts regarding the plaintiff or his conduct that have not been stated by the defendant or assumed to exist by the parties to the communication."[118] The *Restatement* rule in essence seems to hold that a statement should not be actionable if it consists merely of comments on information already disclosed, assumed[119] ("whether the assumed facts are defamatory or not")[120] by

[115] RESTATEMENT (SECOND) OF TORTS § 566 (1977).

[116] *Id.* § 566 cmt. b.

[117] *Id.*

[118] *Id.*

[119] *See id.* § 566 cmt. b & c, recap. 3. Of course, if the defendant discloses facts on which the opinion is based that are themselves defamatory, a defendant might be liable. *See* SMOLLA, *supra* note 46, § 6:29. If the disclosed facts are not defamatory, then defendant would not be liable for either the opinion or the underlying stated facts on which the opinion is based. *See* Kersey v. Wilson, No. M2005-02106-COA-R3-CV, 2006 WL 3952899, at *6 (Tenn. Ct. App. Dec. 29, 2006).

[120] *See* RESTATEMENT (SECOND) OF TORTS § 566 cmt. c, recap. 3 (1977). This section states:

> If the defendant bases his expression of a derogatory opinion on the existence of "facts" that he does not state but that are assumed to be true by both parties to the communication, and if the communication does not give rise to the reasonable inference that it is also based on other facts that are defamatory, he is not subject to liability, whether the assumed facts are defamatory or not.

If, however, the defendant himself republishes false information, and then bases his comment on those republished facts, he may be subject to liability. *See* Condit v. Dunne, 317 F. Supp. 2d 344, 364 (S.D.N.Y. 2004) (stating that "[a] speaker . . . finds protection in the First Amendment when he publishes opinions based either upon fully disclosed, true facts . . . or upon facts otherwise commonly known to the audience, such as facts that are a matter of public knowledge," but "[a] speaker does not necessarily find protection in the First Amendment, however, when he publishes opinions based on disclosed facts which are themselves false"). If the defendant is subject to liability for the republication of the underlying premise-facts, whether he may also be liable for his comment on those republished facts seems largely academic. In any event, there seems to be some disagreement on that point. *Compare Condit*, 317 F. Supp. 2d at 365–66 (defendant also subject to liability for comment on republished facts if those facts are themselves false),

the recipient, or known or perhaps commonly known.[121] Moreover, even if the defendant were commenting on or implying non-disclosed facts, he should also not be liable if those facts were either true or non-defamatory; if the defendant were privileged to communicate; or the defendant did not entertain sufficient fault regarding the truth or falsity of the facts on which he was commenting or which he implied.[122]

The comments also state with respect to "ridicule that exposes the plaintiff to contempt or derision," that:

> If all that the communication does is to express a harsh judgment upon known or assumed facts, there is no more than an expression of opinion of the pure type, and an action of defamation cannot be maintained. For maintaining the action it is required that the expression of ridicule imply the assertion of a factual charge that would be defamatory if made expressly.[123]

However, the *Restatement* also states ambiguously that "[h]umorous writings, verses, cartoons or caricatures that carry a sting and cause adverse rather than sympathetic or neutral merriment may be defamatory."[124] If these humorous writings merely expressed a "harsh judgment upon known or assumed facts, there is no more than an expression of opinion of the pure type, and an action of defamation cannot be maintained,"[125] but what if such writing implies a negative impression in the absence of known or assumed facts? That question may now

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with SMOLLA, *supra* note 47, § 6:29 (defendant subject to liability for the republication of defamatory premise-facts, but not for the comment on them), and RESTATEMENT (SECOND) OF TORTS § 566, recap. 1 (stating that "[i]f the defendant bases his expression of a derogatory opinion of the plaintiff on his own statement of false and defamatory facts, he is subject to liability for the factual statement but not for the expression of opinion").

[121] *See Condit*, 317 F. Supp. 2d at 364 (stating that "[a] speaker finds protection in the First Amendment when he publishes opinions based either upon fully disclosed, true facts or upon facts otherwise commonly known to the audience, such as facts that are a matter of public knowledge"); SMOLLA, *supra* note 46, § 6:33 (stating that an opinion is deductive if it deduces conclusions about the plaintiff based on "true information supplied to the public or already generally known to the public," and is protected and not actionable under the Restatement approach).

[122] RESTATEMENT (SECOND) OF TORTS § 566 cmt. c, recap. 2 (1977); *see also* Flowers v. Carville, 310 F.3d 1118, 1129 n.7 (9th Cir. 2002) (stating that "when [a] speaker outlines the factual basis for his conclusion, his statement is protected," assuming "that the factual basis itself is true").

[123] RESTATEMENT (SECOND) OF TORTS § 566 cmt. d (1977). The comments of section 566 also bring "verbal abuse" within its opinion-protection if the statements "cannot reasonably be understood to be meant literally and seriously and are obviously mere vituperation and abuse." *Id.* at cmt. e.

[124] *Id.* at cmt. d.

[125] *Id.*

have largely been overtaken and subsumed by the Supreme Court holding that "a statement of opinion relating to matters of public concern which does not contain a provably false factual connotation" or that cannot reasonably be interpreted as stating actual facts "will receive full constitutional protection."[126]

The section 566 formulation has garnered widespread support with numerous cases having endorsed the current version of section 566 in principle.[127] In the

[126] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990).

[127] *See, e.g.*, Johnson v. Clark, 484 F. Supp. 2d 1242, 1248 (M.D. Fla. 2007) ("Pure opinion occurs when the defendant makes a comment or states an opinion based on facts which are set forth in the article or which are otherwise known or available to the reader or listener as a member of the public."); Wedbush Morgan Sec., Inc. v. Kirkpatrick Pettis Capital Mgmt., Inc., No. 06-cv-00510-WDM-BNB, 2007 WL 1097872, at *2, (D. Colo. Apr. 9, 2007); Fortson v. Colangelo, 434 F. Supp. 2d 1369, 1378 (S.D. Fla. 2006) (invoking Restatement section 566, which protects "pure opinion"); Gardner v. Martino, No. CV-05-769-HU, 2005 WL 3465349, at *9 (D. Or. Sept. 19, 2005) ("[I]t makes no difference whether the issue is analyzed as one of Oregon common law or as one of First Amendment law. Both hold that if the opinion is made together with disclosed facts, it is not actionable."); Synthes v. Globus Medical, Inc., No. Civ.A. 04-CV-1235, 2005 WL 2233441, at *3 (E.D. Pa. Sept. 14, 2005) (approving the section 566 formulation); Sanders v. Smitherman, 776 So. 2d 68, 74 (Ala. 2000) ("One cannot recover in a defamation action because of another's expression of an opinion based upon disclosed, nondefamatory facts, no matter how derogatory the expression may be since the recipient of the information is free to accept or reject the opinion, based on his or her independent evaluation of the disclosed, nondefamatory facts."); Kinzel v. Discovery Drilling, Inc., 93 P.3d 427, 440 (Alaska 2004) (stating that "[t]he test . . . is whether the statement is properly understood as purely speculation or, alternatively, implies that the speaker or writer has concrete facts that confirm or underpin the truth of the speculation"); Scott v. Busch, 907 So. 2d 662, 668 (Fla. Dist. Ct. App. 2005) ("[t]he facts upon which the opinion is based must be stated and disclosed or known to the audience to whom the publication is made not to be actionable."); Murphy v. Modrall, No. 2005-CA-001559-MR., 2006 WL 2328588, at *2 (Ky. Ct. App. Aug. 11, 2006) (adopting section 566 of the Restatement); Biber v. Duplicator Sales & Serv., Inc., 155 S.W.3d 732, 737 (Ky. Ct. App. 2004) (stating that "opinion . . . is actionable only if it implies the allegation of undisclosed defamatory fact as the basis for the opinion" (quoting Yancey v. Hamilton, 786 S.W.2d 854, 857 (Ky. 1989))); Fikes v. Furst, 61 P.3d 855, 865 (N.M. Ct. App. 2003) ("[s]tatements that imply the speaker's reliance on specific, undisclosed facts are considered factual."), *aff'd and rev'd in part on other grounds*, 81 P.3d 545 (N.M. 2003); Pub. Relations Soc'y of Am., Inc. v. Road Runner High Speed Online, 799 N.Y.S.2d 847, 853 (N.Y. App. Div. 2005) (citing section 566 and suggesting that whether opinion is actionable depends on whether it implies undisclosed defamatory facts); Choi v. Korea Times Los Angeles, Inc., No. 000930, 2005 WL 4125853, at *5 (Pa. C.P. July 19, 2005) (stating that "in deciding whether a statement is an actionable opinion, the court may rely on section 566 of the Restatement" because the recipient of the information is free to accept or reject the opinion, based on his or her independent evaluation of the disclosed, nondefamatory facts); Budget Termite & Pest Control, Inc. v. Bousquet, 811 A.2d 1169, 1173 (R.I. 2002) (holding that the cartoon at issue did not imply the existence of undisclosed defamatory facts, thus impliedly supporting the section 566 rule without citing it); Beattie v. Fleet Nat. Bank, 746

wake of the *Milkovich* decision, however, there is the question of whether cases following section 566 are doing so in the belief that such a rule is constitutionally mandated or simply as a matter of state law. The cases sometimes seem to rely on state law,[128] sometimes constitutional law,[129] and sometimes both,[130] although the courts are far from clear on this[131] and sometimes simply do not unequivocally express the basis for adopting section 566.[132]

There has also remained significant variation among the states in the details or operation of the method used to distinguish fact from protected opinion. For example, in the oft-cited *Ollman* case,[133] the court adopted a four part analysis,[134]

A.2d 717, 724 (R.I. 2000) (holding that the rule of section 566 of the Restatement is supported by the Rhode Island Constitution).

[128] *See, e.g.*, *Synthes*, 2005 WL 2233441, at *3 (invoking section 566 and relying on state law); *Biber*, 155 S.W.3d at 737 (stating that "[t]he right to recover for injuries to reputation is embodied in section 14 of the Kentucky Constitution); *Fikes*, 61 P.3d at 861–62 (invoking section 566 and relying on state law); *Choi*, 2005 WL 4125853, at *5 (stating that "Pennsylvania courts hold that the trial court must determine, as a matter of law, whether a statement is one of fact or opinion").

[129] *See, e.g.*, *Johnson*, 484 F. Supp. 2d at 1247 (stating that "statements of pure opinion-as opposed to statements of fact-are not actionable as defamation because they are protected by the First Amendment"); *Kinzel*, 93 P.3d at 439 (stating that "if the context demonstrates to the audience that the speaker is not purporting to state or imply actual, known facts, then the speech is protected by the First Amendment").

[130] *See, e.g.*, *Wedbush Morgan*, 2007 WL 1097872, at *2 (relying on both "the legal principles developed in First Amendment jurisprudence protecting free expression of opinions on matters of public concern," and on state law, with respect to protected opinion, and adopting the section 566 construct); *Gardner*, 2005 WL 3465349, at *9 (stating that both state and constitutional law "hold that if the opinion is made together with disclosed facts, it is not actionable").

[131] *See Gardner*, 2005 WL 3465349, at *9 (noting that "[t]he Oregon cases are not entirely clear about whether the basis for protecting opinion from liability is grounded in the jurisprudence of Oregon common law or in the First Amendment").

[132] *See, e.g.*, Sanders v. Smitherman, 776 So.2d 68, 74 (Ala. 2000) (acknowledging the application of First Amendment principles, and approving section 566, but never expressly tying the two together); Scott v. Busch, 907 So.2d 662, 668 & 668 n.26 (Fla. Dist. Ct. App. 2005) (referring to "deference for free speech and the First Amendment," and approving section 566 but never expressly tying the two together).

[133] Ollman v. Evans, 750 F.2d 970 (D.C. Cir. 1984).

[134] The court stated:

> First, . . . [o]ur analysis of the specific language under scrutiny will be aimed at determining whether the statement has a precise core of meaning for which a consensus of understanding exists or, conversely, whether the statement is indefinite and ambiguous . . . . Second, we will consider the statement's verifiability-is the statement capable of being objectively characterized as true or false? . . . . Third, moving from the challenged language itself, we will consider the full context of the statement-the entire article or column, for

and sought to develop its own methodology,[135] albeit often articulated in terms of the mandates of the First Amendment.[136] The *Ollman* and various other multi-factor methodologies[137] have come to be referred to as the "totality of the circumstances" approach.[138] Other courts have concentrated on, or primarily on, the extent to which the statement at issue was verifiable—whether the existence of the alleged "facts" could be objectively proved or disproved.[139] The focus on the verifiability of the statement has also received a constitutional imprimatur in 1990 in *Milkovich*.[140] Regardless of the specific features or nuances in a court's methodology, the cases all have the same objective—to decide on which side of the fact versus protected opinion a statement falls. Notwithstanding the variations in the details, "[a]n easy consensus holds that in some way and to some extent expressions of opinion must be protected from the legal process."[141]

> example-inasmuch as other, unchallenged language surrounding the allegedly defamatory statement will influence the average reader's readiness to infer that a particular statement has factual content . . . . Finally, we will consider the broader context or setting in which the statement appears. Different types of writing have . . . widely varying social conventions which signal to the reader the likelihood of a statement's being either fact or opinion.

Id. at 979.

[135] The court stated that although it had "no quarrel with the purpose of section 566," in the court's view, "the tests already articulated are a sufficient aid in determining whether a statement implies the existence of undisclosed facts." *Id.* at 984–85. The court elaborated, stating that "[i]n short, we believe that the application of the four-factor analysis set forth above, and drawn from the considerable judicial teaching on the subject, will identify those statements so 'factually laden' that they should not receive the benefit of the opinion privilege." *Id.* at 985.

[136] "The degree to which such kinds of statements have real factual content can, of course, vary greatly. We believe, in consequence, that courts should analyze the totality of the circumstances in which the statements are made to decide whether they merit the absolute First Amendment protection enjoyed by opinion." *Id.* at 979. Although the constitutional underpinnings of the *Ollman* analysis may arguably have been left in limbo in the wake of *Milkovich, Ollman* still exerts great influence. *See* Guilford Transp. Indus., Inc. v. Wilner, 760 A.2d 580, 583 n.1 (D.C. 2000) (stating that *Milkovich* declined to impose, as a matter of constitutional law, "a multi-factor text previously used in *Ollman* and other cases to distinguish fact from opinion," but that "nothing in *Milkovich* affects the continued vitality of *Ollman*'s discussion of Op-Ed columns");Yates v. Iowa W. Racing Ass'n, 721 N.W.2d 762, 771 (Iowa 2006) (continuing to employ the "four-factor test"); Robert D. Sack, *Protection of Opinion under the First Amendment: Reflections on Alfred Hill,* "Defamation and Privacy under the First Amendment," 100 COLUM. L. REV. 294, 322–25 (2000).

[137] *See* SMOLLA, *supra* note 47, § 6:51.

[138] *Id.* §§ 6:47–:56.

[139] *Id.* §§ 6:44–:46.

[140] *See infra* Part II.E.

[141] SACK, *supra* note 73, §4.1.

One must also consider the effect of the United States Supreme Court decisions that have held that protection of at least some types of opinion is compelled by the First Amendment. Indeed, the comments to the current *Restatement* rule suggest that it was crafted in large measure in response to the often-quoted *Gertz* "no such thing as a false idea" dicta,[142] and accordingly to the perception that protection of opinion was constitutionally compelled. Revised section 566 was approved in 1976 before a number of important Supreme Court decisions, especially *Hepps*, *Falwell*, and most significantly, *Milkovich*. Thus, section 566 was written without the benefit of the *Milkovich* Court's doubt about the relevance of the *Gertz* dicta to the question of the extent to which protection of opinion was mandated by the First Amendment. It was also written without the *Milkovich* Court's ambiguity in applying its constitutionally-based, protected-opinion rule, especially with respect to the application of the rule to the type of "pure" opinions that do not express or imply undisclosed facts.

Notwithstanding section 566's improvident reliance on the *Gertz* dicta, the section has been very influential and widely followed by the courts in many jurisdictions. However, after *Milkovich*, there is now also a question whether the assumption of the *Restatement* that its particular formulation was constitutionally-compelled seems debatable. Thus, it is possible that the state courts that have endorsed section 566 will have to decide, while awaiting more definitive guidance from the Supreme Court, whether section 566 is indeed required by the First Amendment, and even if not, whether it should nevertheless still be followed at least as a matter of state law.[143]

A fundamental step under section 566 is to decide whether the statement reasonably implies the assertion of new facts—that is, facts that were not disclosed to, known by, or assumed by the recipient of the communication, or otherwise generally known. If not, then the statement is protected opinion under the *Restatement*. This crucial inquiry, I contend, is too often missing from the courts' analysis of defamation claims based on parody.[144]

E. Milkovich and the Fact or "Non-fact" Distinction[145]

"[C]ourts and commentators have struggled with the contours of th[e constitutional] protection [of opinion] and its relationship to other doctrines within our First Amendment jurisprudence."[146] In *Milkovich v. Lorain Journal Co.*,[147] the

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[142] RESTATEMENT (SECOND) OF TORTS § 566 cmt. c (1977).

[143] For one discussion of the variety of judicial approaches to opinion following the decision, see Kathryn Dix Sowle, *A Matter of Opinion:* Milkovich *Four Years Later*, 3 WM. & MARY BILL RTS. J. 467, 499–511 (1994).

[144] *See infra* Part III.B.

[145] SMOLLA, *supra* note 47, § 6:2.

[146] Milkovich v. Lorain Journal Co., 497 U.S. 1, 23 (1990) (Brennan, J., dissenting).

[147] *Id.* at 1 (majority op.)

Court for the first time attempted to "address this question directly,"[148] though not definitively. The *Milkovich* decision is the most explicit recognition by the Supreme Court, albeit somewhat obliquely (from its professed eschewing a separate constitutional rule), that the protection of at least some *forms of* opinion is compelled by the First Amendment. Even here, the Court could not quite bring itself to articulate its holding in terms of opinion, rather than stating its rule as requiring that the statement have communicated a "provably false factual connotation" that could be interpreted as stating actual facts.[149]

Plaintiff-Milkovich was a high school wrestling coach whose team was involved in an altercation with another team. In response to the incident, the state athletic association, following a hearing, placed the team on probation and declared it ineligible for the state tournament. Several parents and wrestlers then sued the association in court seeking a restraining order against the ruling. The defendants, a reporter and local newspaper, authored and published respectively a column discussing the hearing before the court. That column contained passages that allegedly implied that the coach had committed perjury during the court hearing.[150]

The coach and the school superintendent both sued for defamation in separate cases.[151] The litigation involved seemingly endless appeals. For present purposes, the stage for the current decision was set when the Ohio Supreme Court, in the former superintendent's lawsuit, concluded that the column was constitutionally protected opinion.[152] Subsequently, considering itself bound by the decision in the superintendent's case that arose out of the identical newspaper column, the Ohio Court of Appeals affirmed the trial court's summary judgment in favor of the defendants in the coach's case.[153] The United States Supreme Court took the case to consider the implications of the recognition by the Ohio courts that the First Amendment mandated a separate constitutionally-based "opinion" exception or bar to potential defamation liability.[154] In a circular analysis, the Court began by refusing to adopt some special freestanding "wholesale defamation exemption for

[148] *Id.* at 23 (Brennan, J., dissenting).

[149] *Id.* at 20. (majority op.).

[150] *Id.* at 6–7.

[151] *Id.* at 8.

[152] *See* Scott v. News-Herald, 496 N.E.2d 699, 709 (Ohio 1986).

[153] *Milkovich*, 496 U.S. at 10. The Ohio Supreme Court then dismissed the appeal in *Milkovich*, the coach's case. *Id.* at 8–9.

[154] The Court in particular pointed to the language of the Ohio Supreme Court that "[t]he federal Constitution has been construed to protect published opinions ever since the United States Supreme Court's opinion in *Gertz v. Robert Welch, Inc.*," and the court's concomitant conclusion that "[b]ased upon the totality of circumstances it is our view that [the reporter's] article was constitutionally protected opinion both with respect to the federal Constitution and under our state Constitution." *Id.* at 10 n.5 (quoting *Scott*, 496 N.E.2d at 701, 709).

anything that might be labeled 'opinion.'"[155] The Court was unwilling to enshrine all statements within some new "First-Amendment-based protection"[156] merely because a statement was characterized or labeled as "opinion" or because it fell within some loosely-defined concept of "opinion." The Court seemed unimpressed by the argument that "in every defamation case the First Amendment mandates an inquiry into whether a statement is 'opinion' or 'fact,' and that only the latter statements may be actionable," or that "a number of factors developed by the lower courts . . . be considered in deciding which is which."[157] The Court pointedly rejected the premise from *Gertz* that the "no such thing as a false idea" dictum supported a separate freestanding rule for constitutionally protected opinion apart from what was already implicit in existing constitutional limitations of defamation claims.[158]

Notwithstanding his ostensible disinclination to create a separate constitutional exception, Chief Justice Rehnquist almost immediately set about to reaffirm and underscore constitutional limits on defamation liability for at least some types of opinion-statements. The essential "breathing space"[159] for the freedom of expression was, according to the Court, "adequately secured by existing constitutional doctrine without the creation of an artificial dichotomy between 'opinion' and fact."[160] Thus, while on the one hand the Court eschewed a separate freestanding constitutional "opinion" rule, the Court nevertheless at the same time derived from the holding in *Hepps* a rule placing the burden of proof on the plaintiff to prove falsity, a requirement that the allegedly defamatory statement be "provably false,"[161] in other words, "sufficiently factual to be susceptible of being proved true or false."[162] From other existing constitutional doctrine in "the

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[155] *Milkovich*, 497 U.S. at 18.

[156] *Id.* at 17.

[157] *Id.* at 19.

[158] *Id.* at 19 ("[it] would be destructive of the law of libel if a writer could escape liability for accusations of [defamatory conduct] simply by using, explicitly or implicitly, the words 'I think.'" (quoting Cianci v. New Times Publ'g Co., 639 F.2d 54, 64 (2d Cir. 1980)). Judge Friendly appropriately observed that this *Gertz* passage "has become the opening salvo in all arguments for protection from defamation actions on the ground of opinion, even though the case did not remotely concern the question." *Id.* at 61. "Read in context, though, the fair meaning of the passage is to equate the word 'opinion' in the second sentence with the word 'idea' in the first sentence. Under this view, the language was merely a reiteration of Justice Holmes' classic 'marketplace of ideas' concept." *See* Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting) ("the ultimate good desired is better reached by free trade in ideas . . . the best test of truth is the power of the thought to get itself accepted in the competition of the market").

[159] N.Y. Times Co. v. Sullivan, 376 U.S. 254, 271–72 (1964) (referring to the "'breathing space' that the freedoms of expression 'need to survive'" (quoting N.A.A.C.P. v. Button, 371 U.S. 415, 433 (1963))).

[160] *Milkovich*, 497 U.S. at 19.

[161] *Id.* at 20.

[162] *Id.* at 21.

Bresler-Letter Carriers-Hustler line of cases,"[163] the Court deduced protection for statements that cannot "reasonably [be] interpreted as stating actual facts" about an individual. [164] Thus, "a statement of opinion relating to matters of public concern which either does not contain a provably false factual connotation" or that cannot reasonably be interpreted as stating actual facts "will receive full constitutional protection."[165] This semantic sleight of hand led Dean Smolla to comment that "[r]ather than recognize a constitutional distinction between 'fact' and 'opinion,' the Court recognized a constitutional distinction between 'fact' and 'non-fact.'"[166]

What may have worried the Court was the possibility that under a separate constitutionally-based "artificial dichotomy" between fact and opinion, too many statements labeled as "opinion," could magically be transformed into a Constitutional matter or issue. [167] The Court seemed concerned over the possibility a defendant would argue that simply by characterizing a statement as an "opinion" should *ipso facto* constitutionally insulate it from defamation liability.[168] The Court worried that misreading the *Gertz* "no such thing as a false idea"[169] passage might be used "to create a wholesale defamation exemption for anything that might be labeled 'opinion.'" [170] Nor did the Court find it appropriate, beyond the limitations in existing constitutional doctrines, to go further and create some ill-defined or loosely conceived constitutionally based, multi-factor test or catalogue of rule that would determine whether a statement were fact or opinion.[171]

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[163] *Id.* at 20.

[164] *Id.* (quoting Hustler Magazine v. Falwell, 485 U.S. 45, 50 (1988)).

[165] *Id.* at 19.

[166] SMOLLA, *supra* note 46, § 6:2. He explains further:

> The Court in *Milkovich* was primarily rejecting only the *terminology* of "fact v. opinion." The Court actually *endorsed* rather than rejected the essential substance of the previously existing constitutional protection for opinion. This was accomplished by what might be called a "backhand" rather than "forehand" stroke: rather than concentrate on whether the language at issue is opinion, *Milkovich* instructs lower courts to concentrate on whether it is factual. In short, *the Court substituted the old dichotomy between "fact and opinion" with a new dichotomy between "fact and non-fact."*

Id. § 6:21.

[167] *Milkovich*, 497 U.S. at 19.

[168] *See* SMOLLA, *supra* note 46, § 6:41 ("Critically, the mere fact that a statement is couched in the surface language of 'opinion' does not shield the statement from liability if it implies the existence of supporting facts.").

[169] Gertz v. Robert Welch, Inc., 418 U.S. 323, 339–40 (1974). Construing the *Gertz* language, especially the antecedent to the word, "opinion" the Court said that "opinion" as used in *Gertz* was simply equated with the word "idea," in the sense of the "marketplace of ideas" metaphor. *Milkovich*, 497 U.S. at 18.

[170] *Id.*

[171] *See id.* at 19 (stating that "existing constitutional doctrine" adequately secures First

On the specific statements at issue, the Court held that under its formulation, the "the connotation that petitioner committed perjury is sufficiently factual to be susceptible of being proved true or false,"[172] and thus satisfied the Court's Constitutional "opinion" rule that it derived from "existing constitutional doctrine."[173] The Court explained:

> A determination whether petitioner lied in this instance can be made on a core of objective evidence by comparing, inter alia, petitioner's testimony before the OHSAA board with his subsequent testimony before the trial court. As the Scott court noted regarding the plaintiff in that case: "[W]hether or not H. Don Scott did indeed perjure himself is certainly verifiable by a perjury action with evidence adduced from the transcripts and witnesses present at the hearing. Unlike a subjective assertion the averred defamatory language is an articulation of an objectively verifiable event." . . . So too with petitioner Milkovich.[174]

The most problematic aspect of *Milkovich* is its ambiguity on the scope of its constitutionally mandated rule. Specifically, the majority is unclear on the constitutional standing of the rule promoted and popularized in *Restatement* section 566 that a statement in the form of an opinion is protected if it does not state or imply *undisclosed* facts. Some commentators have deconstructed section 566, reasoning that it contemplates two types of opinions that may be stated in response to "undisclosed" facts (including facts disclosed by the defendant, already known by the recipient, assumed to exist by the parties to the communication, or generally already before recipients).[175] One type is a *deductive* opinion that "deduces misconduct or a disparaging *fact* about the plaintiff on the basis of true information supplied to the public or already generally known to the public. . . . The 'deduction' is the publisher's judgment that a particular fact exists, given the existence of other known or disclosed true facts."[176] The second type is an *evaluative* opinion that "conveys the publisher's judgment as to the value of another's behavior or work product, rather than the publisher's judgment as to the

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Amendment interests without adopting the kind of broad-based loosely defined Constitutional rule "without the creation of an artificial dichotomy between 'opinion and fact'" that defendants were urging.).

[172] *Id.* at 21.

[173] *Id.* at 19.

[174] *Id.* at 20 (quoting Scott v. News-Herald, 496 N.E.2d 699, 707 (1986)).

[175] *See* WILLIAM L. PROSSER AND W. PAGE KEETON, THE LAW OF TORTS § 113A (5th ed. 1984); SMOLLA, *supra* note 47, §§ 6:33–:34.

[176] SMOLLA, *supra* note 47, § 6:33 (emphasis added); *see also* PROSSER & KEETON, *supra* note 176, § 113A.

existence of facts."[177] The *Restatement* does not draw a distinction between the two types, and clearly both types would be protected opinion under the *Restatement* rule.[178]

Professor Kathryn Sowle, drawing upon the distinction between deductive and evaluative opinions, argues that *Milkovich* (under constitutional law) "immunized only pure, evaluative opinion," but that "a pure, deductive opinion, which is provable as true or false on the basis of objective evidence, carries no immunity."[179] Sowle relies on three aspects of the opinion for her conclusion. First, she notes the Court's implicit approval of continuing potential liability (depending of course on state law) for implied inferences from a statement where the inference could be established by objective evidence.[180] Thus, the Court suggested the following statement could still be deemed factual without running afoul of the First Amendment:

> If a speaker says, "In my opinion John Jones is a liar," he implies a knowledge of facts which lead to the conclusion that Jones told an untruth. Even if the speaker states the facts upon which he bases his opinion, if those facts are either incorrect or incomplete, *or if his assessment of them is erroneous*, the statement may still imply a false assertion of fact.[181]

Sowle also emphasized the Court's citation of Judge Friendly's opinion in *Cianci v. New Times Publishing Co.*[182] In *Cianci*, Judge Friendly seemed to conclude that deductive opinions, "whether or not the basis for the opinion is stated along with the opinion,"[183] should not be protected under either constitutional principles or under common law.[184] And, finally, Sowle pointed to the contrast between the majority's analysis and the dissent by Justice Brennan, the latter of which seemed to follow section 566 rather than *Cianci*.[185] Irrespective of Sowle's

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[177] SMOLLA, *supra* note 47, § 6:34; *see also* PROSSER & KEETON, *supra* note 175, §113A (stating that an "evaluation opinion only is published when the publisher makes a value judgment about another or another's conduct").

[178] *See* Sowle, *supra* note 143, at 474, 490.

[179] *See* Sowle, *supra* note 143, at 625 (stating "[c]learly the Court did not intend to immunize the statement of an opinion, even if the factual predicate were sufficient to permit the recipients to judge the soundness of the inference, if the inference could be proved false on the basis of objective evidence").

[180] Sowle, *supra* note 143, at 490.

[181] Milkovich v. Lorain Journal Co. 497 U.S. 1, 18–19 (1990) (emphasis added); Sowle, *supra* note 143.

[182] 639 F.2d 54 (2d Cir. 1980).

[183] Sowle, *supra* note 143, at 575.

[184] *Cianci*, 639 F.2d at 64–67 (noting that if section 566 pointed to a different conclusion, "we would be unable to agree with it").

[185] Sowle, *supra* note 143, at 498.

reading of *Milkovich*, most cases applying the rule represented by section 566—protecting opinions that do not imply *undisclosed* facts—have held on one basis or another (under constitutional or state law) that the rule is applicable, at least in principle, to all "pure" opinions irrespective of whether such opinions are deductive or evaluative.[186] There is, however, less agreement on whether the Constitution mandates adoption of the section 566 rule—protecting opinions that do not imply *undisclosed* facts.[187]

While concluding that the statement implying that the plaintiff committed perjury was sufficiently factual or "provably false" to be potentially actionable, the *Milkovich* majority did not offer much guidance on whether the section 566 rule entered into its decision. In other words, it was not clear whether the majority

[186] *See, e.g.*, Lassiter v. Lassiter, 456 F. Supp. 2d 876, 882 (E.D. Ky. 2006) (deciding based on state case law); Harrington v. Wilber, 353 F. Supp. 2d 1033, 1042 (S.D. Iowa 2005) (following on First Amendment grounds); Montanye v. Wissachickon Sch. Dist., No. Civ.A. 02-8537, 2003 WL 22096122, at *16 (E.D. Pa. Aug. 11, 2003) (relying on state case law); Silverman v. Clark, 822 N.Y.S.2d 9, 21 (N.Y. App. Div. 2006); Pub. Relations Soc'y of Am., Inc. v. Road Runner High Speed Online, 799 N.Y.S.2d 847, 853(N.Y. App. Div.. 2005) (relying on state law); Feldman v. Lafayette Green Condo. Ass'n, 806 A.2d 497, 501–02 (Pa. Commw. Ct. 2002) (deciding based on state case law); Jones v. Philadelphia, 73 Pa. D. & C.4th 246, 267–68 (Ct. Com. Pl. 2005) (relying on the First Amendment and state law). Sowle herself acknowledged that there is not much support in the cases for making deductive opinions subject to potential defamation liability. *See* Sowle, *supra* note 143, at 550–51. There nevertheless have been some cases that seem to go in that direction. For a case that holds that a deductive conclusion is not protected opinion, see Pisharodi v. Barrash, 116 S.W.3d 858, 862 (Tex. App. 2003) (stating that "[t]he disavowed dichotomies include the four-part test established in Ollman . . . and the rule of section 566," and that "[i]n lieu of such distinctions, *Milkovich* focuses the analysis on a statement's verifiability and the entire context in which it was made").

[187] There is support for both positions. Thus, some cases suggest that the section 566 rule reflects constitutional principles. *See, e.g.*, *Harrington*, 353 F. Supp. 2d at 1042 (citing section 566 and stating that "in determining whether . . . [a] statement was . . . constitutionally protected First Amendment opinion," the [c]ourt [should] determine whether a 'reasonable fact finder could conclude that impl[ied] . . . [an] objective fact'" (quoting Unelko Corp. v. Rooney, 912 F.2d 1049, 1053 (9th Cir. 1990))); Gardner v. Martino, No. CV-05-769-HU, 2005 WL 3465349, at * 9 (D. Or. Sept. 19, 2005) ("In the end, it makes no difference whether the issue is analyzed as one of Oregon common law or as one of First Amendment law. Both require the court to examine the statements in the context they were made and not in isolation. Both hold that if the opinion is made together with disclosed facts, it is not actionable."). Other courts seem to suggest that the section 566 rule was not within the constitutional purview. *See, e.g.*, Henneberry v. Sumitomo Corp. of Am., No. 04 Civ. 2128(PKL), 2005 WL 991772, at *16 (S.D.N.Y. 2005) (relying on the state constitution for protection of pure opinions); Bentley v. Bunton, 94 S.W.3d 561, 580–81(Tex. 2002) (stating that "the analysis prescribed by *Milkovich* supplants various proposed dichotomies between fact and opinion," including the *Ollman* and section 566 formulations). For additional background, see also *supra* notes 118–20 and accompanying text.

thought that the defendant's charge implied new facts (which would make it actionable under section 566), or rather was merely offering a deductive opinion based on facts already disclosed. If the latter, then by finding the statement sufficiently factual, the majority would seem to be suggesting that the deductive opinions, even when based on disclosed facts, did not fall within the purview of the constitutionally mandated protection. Although Justice Brennan said he agreed that the legal principles enunciated by the majority in *Milkovich* were largely correctly stated, he dissented from the majority's application of those principles to the facts.[188] Thus, the majority and dissenting opinions both agreed that non-factual statements were protected. They disagreed on how to get there. Justice Brennan believed that the allegedly defamatory statements that the plaintiff-coach perjured himself at the court hearing were nothing more than the defendant-reporter's *conjecture* rather than an assertion of undisclosed facts. Justice Brennan takes the majority to task for not deciding the case in favor of the defendants on the basis of one of the key subsidiary fact-opinion rules—that a statement is a matter of protected opinion if it does not state or imply *undisclosed* facts.[189] Apparently, Justice Brennan would not only endorse that rule but would, as with the *Restatement*, apply it not only to evaluative opinions but also to deductive opinions as well, as long as they were not based on undisclosed facts. Justice Brennan would follow a multi-factor (flexible) approach to deciding whether the statement was fact or protected opinion.[190]

In applying his approach, Justice Brennan emphasized that the defendant-reporter "not only reveals the facts upon which he is relying but he makes it clear at which point he runs out of facts and is simply guessing. Read in context, the statements cannot reasonably be interpreted as implying such an assertion as fact."[191] In other words, the reporter was surmising or conjecturing about disclosed facts, which were "old news."[192] Brennan also noted that it was clear from the column that the reporter did not attend the court hearing and "had no detailed second hand information."[193] In keeping with his multi-factor approach, Justice

[188] Milkovich v. Lorain Journal Co. 497 U.S. 1, 23–24 (1990) (Brennan, J., dissenting).

[189] *Id.* at 28–33.

[190] *Id.* at 31–32.

[191] *Id.* at 28.

[192] *Id.* at 30.

[193] *Id.* at 30.

Brennan also relied on the column's use of "cautionary terms,"[194] its "tone,"[195] and its "format."[196]

What is most significant, for present purposes, is Justice Brennan's unequivocal view that the constitutional limitations on defamation liability for opinion extend not only to statements which, according to the majority opinion, do not contain a "provably false factual connotation" [197] and to those that cannot reasonably be interpreted as stating actual facts, but also when the defendant has not stated or implied *undisclosed* facts or premises.[198] Thus, Brennan distinguished between situations in which the defendant implies that he possesses undisclosed facts and those in which the defendant's premises are explicit or his audience knows or has access to the underlying facts.[199] Moreover, Brennan would protect even deductive opinions, which he calls "conjecture," unless they were based on undisclosed facts.[200] Brennan eloquently defends the "intrinsic"[201] place and importance of conjecture in the free flow of ideas, as "a means of fueling a national discourse" on matters of public concern "long before all the facts are unearthed."[202]

So where does this leave us? The scope of constitutionally mandated protection for opinion under *Milkovich* is unclear in at least four respects. First, the majority does not clearly explain the constitutional standing of the rule in section 566 of the latest *Restatement*—specifically, whether deductive opinions, even when not based on undisclosed facts, should be protected under the constitution. In finding that the statements in the instant case were sufficiently factual to proceed with the case, the Court may arguably have tacitly declined to endorse as a constitutional imperative application of the rule from section 566 protecting opinions (both deductive and evaluative) that do not imply "undisclosed" facts. Second, the majority is vague on how its "rule" should operate in practice after it rejected the defendants' proposal "that a number of factors developed by the lower

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[194] *Id.* at 31 (stating that the cautionary term "apparently" was "an unmistakable sign that Diadiun did not know what Milkovich had actually said in court").

[195] *Id.* at 32 ("The tone is pointed, exaggerated, and heavily laden with emotional rhetoric and moral outrage. Diadiun never says, for instance, that Milkovich committed perjury. He says that "'[a]nyone who attended the meet . . . knows in his heart' that Milkovich lied-obvious hyperbole as Diadiun does not purport to have researched what everyone who attended the meet knows in his heart" (citation omitted)).

[196] *Id.* at 32 ("The format of the piece is a signed editorial column with a photograph of the columnist and the logo 'TD Says.' Even the headline on the page where the column is continued—'Diadiun says Maple told a lie' . . . —reminds readers that they are reading one man's commentary. While signed columns may certainly include statements of fact, they are also the 'well recognized home of opinion and comment.'" (quoting Mr. Chow of New York v. Ste. Jour Azur S.A., 759 F.2d 219, 227 (2d Cir. 1985))).

[197] *Id.* at 20 (majority op.).

[198] *Id.* (Brennan, J., dissenting).

[199] *Id.* at 30–31 & 31 n.7.

[200] *Id.* at 34.

[201] *Id.* at 34.

[202] *Id.* at 35.

courts . . . be considered in deciding which is which."[203] Third, the Court assiduously avoids deciding whether its constitutional-based rule, whatever its parameters, applies to non-media defendants.[204] Finally, as a nod to the *Greenmoss*[205] case, the Court does not decide whether its constitutional rule extends beyond statements on matters of "public concern."[206]

The uncertain scope of *Milkovich* regarding the constitutional underpinnings of the section 566 rule may prove to have more academic than practical importance. First, while some view language in the majority opinion as arguably impliedly excluding the "undisclosed" facts rule from the purview of constitutionally mandated protected opinion,[207] the Court never explicitly said that.

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[203] *Id.* at 19 (majority op.)

[204] The Court stated, as a central part of its holding, that "a statement on *matters of public concern* must be provable as false before there can be liability under state defamation law, at least in situations where a *media defendant* is involved." *Id.* at 19–20 (emphasis added); *see also* Lewis & Mersol, *supra* note 43, at 61–62.

[205] Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749 (1985).

[206] *Milkovich*, 497 U.S. at 19–20. For background on this content-based limitation on the scope of constitutional scrutiny of defamation claims, see King, *supra* note 52, at 667–68, 694–98.

[207] Sowle, *supra* note 143, at 490, 625 (referring to deductive opinions); *supra* notes 179-185 and accompanying text; *see* Bentley v. Bunton, 94 S.W.3d 561, 580–81 (Tex. 2002). The court in *Bentley* stated:

> The analysis prescribed by *Milkovich* supplants various proposed dichotomies between fact and opinion. For example, more than a decade before *Milkovich*, section 566 of the Restatement (Second) of Torts set out a rule making a statement of opinion actionable "only if it implies the allegation of undisclosed defamatory facts as the basis for the opinion." Six years before *Milkovich* . . . *Ollman v. Evans* designed a four-part test for distinguishing between fact and opinion. In lieu of such distinctions, *Milkovich* focuses the analysis on a statement's verifiability and the entire context in which it was made.

Id. The court also pointed out in dicta that even under the section 566 rule, the statement in question was not protected opinion. *Id.* at 584 ("Even under the common law rule stated in section 566 . . . (to which *Milkovich* referred) that requires an implication of undisclosed facts for an opinion to be actionable, Bunton's statements were defamatory."). The defendant-talk-show host of a call-in talk show televised had apparently sought to prove that his opinion that the plaintiff, a local district judge, was corrupt was based on, inter alia, public records that the defendant had "seen but had not disclosed." *Id.* at 584. The court responded that the defendant Bunton's "consistent position at trial that his accusations of corruption were true is a compelling indication that he himself regarded his statements as factual and not mere opinion, right up until the jury returned its verdict." *Id.* Arguably the court misapplied the section 566 rule by requiring that the defendant establish the truth of his opinion. That seems to conflate the fact-or-opinion issue with the separate truth-or-falsity issue.

Moreover, others opine that the majority's actual formulation may arguably be consistent with section 566.[208] Second, one may question just how important the majority's ambiguity is on the development of the scope of protected opinion in the state and lower federal courts,[209] given the widespread adoption by the states of section 566, the latitude of the courts in interpreting the scope of *Milkovich*, and in any event, the freedom of courts to impose *as matter of state law* even more rigorous limits on liability for opinion than that mandated by the First Amendment.[210]

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[208] *See* Beattie v. Fleet Nat. Bank, 746 A.2d 717 (R.I. 2000); SACK, *supra* note 73, § 4.3.2 (stating with respect to the section 566 "undisclosed" facts concept that "nothing in *Milkovich* altered principles. Once the facts are correctly stated, an author's views about them are neither provably true nor provably false and therefore are protected under *Hepps*." (quoting Standing Comm. on Discipline v. Yagman, 55 F.3d 1430, 1439 n.15 (9th Cir. 1995))). In *Beattie*, the court reasoned:

> *Milkovich* . . . did not purport to disagree with § 566 of the Restatement (Second) Torts nor did it purport to control what the states may require for defamation claims to be actionable . . . . Equally important, the facts in *Milkovich* obviated any need for the Supreme Court to address the critical distinction between communications covered by § 566 of the Restatement (Second) Torts (opinions based upon disclosed, nondefamatory facts) and the communications like the one it faced in that case (opinions based upon implied allegations of undisclosed, defamatory facts). The *Milkovich* majority held only that the communication in that case implied an assertion that the plaintiff had perjured himself in a judicial proceeding and that the assertion was one that was capable of being proven true or false by resorting to a comparison of the undisclosed transcripts of the athletic association hearing and those of the court hearing . . . . Thus, the implied but undisclosed defamatory fact in *Milkovich* was the writer's implication that he was privy both to what Milkovich had testified to in court and at the athletic association hearing, and that, as a result, he knew that Milkovich had perjured himself. And, according to the writer, either one or both of these statements did not jibe with what the writer had witnessed first hand at the wrestling match.

Beattie, 746 A.2d at 723–24.

[209] *See* Sack, *supra* note 136, at 322–24 (stating that "*Milkovich* had little impact on the law," that "[m]ost courts considering opinion since *Milkovich* have . . . reached the result that they likely would have before the Supreme Court decided the case," and that "[e]ven the *Ollman*-type factors used to identify statements of opinion survived *Milkovich* despite *Milkovich*'s explicit disapproval of them").

[210] *See* SMOLLA, *supra* note 47, §§ 6:22–27 (noting "the independence that state courts retain after *Milkovich* to craft their own broader approaches to the fact/opinion distinction"); *see, e.g.*, Immuno AG. v. Moor-Jankowski, 567 N.E.2d 1270, 1277 (N.Y. 1991). The court in *Immuno* commented:

> It has long been recognized that matters of free expression in books,

F. Protected Opinion: A Synthesis

Pulling together the constitutional rules from *Milkovich* and the widely followed (at the very least as a matter of state law) section 566 "undisclosed defamatory facts" rule, four core limitations on defamation liability for opinion emerge.[211] First, "a statement of opinion relating to matters of public concern which does not contain a *provably false* factual connotation will receive full constitutional protection."[212] The truth or falsity of these types of opinions would often be inherently unprovable, such as a statement that the plaintiff is "stupid," a "real pain," a "butt-head,"[213] or "a bastard."[214] Second, the constitution mandates "protection for statements that cannot 'reasonably [be] interpreted as stating actual facts.'"[215] This limitation figures centrally in most parody cases. Third, there are "constitutional limits on the type of speech which may be the subject of state defamation actions," which protect statements consisting of "rhetorical hyperbole, a vigorous epithet,"[216] or "imaginative expression."[217] And fourth, under the

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> movies and the arts generally, are particularly suited to resolution as a matter of State common law and State constitutional law, the Supreme Court under the Federal Constitution fixing only the minimum standards applicable throughout the Nation, and the State courts supplementing those standards to meet local needs and expectations.

Id. at 1277.

> The Supreme Court has specifically directed us to consider the case in light of *Milkovic*h, and we comply with that direction . But that does not compel us to ignore our prior decision or the arguments fully presented on remand that provide an alternative basis for resolving the case. Turning our back on the now developed, controlling State law issues would be no service to the Supreme Court, or the litigants, or the law of this State.

Id. at 1279–80.

[211] There may be some overlap between some of these categories, especially between the first and third rules.

[212] Milkovich v. Lorain Journal Co. 497 U.S. 1, 20 (1990) (emphasis added).

[213] *See* Sagan v. Apple Computer, Inc., 874 F. Supp. 1072, 1075–76 (C.D. Cal. 1994) (stating in a libel action based on the allegation that the defendant "changed the 'code name' on its personal computer from 'Carl Sagan' to 'Butt-Head Astronomer,'" that "the use of the figurative term 'Butt-Head' negates the impression that Defendant was seriously implying an assertion of fact, or that "a reasonable fact finder could conclude that the published statements imply a provably false factual assertion").

[214] *See* RESTATEMENT (SECOND) OF TORTS § 566 cmt. e (1977).

[215] *Milkovich*, 497 U.S. at 21 (quoting Hustler Magazine v. Falwell, 485 U.S. 45, 50).

[216] Greenbelt Coop. Publ'g Ass'n v. Bresler, 398 U.S. 6, 13–14 (1970); *see, e.g.*, Knievel v. ESPN, 393 F.3d 1068, 1074 (9th Cir. 2005) (stating that the word "pimp" when considered in context was not actionable); Flowers v. Carville, 310 F.3d 1118, 1127 (9th Cir. 2002) (statements referring to plaintiff as "trash," "crap," or "garbage" were "nothing

Restatement section 566 rule, at least as a matter of state law, statements of opinion are not actionable unless they state or imply undisclosed, unassumed, or unknown defamatory facts.[218] Thus, an opinion *either evaluative or deductive* is protected if it neither states nor implies new ("undisclosed") defamatory facts. As amplified, the rule is that protected opinions include comments on information already known, understood, or assumed by the recipient, comments on or implying true or non-defamatory facts or facts the defendant is privileged to communicate, or pure conjecturing (deduction) which is understood as nothing more, and thus does not imply reliance on any new or "undisclosed" defamatory facts.[219] As contemplated by the *Restatement*, this rule would protect both evaluative (value judgment) opinions and deductive opinions.[220]

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more than generic invective," and "[t]he law provides no redress for harsh name-calling"); s*ee also* Milkovich, 497 U.S. at 17.

[217] *Milkovich*, 497 U.S. at 20; *cf.* Old Dominion Branch No. 496, Nat. Ass'n of Letter Carriers v. Austin, 418 U.S. 264, 286 (1974) (describing Jack London's definition of a scab as "imaginative expression" (discussed *supra* in Part II.C.3)).

[218] *See supra* Part II.D.

[219] *Milkovich* 497 U.S. at 28–36 (Brennan, J., dissenting). Justice Brennan explains:

> Conjecture, when recognizable as such, alerts the audience that the statement is one of belief, not fact. The audience understands that the speaker is merely putting forward a hypothesis. Although the hypothesis involves a factual question, it is understood as the author's "best guess." Of course, if the speculative conclusion is preceded by stated factual premises, and one or more of them is false and defamatory, an action for libel may lie as to them. But the speculative conclusion itself is actionable only if it implies the existence of another false and defamatory fact.
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> . . . .
>
> But as long as it is clear to the reader that he is being offered conjecture and not solid information, the danger to reputation is one we have chosen to tolerate . . . .

Id. at 28 n.5, 36 (emphasis omitted). Statements that are protected pure conjecture will, taking into account the language and context, "put the reader on notice that what is being read is opinion and thus weaken any inference that the author possesses knowledge of damaging, undisclosed facts." *Id.* at 31 (quoting Ollman v. Evans, 750 F.2d 970, 983 (D.D.C. 1984).

[220] *See supra* notes 175–178 and accompanying text. For a recent example of this rule applied to deductive opinions, see Kersey v. Wilson, No. M2005-02106-COA-RV-CV, 2006 WL 3952899 (Tenn. Ct. App. April 23, 2006). The plaintiff sued the defendant for defamation based on comments the defendant had allegedly made regarding a poem that the plaintiff had written and attached to a bulletin board. *Id.* at *1. Specifically, defendant allegedly stated that the plaintiff "wrote a poem that threatened the life of one of our members." *Id.* The court reasoned:

I believe that most courts would accept the preceding four limitations under either the First Amendment (when the controversy is subject to constitutional First Amendment scrutiny)[221] or as a matter of state law. How the courts get there is another matter, on which there is more variation. In other words, there is significant variation in the methodology, process, or set of relevant factors that the courts may consider in deciding whether a statement constitutes protected opinion under one or more of the four bases listed above.[222] Bear in mind Dean Smolla's injunction:

> [I]n any given case an intelligent argument concerning the fact/opinion distinction cannot be marshaled without resort to discussion of the true purposes served by the fact/opinion distinction in defamation law: an accommodation between protection of valuable interests in reputation and the provision of sufficient breathing space for critical and sometimes caustic free expression.[223]

> We must also note that a poem is a work of the imagination which allows the minds of both poets and readers to venture into areas that lie beyond the realm of verifiable facts. Just as the poet is granted "poetic license," so the reader enjoys considerable latitude to interpret the meaning of a poem in a way that matches his or her understanding . . . . [I]t appears to us that [the defendant] was not accusing [the plaintiff] of committing a crime, but was merely giving excited expression to her opinion of the underlying meaning of his poem.

Id. at *4–5; *see also* Flowers v. Carville, 310 F.3d 1118, 1129 (9th Cir. 2002) ("when speaker outlines the factual basis for his conclusion, his statement is protected," assuming "that the factual basis itself is true" (quoting Partington v. Bugliosi, 56 F.3d 1147, 1156 (9th Cir. 1995))).

[221] *See supra* notes 205–206 and accompanying text.

[222] Dean Smolla writes that "today there are as many tests for identifying opinion as there are home remedies for hiccups." SMOLLA, *supra* note 47, § 6:1. He continues:

> It is true that the Court's rather single-minded emphasis on whether the assertions that give rise to the suit are 'provable as false' is a relatively narrow and mechanistic formula. It lacks the flexibility of the multi-factor tests articulated in cases such as *Ollman*. In close cases, lower courts applying only the 'provable as false' formulation of *Milkovich* may be more inclined to hold the speech actionable than courts applying more subtle and complex tests. But no matter what test is employed, the susceptibility of the statement to objective proof or disproof will inevitably be a dominant factor in separating what is actionable—whether one calls the separation process 'fact v. opinion' or 'fact v. non-fact.'

SMOLLA, *supra* note 47, § 6:21.

[223] SMOLLA, *supra* note 47, § 6:1.

Whether a statement is fact or protected opinion is usually said to be a question for the court to decide under the so-called majority rule.[224] Dean Smolla points out that this could mean either there is no role for the jury at all with respect to this element, or instead that if the court decides that the statement was factual because a reasonable recipient would understand that it communicated actual facts, then the jury may next still have to decide whether the statement was actually "understood . . . as a statement of defamatory fact."[225]

Dean Smolla also describes a so-called minority position under which the jury may decide whether a statement represented actual fact or opinion if reasonable minds could disagree on the matter.[226] I'm not sure how useful attempts to categorize or label various positions regarding the allocation of decision-making responsibility between the court and jury are in the parody cases. There, the role of the courts and juries may depend in part on which of the four categories of potentially protected opinion[227] the court is addressing. In particular, when the question is whether a statement is protected opinion because it could not "reasonably [be] interpreted as stating actual facts,"[228] the courts usually (though not always)[229] decide the threshold question of whether or not a reasonable recipient of the communication could interpret it as representing that the events depicted actually occurred.[230] Presumably, if a court finds that a reasonable

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[224] *See* SMOLLA, *supra* note 47, §§6:61–:62; SACK, *supra* note 73, § 4.3.7.

[225] SMOLLA, *supra* note 47, § 6:62.

[226] SMOLLA, *supra* note 47, § 6:63; *see also* SACK, *supra* note 73, § 4.3.7.

[227] *See supra* notes 211–220 and accompanying text.

[228] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990) (quoting Hustler Magazine v. Falwell, 485 U.S. 45, 50 (1988)).

[229] Indeed, apparently, the question of whether "the ad parody" could "reasonably be understood as describing actual facts about [respondent] or actual events in which [he] participated," was submitted to and decided by the jury in *Hustler*. *Hustler*, 485 U.S. at 49, 57 (noting "[t]he jury found against respondent on his libel claim when it decided that the Hustler ad parody could not 'reasonably be understood as describing actual facts about [respondent] or actual events in which [he] participated' . . . . The Court of Appeals interpreted the jury's finding to be that the ad parody 'was not reasonably believable,' . . . and in accordance with our custom we accept this finding"); *see also* Falwell v. Flynt, 797 F.2d 1270, 1273 (4th Cir. 1986), *rev'd on other grounds*, 485 U.S. 46 (1988) (noting that the question of whether a reasonable person "would believe that the parody was describing actual facts about Falwell" was submitted to the jury which decided that no reasonable person could so interpret the publication).

[230] For examples of cases in which the court decided the threshold question of whether or not a reasonable recipient of the communication could interpret it as representing that the events depicted actually occurred, see e.g., Knievel v. ESPN, 393 F.3d 1068, 1070, 1077–78 (9th Cir. 2005) (stating that a photograph depicting Evel Knievel, who was wearing a motorcycle jacket and rose-tinted sunglasses, with his right arm around his wife and his left arm around another young woman, with a caption that read "Evel Knievel proves that you're never too old to be a pimp," could not reasonably be interpreted as actual fact); Dworkin v. Hustler Magazine, Inc., 867 F.2d 1188, 1192–94 (9th Cir. 1989)

(holding that obscene cartoon "depict[ing] two women engaged in a lesbian act of oral sex with the caption [stating] '[y]ou remind me so much of [the feminist-plaintiff]' and '[i]t's a dog-eat-dog world,' could not reasonably be understood as expressing statements of fact about the plaintiff"); Pring v. Penthouse Int'l, 695 F.2d 438, 441–42 (10th Cir. 1982) (holding that a fanciful article, which did not name the plaintiff, that portrayed the thoughts of a "Charlene," a fictitious Miss Wyoming at a Miss America contest, in which she contemplated performing fellatio on her coach causing him to levitate, could not reasonably be understood as describing actual facts about the plaintiff); Netzer v. Continuity Graphic Assocs., 963 F. Supp. 1308, 1325 (S.D.N.Y. 1997) (holding, in connection with a comic book that allegedly named a fictional terrorist after the plaintiff, that "no average reader could reasonably conclude that the comic book actually charged [the plaintiff] with terrorist activities"); Mitchell v. Globe Int'l Publ'g, Inc., 773 F. Supp. 1235, 1240 (W.D. Ark. 1991) (deciding in the instant case that it "cannot say as a matter of law that the article is incapable of being interpreted as portraying actual events or facts regarding the plaintiff," and that "[t]he 'facts' conveyed are not so inherently impossible or fantastic that they could not be understood to convey actual facts"), *aff'd*, Peoples Bank and Trust Co. v. Globe Int'l Publ'g, 978 F.2d 1065 (8th Cir. 1992); Winter v. DC Comics, 121 Cal. Rptr. 2d 431, 435, 438 (Cal. Ct. App. 2002) (holding with respect to comic book series that allegedly depicted and falsely portrayed plaintiffs, well-known recording musicians, as "vile, depraved, stupid, cowardly, sub-human individuals who engage in wanton acts of violence, murder and bestiality for pleasure and who should be killed," that no reasonable reader would understand any portion of the depiction arguably relating to the plaintiffs "as factual"), *rev'd in part on different claim and grounds*, 69 P.3d 473 (Cal. 2003); Couch v. San Juan Unified Sch. Dist., 39 Cal. Rptr. 2d 848, 856 (Cal. Ct. App. 1995) (holding with respect to a satirical multiple-choice "test" in a high school newspaper that included a question allegedly about the plaintiff-school security guard with possible "answers" that allegedly would accuse plaintiff of being a murderer, drug dealer, or bully, that even if the nonfactual character of the writing might not have been obvious at first sight, the adjoining material should have clarified its satirical nonfactual nature "even for the most unsophisticated of readers"); Patrick v. Superior Court, 27 Cal. Rptr. 2d 883, 890 (Cal. Ct. App. 1994) (holding with respect to a phony legal memo that defendant-small legal newspaper circulated and said was authored by plaintiff-judge and contained "references to Gestapo-like searches, amorous escapades and megalomania," that it was "simply unreasonable to believe that anyone, and particularly the *audience actually intended*, could conclude that [the plaintiff] wrote *this* memo"); S.F. Bay Guardian, Inc. v. Superior Court, 21 Cal. Rptr. 2d 464, 467 (Cal. Ct. App. 1993) (holding with respect to falsely attributed fake letter to the editor in April Fool's Day edition of newspaper that "[b]ecause the average reader would recognize the April Fool's issue as a parody," that it did not present "false facts"); Polygram Records, Inc. v. Superior Court, 216 Cal. Rptr. 252, 259 (Cal. Ct. App. 1985) (articulating its analysis in terms of the defamatory meaning element, but holding in connection with a joke during a performance by Robin Williams, later distributed, allegedly about plaintiff's wine distribution business, that "[s]uggestions that the hypothetical wine is a 'motherfucker,' black in color, tastes like urine, goes with anything 'it' damn well pleases, or is 'tough' or endorsed by ruffians are obvious figments of a comic imagination impossible for any sensible person to take seriously") (footnotes omitted); Victoria Square v. The Glastonbury Citizen, 891 A.2d 142, 145 (Conn. Super. Ct. 2006) (holding that parody in April Fool's Day edition of the defendant-newspaper that

recipient could so interpret the statement, then the jury would have to decide whether the statement was so interpreted.[231] In any event, irrespective of precisely

portrayed plaintiff-commercial real estate developer as planning "to build a 250,000 square foot Wal-Mart store" that would also house "the state's largest Hooters restaurant" and a "helicopter launching pad," and that appeared on the same page as articles announcing that a "Glastonbury student had won a Noble Prize, the discovery of a 'black hole' at a local school, and other improbable 'news stories,'" was protected opinion); Bollea v. World Championship Wrestling, Inc., 610 S.E.2d 92, 96 (Ga. Ct. App. 2005) (holding that a claim by plaintiff (professionally known as "Hulk Hogan") based on a scripted speech that another speaker made at on pay-per-view wrestling event following the story line that defendant's and plaintiff's characters hated each other, could not be understood as stating actual facts); Flip Side, Inc. v. Chicago Tribune Co., 564 N.E.2d 1244, 1253 (Ill. App. Ct. 1990) (holding with respect to a company depicted in a "Dick Tracy" comic strip that the episode cannot "be reasonably understood by persons of ordinary intelligence as describing actual facts about the plaintiffs or actual events in which the plaintiffs participated"); Hamilton v. Prewett, 860 N.E.2d 1234, 1247 (Ind. Ct. App. 2007) (stating that the parody was not actionable "because no reasonable person could believe its claims to be true"); Jones v. Lexington H-L Servs., Inc., No. 2003-CA-002072-MR, 2004 WL 2914880, at *1, 7 (Ky. Ct. App. Dec. 17, 2004) (holding that a claim based on joke posted on an intra-office electronic bulletin board in response to an earlier statement by the plaintiff that he was a believer in caning, that had also been published on the bulletin board, that "[y]ou can't spell Amos without S & M," could not be taken seriously); Walko v. Kean Coll., 561 A.2d 680, 683–84 (N.J. Super. Ct. Law Div. 1988) (holding with respect to a phony "Whoreline" ad listing plaintiff's name in a self-parody "spoof" section of a college student newspaper, that "no reasonable person would read as a factual statement, or as anything other than a joke," and was not "an assertion of fact"); Silberman v. Georges, 456 N.Y.S.2d 395, 396–97 (N.Y. App. Div. 1982) (holding that an "obviously allegorical and symbolic painting" that allegedly depicted two plaintiffs as muggers pursuing a barefoot woman in a fanciful allegorical setting, was rhetorical hyperbole); Budget Termite & Pest Control, Inc. v. Bousquet, 811 A.2d 1169, 1173–74 (R.I. 2002) (holding that newspaper cartoon allegedly portraying plaintiff-pest control company burning down a house to kill bugs, could not reasonably have been construed as referring to plaintiff's business, but "only, at best, a humorous idea that did not imply the existence of one or more undisclosed defamatory facts"); New Times, Inc. v. Isaacks, 146 S.W.3d 144, 155, 161 (Tex. 2004) (deciding that the article "contain[ed] such a procession of improbable quotes and unlikely events that a reasonable reader could only conclude that the article was satirical") (discussed *infra*); *cf.* Stien v. Marriott Ownership Resorts, Inc., 944 P.2d 374, 376, 381(Utah Ct. App. 1997) (holding with respect to a claim for false light invasion of privacy based on a spoof video in which interviewees described the household chore they hated doing, but then was edited to make it appear that as if interviewees were answering the question, "what's sex like with your partner," that "no reasonable viewer would treat the production as a factual commentary on the plaintiff's sex life or any other private matter").

[231] This seems to be a process analogous to that contemplated by section 614. *See* RESTATEMENT (SECOND) OF TORTS § 614 (1977) (stating inter alia that the court determines "whether a communication is capable of bearing a particular meaning," and if so the "jury determines whether a communication, capable of a defamatory meaning, was so understood by its recipient"). Here the question is not simply one of defamatory

how the courts allocate decision-making between them and the jury, our focus here will be on arriving at a sensible framework for addressing the fact-parody demarcation—a framework that should be useful regardless of which entity decides.

Assuming, then, the acceptance of the preceding limitations on defamation liability for opinion, we face the underlying question of how these limitations should be applied to defamation claims based on parodies. In the next subsection, I will offer an overview of representative parody cases, and identify how I believe the typical analysis by the courts, while usually correct as far as it goes, has been incomplete and half-done. Thereafter, I will propose a broader, more complete framework, and suggest some guidelines.

III. THE PARODY CASES

A. Monolithic and One-dimensional Analysis

"There is a history in all men's lives," and a person's reputation is a reflection of the perception of others of that person's life history.[232] It follows then, that for one's reputation to be harmed, misinformation must negatively distort the victim's life history—his reputation. A defamatory statement thus must register on recipients by *expressly* depicting defamatory events or by *implying* the existence of defamatory events indirectly. A victim's reputation can be harmed only if falsely depicted or implied events register in the understanding of the recipients of a communication and thereby change the perception of the events that make up the victim's life history that determines his standing in the minds of others. Whether a parody should be potentially actionable as defamation depends on whether the statement is deemed factual and thus potentially actionable, or is a matter of protected opinion and not actionable. Although the subject has been plagued by confusion and lack of consensus, under the prevailing trends, and based on constitutional law, state substantive defamation law principles, or both, four core bases have emerged for classifying statements as protected opinion. Accordingly, most courts will deem a statement protected opinion if it does not contain a *provably false* factual connotation; it cannot reasonably be understood as suggesting the *occurrence of actual events as depicted*; it consists of *rhetorical hyperbole* or an obvious epithet; *or*, it does not express or imply undisclosed, unassumed, or unknown defamatory facts.

In most defamation claims based on publication of parodies, the element most discretely implicated is the requirement that the statement be of fact rather than protected opinion. Accordingly, the fact-protected opinion element is the most commonly invoked and most appropriate element for addressing whether a parody

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meaning, but whether the words should be interpreted as representing the occurrence of actual events.

[232] SHAKESPEARE, *supra* note 13, at 675.

is potentially actionable as defamation.[233] A few cases, however, occasionally address *one* of the fact-protected opinion tests—whether the parody could "reasonably [be] interpreted as stating actual facts,"[234]—in terms of the defamatory meaning element that asks whether the statement carried a defamatory meaning.[235] Under either characterization of the issue, the courts seem to ultimately examine whether or not the statement could "reasonably [be] interpreted as stating actual facts,"[236] or in other words, whether the parody could reasonably be interpreted as representing that the depicted events actually occurred.[237] For the sake of simplicity, I will develop my analysis within the fact-protected opinion element for present purposes.

It should also be noted that some courts have developed special formulations for the state of mind requirement in cases of parody, satire, and similar fanciful communications.[238] A concern has been that the authors of such not-to-be-believed statements not only know that the portrayal is fanciful, but fully intended it to be so. This, of course, could then mean that if the communication were not deemed protected opinion, the state of mind requirement might *ipso facto* be satisfied even under the demanding requirements for claims by public officials or public figures.[239] Recognizing this paradox, some courts have reformulated the state of

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[233] *See, e.g.*, *Dworkin*, 867 F.2d at 1193; *Pring*, 695 F.2d at 440; *Winter*, 121 Cal. Rptr. 2d at 437; *Patrick*, 27 Cal. Rptr. 2d at 886; *Victoria Square*, 891 A.2d at 145; *Bollea*, 610 S.E.2d at 96–97; *Flip Side, Inc.*, 564 N.E.2d at 1252; *Hamilton*, 860 N.E.2d at 1244; Kiesau v. Bantz, 686 N.W.2d 164, 177 (Iowa 2004); *Jones*, 2004 WL 2914880, at *5; *Walko*, 561 A.2d at 684; *Budget Termite*, 811 A.2d at 1173; *cf. Stien*, 944 P.2d at 380 (addressing a claim for false light invasion of privacy).

[234] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990) (quoting *Hustler*, 485 U.S. at 50).

[235] *See, e.g.*, *Netzer*, 963 F. Supp. at 1324 (stating issue in terms of whether statement was susceptible of a defamatory meaning); *Polygram Records, Inc.*, 216 Cal. Rptr. at 259 (stating that in cases of parody, "[t]he proper focus of judicial inquiry . . . is simply whether the communication in question could reasonably be understood in a defamatory sense by those who received it" (citing RESTATEMENT (SECOND) OF TORTS § 563 (1977))); *Isaacks*, 146 S.W.3d at 155 (stating the question in terms of whether the publication was "capable of a defamatory meaning").

[236] *Milkovich*, 497 U.S.at 20 (quoting *Hustler*, 485 U.S. at 50).

[237] On the role of the judge and jury, see *supra* notes 224–231 and accompanying text.

[238] *See supra* note 38 and accompanying text (identifying elements for defamation). The reference-to-the-plaintiff element may also occasionally arise in some parody and similar cases. *See, e.g.*, *Budget Termite*, 811 A.2d at 1173 (holding in the alternative that the reference to the plaintiff element was not satisfied). This element will not be examined in this article.

[239] *See* DAVID A. ELDER, DEFAMATION: A LAWYER'S GUIDE § 7:25 (2003); SACK, *supra* note 73, § 5.5.2.7.1. Judge Sack notes that, in the context of claims by public officials or figures for example, "its application becomes confused because the author is usually well aware of any 'falsity' contained in the comment and indeed intends no 'truth.' That sounds like 'actual malice.'" SACK, *supra* note 73, § 5.5.2.7.1.

mind requirement to focus not simply on the defendant's state of mind with respect to the truth or falsity of the alleged defamatory message, but rather with respect to "whether the article could reasonably be interpreted as stating actual facts."[240] That aspect of the parody question, however, will, not be examined in further detail here.

Most courts agree that "the fictional or humorous nature of a publication will not necessarily insulate it from a libel claim."[241] Thus, there is no categorical dispensation for everything considered "humor," but rather whether a statement is potentially actionable depends on the rules distinguishing factual statements from protected opinion and depends on whether the statement is or is not protected opinion. [242] Of the four rules identified above that determine the line separating

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[240] *Isaacks*, 146 S.W.3d at 164; *accord* Hoppe v. Hearst Corp., 770 P.2d 203, 208 (Wash. Ct. App. 1989) (stating that "a different standard has been developed for determining malice in these situations, namely: whether the author intended, or recklessly failed to anticipate, that readers would construe the publication as a statement of defamatory facts"). The *Isaacks* court reasoned:

> Equating intent to ridicule with actual malice would curtail the "uninhibited, robust, and wide-open" public debate that the actual malice standard was intended to foster, particularly if that debate was expressed in the form of satire or parody.
>
> . . . .
>
> If indeed these undisputed facts are treated as evidence of actual malice, however, there would be automatic actual malice in all cases of satire. As set forth above, this cannot be reconciled with the First Amendment as interpreted by *Falwell.*

Isaacks, 146 S.W.3d at 165, 167.

[241] *See* Pring v. Penthouse Int'l, 695 F.2d 438, 442 (10th Cir. 1982) ("The test is not whether the story is or is not characterized as 'fiction,' 'humor,' or anything else in the publication, but whether the charged portions in context could be reasonably understood as describing actual facts about the plaintiff or actual events in which she participated. If it could not be so understood, the charged portions could not be taken literally."); Netzer v. Continuity Graphic Assoc., 963 F. Supp. 1308, 1325 (S.D.N.Y. 1997) (holding in connection with a comic book that allegedly named a fictional terrorist after the plaintiff that "no average reader could reasonably conclude that the comic book . . . actually charged [the plaintiff] with terrorist activities"); Polygram Records, Inc. v. Superior Court, 216 Cal. Rptr. 252, 257–58 (Cal. Ct. App. 1985) (stating that "[p]etitioners do not simply maintain that the statements at issue in this case are not defamatory, but that comedy is a form of expression that is *categorically* protected by the First Amendment . . . . We reject this latter theory"); Leslie Kim Treiger, Note, *Protecting Satire Against Libel Claims: a New Reading of the First Amendment's Opinion Privilege*, 98 YALE L.J. 1215, 1225 (1989) (stating that most courts have held that "comedy is not per se immune from a defamation action").

[242] *See Polygram Records*, 216 Cal. Rptr. at 259 (stating that "considerations of

potentially actionable statements of fact from protected opinion, the second one has figured most centrally in the parody cases. Thus, the courts addressing whether a statement is protected opinion have typically focused on whether or not it could "reasonably [be] interpreted as stating actual facts."[243] In deciding whether the allegedly defamatory statement is fact or protected opinion, the courts typically follow a case-by-case approach[244] and look to the "full context in which the alleged libel appears."[245]

Thus, in addressing defamation claims arising from parodies, the courts usually consider the entire article and publication and its full context in their

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[humor] will bear upon the determination whether a defamatory meaning could reasonably be attached to the communication" but are not decisive).

Similarly, the court cautioned:

> Petitioners do not simply maintain that the statements at issue in this case are not defamatory, but that comedy is a form of expression that is *categorically* protected by the First Amendment . . . . We reject this latter theory.
>
> . . . .
>
> Most significantly, however, petitioners' argument assumes that the concept of "comedy" or "humor" can be judicially defined; for unless this is so the courts could not usefully adopt and consistently apply the rule, urged upon us, that comedy, as such, is a protected form of speech.
>
> Comedy . . . does not, in our view, admit of definition by any readily ascertainable general principle. What is one man's amusement is another's calumny . . . . Mindful that judicial efforts to define a concept similarly resistant to explication, i.e., "obscenity," have confused rather than clarified the jurisprudence of the First Amendment . . . and because, in any event, as we explain, no definition is here necessary, we decline to undertake what would almost surely prove a quixotic endeavor. Such judicial timidity should not distress advocates of the constitutional rights of comedians and humorists; for if judges assumed the responsibility to decide what is amusing and made the protections of the First Amendment turn upon their views, perhaps less putative humor would be safeguarded than our restrained approach permits.

Id. at 257–58 (footnotes, quotations, and citations omitted).

[243] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990) (quoting Hustler Magazine v. Falwell, 485 U.S. 45, 50 (1988)).

[244] *See* Couch v. San Juan Unified Sch. Dist., 39 Cal. Rptr. 2d 848, 855 (Cal. Ct. App. 1995) ("The facts which determine whether the average reader would grasp the parodistic intent of a newspaper article necessarily differ from case to case and from newspaper to newspaper.").

[245] *Isaacks*, 146 S.W.3d at 157; *Couch*, 39 Cal.Rptr.2d at 855; *see also*, S. F. Bay Guardian, Inc. v. Superior Court, 21 Cal. Rptr. 2d 464, 467 (Cal. Ct. App. 1993) (stating that "[t]he question is not one that is to be answered by taking a poll of readers but is to be answered by considering the entire context in which the offending material appears").

assessment of the fact versus protected opinion question. Moreover, in assessing specific statements, the courts also consider the effect of the overall article and publication on how the specific statements will be understood. The problem is that a number of courts sometimes go further. By that, I mean that such courts seem to follow a monolithic analysis, and also frequently apply a one-dimensional approach. Their analysis may be monolithic in that they seem to reason that if the overall tenor of an article is deemed a parody, then they seem to assume *ipso facto* that they need not consider whether some of the events depicted could reasonably be interpreted as having actually occurred. Some courts at least appear to make this explicit with a stated tendency, if they conclude that the language in question could not reasonably be interpreted as other than parody, to regard parody and defamation as mutually exclusive.[246] In other words, they state that "parody cannot constitute a false statement of fact and cannot support a defamation claim."[247] This short-circuited analysis may overlook the possibility that even if the overall tenor of the parody is not believable as actual events, there may be *some depicted events* that are reasonably believable or the parody may *imply other events or conduct* that

[246] *See* Browning v. Clinton, 292 F.3d 235, 248 (D.C. Cir. 2002) (referring to the "constitutional protection afforded to parody, satire, and other imaginative commentary" (quoting Moldea v. N.Y. Times Co., 22 F.3d 310, 313 n.2, 314 (D.C. Cir. 1994))); Patrick v. Superior Court, 27 Cal. Rptr. 2d 883, 886 (Cal. Ct. App. 1994) ("Defamation, by contrast, is by its nature mutually exclusive of parody. *By definition* defamation requires a false statement of fact, while parody, *to the degree that it is perceived as parody by its intended audience*, conveys the message that it is not the original, and therefore cannot constitute a false statement of fact." (internal citations omitted)); Victoria Square, LLC v. Glastonbury Citizen, 891 A.2d 142, 145 (Conn. Super. Ct. 2006) (making similar point to language in *Patrick*); Hamilton v. Prewett, 860 N.E.2d 1234, 1244–45, 1245 n.6 (Ind. Ct. App. 2007) (approving the "mutually exclusive" proposition that one cannot reasonably believe parody "to be fact," and that "by definition" cannot constitute a statement of fact, although adding a confusing caveat that it was not "implying that a defendant can never be . . . liable for a parody" based on a misreading of the alternative holding in *Isaacks*, 146 S.W.3d at 161); Kiesau v. Bantz, 686 N.W.2d 164, 176–77 (Iowa 2004) (referring to parody as an "affirmative defense" to plaintiff's defamation claim); Stien v. Marriott Ownership Resorts, Inc., 944 P.2d 374, 380 (Utah Ct. App. 1997) (stating in connection with a false light invasion of privacy claim, that "[a] parody or spoof that no reasonable person would read as a factual statement, or as anything other than a joke[,] cannot be actionable as a defamation") (citing Walko v. Kean Coll., 561 A.2d 680, 683 (N.J. Super. Ct. Law Div. 1988)); 50 AM. JUR. 2D *Libel and Slander* § 156 (2007) (making similar point to language in *Patrick*).

[247] *Hamilton*, 860 N.E.2d at 1247; *see also S. F. Bay Guardian, Inc.*, 21 Cal. Rptr. 2d at 468 (stating that "[a]s long as it is recognizable to the average reader as a joke, it must be protected or the rather common parody issues of newspapers and magazines must cease to exist"); *Kiesau*, 686 N.W.2d at 177 (referring to parody as an "affirmative defense" to a defamation allegation); *Stein*, 944 P.2d at 380 (stating in connection with a false light privacy claim that "[a] parody or spoof that no reasonable person would read as a factual statement, or as anything other than a joke cannot be actionable as a defamation" (quoting *Walko*, 561 A.2d at 683)).

are believable as actual facts. Although a number of parody cases have been decided under this type of a *monolithic* analysis, not all cases have painted with such broad brush strokes. In *Peoples Bank and Trust Co. v. Globe International Publishing, Inc.*,[248] for example the court rejected an argument that depiction of one virtually impossible event "must render the whole story an obvious, non-actionable 'fiction.'"[249]

By one-dimensional, I mean that the courts usually seem to focus on simply whether or not the events expressly depicted in the parody were reasonably understandable as suggesting that those described events actually happened as depicted. While such an analysis may be appropriate as far as it goes, it may be incomplete when a parody, even if not believable as representing the actual occurrence of the expressly depicted events, nevertheless may have reasonably implied that there were other defamatory events that did occur. Sometimes a one-dimensional analysis is applied by the court even after the plaintiff has urged it to consider the possibility of implied defamation.[250] Most courts seem to apply a one-dimensional analysis to parodies in addressing the question of whether the defamatory events depicted in the parody could reasonably be understood as actual events.[251] And in addressing that question, most courts have concluded that the instant parody could not reasonably be interpreted as suggesting actual events and therefore, was not actionable as defamation,[252] although a few cases have found

[248] 978 F.2d 1065 (8th Cir. 1992).

[249] *Id.* at 1069.

[250] *See S. F. Bay Guardian, Inc.* v, 21 Cal. Rptr. 2d at 467 (citing Polygram Records, Inc. v. Superior Court, 216 Cal. Rptr. 252 (Cal. Ct. App. 1985)).

[251] *See supra* notes 229–231; *infra* notes 252–253.

[252] *See, e.g.,* Hustler Magazine, Inc. v. Falwell, 485 U.S. 46, 57 (1988) (accepting finding that ad parody could not reasonably be interpreted as actual facts); Knievel v. ESPN, 393 F.3d 1068,1077-78 (9th Cir. 2005) (stating that a photograph depicting Evel Knievel, who was wearing a motorcycle jacket and rose-tinted sunglasses, with his right arm around his wife and his left arm around another young woman, with a caption that read "Evel Knievel proves that you're never too old to be a pimp," could not when considered in context reasonably be interpreted as actual fact); Dworkin v. Hustler Magazine, Inc., 867 F.2d 1188, 1192-94 (9th Cir. 1989) (holding that obscene cartoon depicting two women engaged in a lesbian act of oral sex with the caption stating that "'[y]ou remind me so much of [the feminist-plaintiff] . . . . It's a dog-eat-dog world,'" could not reasonably be understood as expressing statements of fact about the plaintiff); Pring v. Penthouse International, 695 F.2d 438, 442 (10th Cir. 1982) (holding that a fanciful article that portrayed the thoughts of the a "Charlene," a Miss Wyoming at the Miss America contest, in which she contemplated performing fallatio on her coach causing him to levitate, 441 could not reasonably be understood as describing actual facts); Netzer v. Continuity Graphic Assocs., Inc., 963 F.Supp. 1308, 1325 (S.D.N.Y. 1997) (holding in connection with a comic book that allegedly named a fictional terrorist after the plaintiff that "no average reader could reasonably conclude that the comic book . . . actually charged [the plaintiff] with terrorist activities"); Winter v. DC Comics, 121 Cal.Rptr.2d 431, 435-38 (Cal.Ct.App. 2002) (holding with respect to comic book series that allegedly depicted and

falsely portrayed plaintiff-well-known recording musicians as "vile, depraved, stupid, cowardly, sub-human individuals who engage in wanton acts of violence, murder and bestiality for pleasure and who should be killed," that no reasonable reader would understand any portion of the depiction arguably relating to the plaintiffs "as factual"), *rev'd in part on different claim and grounds*, 69 P.3d 473 (Cal. 2003); Couch v. San Juan Unified Sch. Dist., 39 Cal.Rptr.2d 848, 851, 856 (Cal. Ct. App. 1995) (holding with respect to a satirical multiple-choice "test" in a high school newspaper that included a question allegedly about the plaintiff-school security guard with possible "answers" that allegedly would accuse plaintiff of being a murderer, drug dealer, or bully, that even if the nonfactual character of the might not have been obvious at first sight, the adjoining material should have clarified its satirical nonfactual nature "even for the most unsophisticated of readers"); Patrick v. Superior Court, 27 Cal. Reptr.2d 883, 890 (Cal. Ct. App. 1994) (holding with respect to a phony legal memo that defendant-small legal newspaper circulated and said was authored by plaintiff-judge and contained "references to gestapo-like searches, amorous escapades and megalomania," that it was "simply unreasonable to believe that anyone, and particularly *the audience actually intended*, could conclude that [the plaintiff] wrote *this* memo"), *rev. denied and ordered not to be officially published* (Cal. 1994); S.F. Bay Guardian, Inc. v. Superior Court, 21 Cal.Rptr.2d 464, 467 (Cal. Ct. App. 1993) (holding with respect to falsely attributed fake letter to the editor in April Fool's Day edition of newspaper that "[b]ecause the average reader would recognize the April Fool's issue as a parody" that did not present "false facts"); Polygram Records, Inc. v. Superior Court, 216 Cal.Rptr. 252, 260-61 (Cal. Ct. App. 1985) (articulating its analysis in terms of the defamatory meaning element, but holding in connection with a joke during a performance by Robin Williams, later distributed, allegedly about plaintiff's wine distribution business, that "[s]uggestions that the hypothetical wine is a 'motherfucker,' black in color, tastes like urine, goes with anything 'it' damn well pleases, or is 'tough' or endorsed by ruffians are obvious figments of a comic imagination impossible for any sensible person to take seriously"); Victoria Square v. The Glastonbury Citizen, 891 A.2d 142, 144 (Conn. Super.Ct. 2006) (holding that parody in April Fool's Day edition of the defendant-newspaper that portrayed plaintiff-commercial real estate developer as planning to build a 250,000 square foot Wal-Mart store that would also house the state's largest Hooters restaurant and a helicopter launching pad, and that appeared on the same page as articles announcing that a Glastonbury student had won a Noble Prize, the discovery of a "black hole" at a local school, and other improbable "news stories," was protected opinion); Bollea v. World Champ. Wrestling, Inc., 610 S.E.2d 92 (Ga.Ct. App. 2005) (holding that a claim by plaintiff (professionally known as "Hulk Hogan") based on a scripted speech that another speaker made at on pay-per-view wrestling event following the story line that defendant's and plaintiff's characters hated each other, could not be understood as stating actual facts); Flip Side, Inc. v. Chicago Tribune Co., 564 N.E.2d 1244, 1253 (Ill. Ct. App. 1990) (holding with respect to a company depicted in a "Dick Tracy" comic strip that the episode "cannot be reasonably understood by persons of ordinary intelligence as describing actual facts about the plaintiffs or actual events in which the plaintiffs participated"); Hamilton v. Prewett, 860 N.E.2d 1234 (Ind.Ct.App. 2007) (discussed *infra*); Jones v. Lexington H-L Services, Inc., No. 2003-CA-002072-MR, 2004 WL 2914880, at *1, 7 (Ky. Ct. App. 2004) (holding that a claim based on joke posted on an intra-office electronic bulletin board in response to an earlier statement by the plaintiff that he was a believer in caning, that had also been published on the bulletin board, that "[y]ou

that the allegedly defamatory events depicted in the parody could reasonably be interpreted as meaning that such events actually occurred as described.[253] In these later cases, a reasonable recipient of the defamatory communication may not realize its parodic nature—in other words may not understand "that critical ironic distance"[254]—and therefore, may interpret the parody as representing that the

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can't spell Amos without S & M," could not be taken seriously); Walko v. Kean Coll., 561 A.2d 680, 683-84 (N.J. Super. 1988) (holding with respect to a phony "Whoreline" ad listing plaintiff's name in a self-parody "spoof" section of a college student newspaper, that "no reasonable person would read as a factual statement, or as anything other than a joke," was not "an assertion of fact"); Silberman v. Georges, 456 N.Y.S.2d 395, 396-97 (N.Y. App. Div. 1982) (holding that an "obviously allegorical and symbolic painting" that allegedly depicted two plaintiff's as two muggers pursuing a barefoot woman, was "'rhetorical hyperbole'") (quoting Greenbelt Coop. Publ'g Ass'n., Inc. v. Bresler, 398 U.S. 6, 14 (1970)); Budget Termite & Pest Control, Inc. v. Bousquet, 811 A.2d 1169, 1173-74 (R.I. 2002) (holding that newspaper cartoon allegedly portraying plaintiff-pest control company burning down a house to kill bugs, could not reasonably have been construed as referring to plaintiff's business, but "only, at best, a humorous idea that did not imply the existence of one or more undisclosed defamatory facts"); New Times, Inc. v. Isaacks, 146 S.W.3d 144 (Tex. 2004) (discussed *infra*); *cf.* Stien v. Marriott Ownership Resorts, Inc., 944 P.2d 374, 381(Utah Ct.App.1997) (holding with respect to a claim for false light invasion of privacy based on a spoof video in which interviewees described the household chore they hated doing, but then was edited to make it appear that as if interviewees were answering the question, "what is sex like with your partner," that "no reasonable viewer would treat the production as a factual commentary on the plaintiff's sex life or any other private matter").

[253] *See, e.g.*, *Peoples Bank and Trust Co.*, 978 F.2d at 1067, 1069 (holding in connection with a false light invasion of privacy claim with respect to tabloid newspaper photo of 101-year-old and headline stating "[p]regnancy forces granny to quit work at age 101," that "we cannot say as a matter of law that readers could not reasonably have believed that the charged story portrayed actual facts or events" by the "implication of sexual impropriety," and that "[e]ven the report of the pregnancy—a physical condition, not an opinion, metaphor, fantasy, or surrealism—could be proved either true or false"); Mitchell v. Globe Int'l Publ'g, Inc., 773 F. Supp. 1235, 1240 (W.D. Ark. 1991) (refusing to grant defendant's motion for summary judgment, and stating that "[t]he court cannot say as a matter of law that the article is incapable of being interpreted as portraying actual events or facts regarding the plaintiff," or that the "'facts' conveyed are not so inherently impossible or fantastic that they could not be understood to convey actual facts"), *aff'd on false light liability and remanding for remittitur on compensatory damages*, Peoples Bank and Trust Co. v. Globe Int'l Publ'g, 978 F.2d 1065, 1069 (8th Cir. 1992) (upholding the determination on the false light claim, while noting that the jury had rendered a verdict for the defendant on the defamation claim apparently on some other grounds); Kiesau v. Bantz, 686 N.W.2d 164, 169, 170, 177 (Iowa 2004) (holding that a photograph of a deputy sheriff that had allegedly been digitally altered to make it appear that she was she was standing with her K-9 dog in front of her sheriff's vehicle "to make it appear that Kiesau had pulled up her shirt to expose her breasts" was a representation the truth or falsity of which was easily verifiable and was not opinion).

[254] HUTCHEON, *supra* note 4, at 34. Linda Hutcheon explains"[u]nlike imitation,

depicted events actually occurred. My main concern here, however, is not with the ultimate outcome on the question of whether or not a reasonable recipient could interpret the depicted events as having actually occurred. Rather, my concern is over the failure to address the possibility that a parody might be reasonably interpreted as implying that other defamatory events occurred.

Although most courts apply a one-dimensional analysis to parodies, that may sometimes not represent a rejection of the possibility that a parody may be actionable based on implied facts. This is because the failure of some of these parody cases to expressly address the possibility of implied defamatory facts may be explicable either because it was clear that no undisclosed facts were implied or because whatever was implied was not factual under the rules distinguishing fact from protected opinion. Moreover, a few cases have expressly acknowledged the possibility of actionable defamatory facts implied from a parody even when not decisive in the instant case.[255] Possible liability for implied defamatory facts has also been expressly approved under appropriate circumstances by both the majority[256] and dissenting[257] opinions in *Milkovich*. It is a core feature of the rule laid out in *Restatement* section 566, which specifies that opinion may be "actionable only if it implies the allegation of undisclosed defamatory facts as the basis for the opinion."[258]

In some parody cases, a court's one-dimensional focus is harmless since the communication obviously did not imply any undisclosed facts. Take the case of *New Times, Inc. v. Isaacks*.[259] A thirteen-year-old seventh-grader had been ordered detained by one of the plaintiffs, a juvenile court judge, after the student had written a graphic Halloween horror story depicting the shooting death of a teacher

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quotation, or even allusion, parody requires the critical distance . . . . [I]f the decoder does not notice, or cannot identify, an intended allusion or quotation, he or she will merely naturalize it, adapting it to the context of the work as a whole." HUTCHEON, *supra* note 4, at 34.

[255] For cases stating the possibility *in principle* of implied defamatory facts embedded in a parody, but deciding that the parody in question was protected opinion or not actionable on other grounds, see Couch v. San Juan Unified Sch. Dist., 39 Cal. Rptr. 2d 848, 854 (Cal. Ct. App. 1995) (holding that the parody was protected opinion, but stating that "[s]tatements intended as humor or parody 'may in certain circumstances convey a defamatory meaning and be actionable even if the words used could not be understood in their literal sense or believed to be true.'" (quoting *Polygram Records, Inc.*, 216 Cal. Rptr. at 258); Hamilton v. Prewett, 860 N.E.2d 1234, 1251–52 (Ind. Ct. App. 2007) (stating that "even a statement uttered in jest may contain express or implied facts that are defamatory," and that "may have embedded within it an express or implied assertion of fact").

[256] Milkovich v. Lorain Journal Co., 497 U.S. 1, 19 (1990) (stating that a "statement may still imply a false assertion of fact").

[257] *Id.* at 25 (Brennan, J., dissenting) (holding that statements of opinion "may be actionable if they *imply* the existence of false and defamatory facts").

[258] RESTATEMENT (SECOND) OF TORTS § 566 (1977); *see supra* Part II.D.

[259] 146 S.W.3d 144 (Tex. 2004).

and two fellow students that was deemed to contain "terroristic threats."[260] The incident was widely-reported nationally,[261] and attracted the attention of defendant newspaper, a self-described "alternative newsweekly."[262] About two weeks later, the defendant newspaper published a parody inspired by the incident.[263] It attributed fabricated words and conduct to the plaintiff-judge and district attorney, who then brought the instant defamation claims against the newspaper and its staff.[264]

The court described the parody:

> Entitled "Stop the Madness," the fictitious article described the arrest and detention of "diminutive 6 year-old" Cindy Bradley, who was purportedly jailed for writing a book report about "cannibalism, fanaticism, and disorderly conduct" in Maurice Sendak's classic children's book, *Where the Wild Things Are*. Adjacent to the article was a picture of a smiling child holding a stuffed animal and bearing the caption, "Do they make handcuffs this small? Be afraid of this little girl." The article states that Bradley was arrested "without incident during 'story time'" at Ponder Elementary School and attributes fabricated words and conduct to Judge Darlene Whitten, District Attorney Bruce Issacks, and others. Other false quotes and bogus factual assertions were strewn throughout the piece. Judge Whitten was said to have ordered Bradley detained for ten days . . . while prosecutors contemplated whether to file charges. Whitten purportedly said: "Any implication of violence in a school situation, even if it was just contained in a first grader's book report, is reason enough for panic and overreaction . . . . It's time for you to grow up, young lady, and it's time for us to stop treating kids like children." Cindy was placed in ankle shackles "after [authorities] reviewed her disciplinary record, which included reprimands for spraying a boy with pineapple juice[,] and sitting on her feet." The article noted that Isaacks had not yet decided whether to prosecute Cindy and quoted him as saying, "We've considered having her certified to stand trial as an adult, but even in Texas there are some limits." . . . The article claimed that school representatives would soon join several local faith-based organizations, including "the God Fearing Opponents of Freedom (GOOF)," in asking publishers to review content

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[260] *Id.* at 147–48.

[261] *See generally* Associated Press, *Texas boy earns 'A,' six days in jail for Halloween tale*, FREEDOMFORUM.ORG, Nov. 3, 1999, http://www.freedomforum.org/templates/document.asp?documentID=10270 (describing the events beginning with the student's removal from school on October 28, 1999, and providing a copy of his essay that precipitated the subsequent events).

[262] *Isaacks*, 146 S.W.3d at 148.

[263] *Id.*

[264] *Id.* at 148–49.

> guidelines for children's books . . . . The article concludes with Cindy "scoff [ing] at the suggestion that *Where the Wild Things Are* can corrupt young minds. 'Like, I'm *sure*,' she said. 'It's bad enough people think like Salinger and Twain are dangerous, but Sendak? Give me a break, for Christ's sake. Excuse my French.'"[265]

The trial court denied the defendants' motions for summary judgment, and the court of appeals affirmed.[266] The Texas Supreme Court reversed, rendering a judgment for the defendants.[267] The test was whether construing the allegedly defamatory statements, based on the publication as a whole, the statements "could reasonably be interpreted as stating actual facts."[268] The court explained that the "appropriate inquiry is objective . . . . [N]ot whether some actual readers were misled . . . but whether the hypothetical reasonable reader could be."[269] On merits, the court reasoned that the combined effect of the "obvious clues" in the article including the irreverent tone, the semi-regular publication of satire, and its timing and commentary on a then-existing controversy, "provides a signal to the reasonable reader that the piece is satirical,"[270] and could not reasonably be read as stating actual facts.

The court in *Isaacks* focused exclusively on whether the events featured in the parody were reasonably understandable as indicating that the events described actually happened. While such analyses are appropriate as far as they go, they may be incomplete in parody cases that present credible issues whether the parodies implied that there were other defamatory events that actually occurred. The outcome in *Isaacks* seems appropriate even though the court focused narrowly on the question of whether events described actually happened. That is because the failure to expressly address the possibility that the parody implied other defamatory events was not suggested by the facts. It seems clear that the inspiration for the parody was exclusively the detention of Chris Beamon only days before the parody was published.

In some parody cases, however, a one-dimensional analysis is more problematic. In *Hamilton v. Prewett*, the plaintiff was in the water conditioning business.[271] He discovered a Website entitled, "Paul Hamilten—The World's

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[265] *Id.* at 148–49 (footnotes omitted). A photo of a six year old girl, identified in the story as "Cindy Bradley," that was included in the article, was actually the daughter of a staff member of the defendant-newsweekly. New Times, Inc. v. Isaacks, 91 S.W.3d 844, 850 (Tex. App. 2002), *rev'd*, 146 S.W.3d 144 (Tex. 2004).

[266] *Isaacks*, 91 S.W.3d 844.

[267] *Isaacks*, 146 S.W.3d at 168.

[268] *Id.* at 163.

[269] *Id.* at 157.

[270] *Id.* at 158. The court also noted that the absence of a disclaimer is not necessarily dispositive, but is merely one of many "signals the reasonable reader may consider." *Id.* at 160–61.

[271] 860 N.E.2d 1234, 1238 (Ind. Ct. App. 2007).

Smartest Man" that allegedly portrayed him as "a manipulative individual both personally and professionally. . . . The Website was written from the perspective of 'Hamilten,'[272] a person in the business of water conditioning."[273] The plaintiff claimed that the Website defamed him and his business.[274] The defendant argued that the Website was protected as a form of comedy, parody, or satire.[275] The Website also stated in part:

> I am known for my ability to seduce women with my quick wit. I have several methods of attracting women as well as socializing skills, which are in the book I am writing . . . .
>
> When my employees are installing a unit at a place where their [sic] is a woman at home, I like to get the target alone and tell her that she doesn't have to "pay for this." A couple of winks and boom, you have another sucker hooked. Please note that this only works on women that have half a brain, the more intelligent ones.[276]

Summary judgment for the defendant was affirmed by the court of appeals.[277] It anchored its analysis on the "the proposition that defamation and parody are mutually exclusive."[278] The court then held that "the Website taken as a whole is not subject to a defamatory interpretation," reasoning that it was "a parody because no reasonable person could believe its claims to be true."[279] Accordingly, the court held that the plaintiff's "defamation claim must fail because parody cannot constitute a false statement of fact and cannot support a defamation claim."[280] The court emphasized that the Website not only contained a disclaimer, but that no reasonable person could interpret it as other than parody.[281] Specifically, the court pointed to tongue-in cheek "Customer Testimonials,"[282] to illustrate the Website's

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[272] *Id.* There was a one-letter difference between the spelling of the name of the plaintiff, Paul Hamilton, and the name of the person on the Website, "Paul Hamilten" ("Hamilten"). *Id.* The defendant-Prewett "never denied that he was the author of the Website or represented that the Website was not a reference to Hamilton or Hamilton Water Conditioning." *Id.*

[273] *Id.* at 1238.

[274] *Id.*

[275] *Id.*

[276] *Id.* at 1238–39.

[277] *Id.* at 1238.

[278] *Id.* at 1244.

[279] *Id.* at 1247.

[280] *Id.*

[281] *Id.* at 1246.

[282] The court quoted the following language from the Website:

> I was a very lonely guy until I discovered Paul Hamilten's web site. After

facetious nature, noting that "[i]t is not reasonable to believe that merely drinking a specific kind of water can attract women, cure severe facial disfigurement, or raise a low intelligence quotient to the level of a rocket scientist."[283]

While the preceding analysis by the court may have been sensible as far as it went, I believe that it was incomplete. Moreover, unlike the *Isaacks* situation, in *Hamilton*, it was not obvious to the readers upon what situational frame of reference the defendant had based his parody—or in other words what events or impulses inspired or precipitated the parody. The parody in *Hamilton* was found not reasonably understandable as indicating that the events described actually happened *as depicted*—that is that Hamilton actually made the first person statements describing his preposterous business practices as described. But perhaps a question arguably remained in *Hamilton* whether the parody may nevertheless have falsely *implied that there were other defamatory events that actually did occur*. In other words, did the parody imply that the description of the kind of conduct described actually was inspired by instances of that type of conduct by the plaintiff? Specifically, could the statements about sexual matters have implied that

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> learning a few tips on how to attract women, I decided to buy some of the Casanova Water Formula to see if the claims were true.... To test out this product, I took a walk in the park and to my surprise women started talking to me and soon a large crowd of the opposite sex were gathered around me.... After 2 short days I met my dream woman and asked her hand in marriage. I know that I would never of [sic] had this opportunity if I had not purchased Casanova Water Formula from Paul Hamilten.
>
> . . . .
>
> I was not very intelligent before I started drinking Paul Hamilten's Water and people made fun of me because I had an IQ of 25. My mother traded for some Hamilten Water and started serving it to me without my knowledge. Soon I learned to read and ... after 30 days of drinking Hamilten Water, I was designing components for space shuttle.
>
> . . . .
>
> I was horribly disfigured at birth and felt I no longer could go on. Just when I was about to jump off the White River Bridge, a man came up and told me about Paul Hamilten and his Water products. I talked to Paul and finally agreed to try some of his water. To the amazement of my physician, I had soon developed normal features. . . .

Id. at 1246. The court also pointed out that "[t]he Website also asserts that in the early 1960's, a group of 'Amish Aliens' from another solar system invaded the Earth and are taking over the world by placing minerals in our water," and that "[t]he Website claims that the only way to 'get by' is to either submit to the Amish Aliens or 'have one of ["Hamilten's"] products installed in [your] home.'" *Id.*

[283] *Id.* at 1246.

there was some basis in past events that involved inappropriate sexual conduct by the plaintiff toward his customers?

Judge Najam concurred in the result because he thought the plaintiff had "not designated evidence showing there is a genuine issue of material fact on the questions of defamatory imputation and actual malice."[284] Notwithstanding his problems with the record, he emphasized his disagreement with the majority on its insular analytical approach:

> [T]he majority . . . insists that parody and defamation are "mutually exclusive," implying that parody is entitled to wholesale protection from defamation actions. I cannot concur with the majority's persistent use of that false dichotomy . . . .
>
> The majority assumes, incorrectly, that parody, satire, or rhetorical hyperbole are a prophylactic against defamation . . . . [T]he majority maintains that facts underlying parody and defamation are mutually exclusive and, hence, that if there is parody there is no defamation . . . . I believe this to be an erroneous and oversimplified statement of the law. What matters is not the category of speech, but whether the facts support a defamatory imputation. [285]

Judge Najam then forcefully argued in favor of an approach that is consistent with the two-step analysis I advocate here. He emphasized the possibility that even if a parody were not reasonably understandable as indicating that the events described actually happened as depicted, it may nevertheless still imply that other defamatory events did actually occur.[286] He reasons:

> [E]ven a statement uttered in jest may contain express or implied facts that are defamatory. Parody is an effective defense only when the jest in its entirety cannot reasonably be interpreted as stating or implying any false fact, but that conclusion does not mean that parody and defamation are mutually exclusive. . . .
>
> An otherwise humorous statement may have embedded within it an express or implied assertion of fact that would support a defamatory imputation if malice can be shown. "[E]xpressions of opinion may often imply an assertion of objective fact and, in such cases, would be considered actionable."[287]

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[284] *Id.* at 1252 (Najam, J., concurring).

[285] *Id.* at 1249–51.

[286] *Id.* at 1251–52.

[287] *Id.* at 1251–52 (quoting Solaia Tech., LLC v. Specialty Pub. Co., 852 N.E.2d 825, 840 (Ill. 2006)).

The parodic nature of a publication should preclude liability "only when the jest in its entirety cannot reasonably be interpreted as stating *or implying* any false fact, but that conclusion does not mean that parody and defamation are mutually exclusive."[288] Although Judge Najam apparently believed that the plaintiff had failed to make a sufficient showing on at least one of the other essential defamation elements—proof of defendant's requisite state of mind—he nevertheless added this pointed observation:

> But I do not find [the defendant's] website entirely humorous. The suggestion that [the plaintiff's] female customers are his targets and that he routinely offers to exchange professional services for sexual favors is potentially libelous. On a properly designated record, an issue of fact on the questions of defamatory imputation and actual malice might well preclude summary judgment.[289]

The monolithic and one-dimensional focus of some courts seems premised on the assumption that the only way a parody could be defamatory would be if the statement could reasonably be interpreted as representing that the events as described actually happened. But why so narrow? Might *some* of the events depicted have been reasonably believable even if the overall tenor of the piece was facetious? And why ignore the possibility of *imbedded* imputations within a parody that reasonably could be construed as *implying* defamatory facts? As Simon Dentith teaches us,

> the parodic paradox, by which parody creates new utterances out of the utterances that it seeks to mock, means that it preserves as much as it destroys . . . and thus the parasite becomes the occasion for itself to act as host. In this . . . parody and its related forms serve to continue the conversation . . . ."[290]

In the following subsection, I will propose a broader, more suitable framework for addressing cases of parody.

B. Proposed Two-Step Approach to Parodies

Drawing on the Supreme Court cases and state law, I believe that the courts should employ a framework under which an allegedly defamatory statement will be deemed protected opinion if it falls within one or more of the four core bases defining protected opinion: (a) it did "not contain a *provably false* factual

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[288] *Id.* at 1251 (emphasis added).
[289] *Id.* at 1252.
[290] DENTITH, *supra* note 3, at 189.

connotation;"[291] (b) it "cannot 'reasonably [be] interpreted as stating actual facts;'"[292] (c) it consists merely of "rhetorical hyperbole, a vigorous epithet,"[293] or "imaginative expression;"[294] *or* (d) it does not state or imply *undisclosed* defamatory facts.[295] Then with this four-pronged grid or framework, I propose that the courts examine both of the potentially defamatory dimensions of parodies. First, with respect to the *specific events expressly described in the parody*, the court should determine whether the allegedly defamatory events expressly depicted in the parody were protected opinion. This inquiry will focus on whether the parody reasonably suggested that at least some of the defamatory events expressly described actually occurred. Thus, even if the overall tenor of the piece is deemed a parody, the court should nevertheless still consider whether giving due consideration to the full context and the fact that the overall piece is a parody, there nevertheless are selected events depicted that are reasonably believable as describing actual events and that do not fall within any of the categories of protected opinion. Secondly, and irrespective of the outcome on the first step, the court should also examine the possibility that imbedded defamatory facts were *implied in the parody*. Furthermore, the outcome under both steps should not depend conclusively on whether or not the overall tenor of the writing conveys to a reasonable reader that it is parody. That should not be the only question.

Under the *first* step, the court should consider whether the statements fell within one or more of the four rules under which a statement may be deemed protected opinion.[296] Most commonly in the parody situation, the court would address whether the allegedly defamatory events expressly depicted could reasonably be interpreted as representing that the immediate events featured in the parody actually occurred. The court should also consider whether any of the matters were protected opinions because they were not the kind of statements that were provably false, or were nothing more than rhetorical hyperboles. Or, the question might be decided based on the *Restatement* formulation, finding that the parody did not add any undisclosed facts.

In deciding whether the alleged defamation fell within protected opinion, particularly whether the parody could reasonably be interpreted as representing that the defamatory events featured in the parody actually occurred, the court should consider a range of factors, or "signals" or "clues"[297] that, while not

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[291] Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990) (emphasis added).

[292] *Id.* at 21 (quoting Hustler Magazine, Inc. v. Falwell, 485 U.S. 46, 50 (1988)).

[293] Greenbelt Coop. Publ'g Ass'n, Inc. v. Bresler, 398 U.S. 6, 13–14 (1970); *see also Milkovich*, 497 U.S. at 17 (quoting *Greenbelt*).

[294] *Milkovich*, 497 U.S. at 20.

[295] *See supra* Part II.D.

[296] *See supra* Part II.F.

[297] New Times, Inc. v. Isaacks, 146 S.W.3d 144, 158, 161 (Tex. 2004) (referring to the "clues" or "many signals the reasonable reader may consider in evaluating a publication"); *see generally* ROSE, *supra* note 6, at 37–38 (identifying the most frequently found "signals" for parody in literature).

necessarily conclusive, may militate in favor of finding a parody is protected opinion. These considerations include the following: the allegedly defamatory events expressly depicted were logically plausible and could conceivably have happened, rather than were exaggerations, distortions,[298] or "nonsensical,"[299] especially if those events were impossible[300] or obviously far-fetched;[301] that the parody was accompanied by a disclaimer;[302] that there was a widely known frame

[298] *Isaacks*, 146 S.W.3d at 158

[299] Freedlander v. Edens Broad., Inc., 734 F. Supp. 221, 228 (E.D. Va. 1990); *see* Couch v. San Juan Unified Sch. Dist., 39 Cal. Rptr. 2d 848, 855 (Cal. Ct. App. 1995) (observing that the questions, answers, and scoring key in a parody multiple choice test in high school newspaper were "unremittingly facetious" and the answers were "patently ludicrous choices"); Victoria Square, LLC v. Glastonbury Citizen, 891 A.2d 142, 145 (Conn. Super. Ct. 2006) (noting that the events described were "obviously preposterous"); Hamilton v. Prewett, 860 N.E.2d 1234, 1246 (Ind. Ct. App. 2007) (stating that "[i]t is not reasonable to believe that merely drinking a specific kind of water can attract women, cure severe facial disfigurement, or raise a low intelligence quotient to the level of a rocket scientist").

[300] *See* Pring v. Penthouse Int'l, 695 F.2d 438, 443 (10th Cir. 1982) (observing that "the story described something physically impossible in an impossible setting," that "it is simply impossible to believe that a reader would not have understood that the charged portions were pure fantasy and nothing else" or that "anyone could understand that levitation could [not] be accomplished by oral sex before a national television audience or anywhere else," and that "[t]he incidents charged were impossible"); Netzer v. Continuity Graphic Assocs., 963 F. Supp. 1308, 1325 (S.D.N.Y. 1997) (finding that the comic was "patently a work of fantasy, involving outlandish plot scenarios and characters with impossible powers," and that "[n]o reasonable reader of such a publication would take the events described as factual events"); Mitchell v. Globe Int'l Publ'g, 773 F. Supp. 1235, 1240 (W.D. Ark. 1991) (denying defendant's motion for summary judgment, and stating that "[t]he 'facts' conveyed are not so inherently impossible or fantastic that they could not be understood to convey actual facts"), *aff'd on false light liability and remanding for remittitur on compensatory damages*, Peoples Bank and Trust Co. v. Globe Int'l Publ'g, 978 F.2d 1065 (8th Cir. 1992); Eric Scott Fulcher, Note, *Rhetorical Hyperbole and the Reasonable Person Standard: Drawing the Line Between Figurative Expression and Factual Defamation*, 38 GA. L. REV. 717, 757 (2004).

[301] *See* Dworkin v. Hustler Magazine, Inc., 867 F.2d 1188, 1193 (9th Cir. 1989) (holding that "the article purports to be an interview of a body part, and therefore cannot be reasonably understood as making assertions of fact"); Fulcher, *supra* note 300, at 757-58.

[302] Although the presence or absence of a disclaimer may not be *per se* dispositive, it may be a relevant factor to consider. *See Isaacks*, 146 S.W.3d at 160–61 ("While a disclaimer would have aided the reasonable reader in determining the article was a satire, such a disclaimer is not necessarily dispositive . . . . Rather, the presence of a disclaimer is one of many signals the reasonable reader may consider in evaluating a publication."); *see also* Kiesau v. Bantz, 686 N.W.2d 164, 176–77 (noting that the altered photograph was sent to others "without any disclaimer" in holding that altered photograph was not protected opinion).

It should be noted, however, that sometimes the presence of certain types of disclaimers may actually undercut a defendant's parody argument. *See Peoples Bank and*

of reference or situation that was an obvious inspiration for the parody or on which the parody commented;[303] that the defendant had a history of making use of satire or parody by the defendant;[304] that the writing had an "irreverent tone;"[305] that the format, type, and style of the publication and the placement of the article within the publication[306]—the quintessential example being an April Fool's section or edition

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Trust Co., 978 F.2d at 1070. There the court held:

> The Sun even published a disclaimer above certain personal advertisements warning its readers that those notices had not been investigated—implying that other advertisements and the news stories had been investigated. These disclaimers and caveats on advertisements, and the absence of any warning or explanation on the admittedly fictional "news" stories, bolster our conclusion that Globe intends for its 366,000 readers to believe the *Sun* prints factual material.

Id. at 1070.

[303] *See* Jones v. Lexington H-L Serv., Inc., No. 2003-CA-002072-MR, 2004 WL 2914880, at *5 (Ky. Ct. App. Dec. 17, 2004) (holding that joke posted on an intra-office electronic bulletin board in response to an earlier statement by the plaintiff that he was a believer in caning, was clearly "intended as humorous responses to [plaintiff's] statements"); *see, e.g.*, Patrick v. Superior Court, 27 Cal. Rptr. 2d 883, 889–90 (Cal. Ct. App. 1994) (noting that even if, *arguendo*, the language of a phony memo that defendant legal newspaper circulated and ascribed to the plaintiff-judge was not alone conclusive, when viewed in the context of the "running feud" between the judge and the newspaper, it was unreasonable to believe that judge himself had written phony, satirical memo); Lane v. Ark. Valley Publ'g Co., 675 P.2d 747, 750–51 (Colo. Ct. App.1983) (noting that context in which satirical articles were published was significant, and that "comments made in the context of a hotly contested political campaign should not be judged by the same standard as those made in other contexts" and topics at issue "had been the subject of extensive reporting and controversy"); Garvelink v. Detroit News, 522 N.W.2d 883, 887 (Mich. Ct. App. 1994) (stating that column was "obviously satire intended to criticize the school budget cuts, which was a controversial issue at the time"); *Isaacks*, 146 S.W.3d at 160 (stating that "[t]he reference in 'Stop the madness' to the actual Beamon incident provides yet another signal to the reasonable reader, who would have understood the satire to be commentary on that controversy"); Hoppe v. Hearst Corp., 770 P.2d 203, 207 (Wash. Ct. App. 1989) (noting that a satirical column critical of plaintiffs' use of public funds was published during a political campaign and in the context of "a well publicized debate" over the plaintiff's use of public funds to hire detectives).

[304] *Isaacks*, 146 S.W.3d at 159–60.

[305] *Id.* at 161.

[306] *See Peoples Bank and Trust Co.*, 978 F.2d at 1069–70 (8th Cir. 1992) (finding that in the instant case "we cannot say as a matter of law that readers could not reasonably have believed that the charged story portrayed actual facts or events," and noting that here "[t]he format and style of the Sun suggest it is a factual newspaper," that "nowhere in the publication does it suggest its stories are false or exaggerated," and that "[t]he Sun also mingles factual, fictional, and hybrid stories without overtly identifying one from the other"); Netzer v. Continuity Graphic Assocs., 963 F. Supp. 1308, 1324 (S.D. N.Y. 1997)

of a newspaper[307]—suggested that it was a parody; and that the defendant did not apparently have access to undisclosed information upon which the alleged defamatory imputation could be based.

Next, and irrespective of the outcome on the first step, the court should proceed to the *second* step and examine the possibility of imbedded defamatory facts implied in the parody suggesting that the plaintiff actually did engage in other defamatory conduct. In addressing the possibility of implied defamatory facts, the court would have to decide both whether the parody impliedly conveyed some negative message, and if so, then whether that message was itself factual rather than protected opinion under one or more of the four core rules for distinguishing fact and protected opinion. In deciding these questions, the courts should consider the range of factors identified above used in the first step. The courts should pay special attention to whether there was a preexisting frame of reference—a previously disclosed, assumed, or widely known factual setting which inspired the parody. In conjunction, the court should also consider whether the defendant appeared to have had access to sources of the undisclosed information that the plaintiff contends was implied in the parody.[308] If the parody was not based solely on preexisting disclosed, generally known, or assumed facts, then the court should carefully examine whether what is implied is a specific type of defamatory conduct—the actual occurrence of which is reasonably suggested by implication from the parody.[309]

(stating that "[a]n allegedly defamatory statement must be interpreted in the context of the type of publication in which it appears"); Victoria Square, LLC v. Glastonbury Citizen, 891 A.2d 142, 145 (Conn. Super. Ct. 2006) (stating that "[t]he article is surrounded by other mock articles which any reasonable reader would quickly determine to be both false and humorous"); Couch v. San Juan Unified Sch. Dist., 39 Cal. Rptr. 2d 848, 855 (Cal. Ct. App. 1995) (discussing placement of article on the Entertainment page); S.F. Bay Guardian, Inc. v. Superior Court, 21 Cal. Rptr. 2d 464, 466 (Cal. Ct. App. 1993) ("The parody section commenced at the back of the regular edition and, if the paper were picked up as presented, could only be read by turning the paper upside down"); Walko v. Kean Coll., 561 A.2d 680, 684 (N.J. Super. Ct. Law Div. 1988) (emphasizing, with respect to a phony "Whoreline" ad listing plaintiff's name in a self-parody "spoof" section of a college student newspaper, that the ad was "surrounded by other short, absurd announcements in a section which is clearly delineated as intended humor"); Budget Termite & Pest Control, Inc. v. Bousquet, 811 A.2d 1169, 1174 (R.I. 2002) (stating that the cartoon's "appearance in the comics section of the Sunday newspaper effectively dispelled any reasonable perception that it could be viewed as an assertion of objective fact").

[307] *See, e.g.*, *Victoria Square*, 891 A.2d at 142; *S.F. Bay Guardian, Inc.*, 21 Cal. Rptr. 2d at 464.

[308] *See* Fortson v. Colangelo, 434 F. Supp. 2d 1369, 1380–81 (S.D. Fla. 2006) (noting that the defendant "[s]ignificantly . . . did not imply that he had access to any facts beyond those that were already known to the basketball audience").

[309] *See* Hopewell v. Vitullo, 701 N.E.2d 99, 104–05 (Ill. Ct. App. 1998). In holding that "the alleged defamatory statement—'fired because of incompetence'—is too vague and general to support an action for defamation as a matter of law," the court explained:

Using the preceding framework, some parodies will obviously have been created in response to a specific preexisting widely-publicized situation, and therefore will imply nothing new. The *Isaacks* parody[310] discussed above[311] is a good example. The court emphasized that "[t]he reference in 'Stop the Madness' to the actual Beamon incident provides yet another signal to the reasonable reader, who would have understood the satire to be commentary on that controversy."[312] Thus, the failure of the court to expressly address the possibility of implied defamatory facts from the parody was inconsequential.

Even in the absence of a preexisting set of known or assumed circumstances to account for the parody, the sheer preposterousness of the parody may make it protected and obviously exclude the possibility of implied defamatory facts. Take the case of *Budget Termite & Pest Control, Inc. v. Bousquet*.[313] A defamation claim was based on a cartoon allegedly portraying the plaintiff-pest control company as burning down a house to kill insects.[314] The court held[315] that this

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> Although the public might infer undisclosed and unassumed facts that support [the defendant's] opinion, the statement is so ambiguous and indefinite that any inferable facts flow from numerous possible facts that might conceivably support the conclusion that [the plaintiff] was "incompetent." Without a more specific reference to [the plaintiff's] conduct or character *to narrow the undisclosed, implied facts to a finite group*, one cannot reasonably determine which implied fact or set of facts was necessary to support [the defendant's] opinion. As such, any reasonable determination of whether the statement's possible underlying facts are indeed false is foreclosed because it would entail an endless analysis of each and every fact connected with the execution of [the plaintiff's] duties as treasurer and CFO of the Committee. Thus, we find that the statement is too broad, conclusory, and subjective to be objectively verifiable.

Id. at 104 (emphasis added).

[310] New Times, Inc. v. Isaacks, 146 S.W.3d 144 (Tex. 2004).

[311] *See supra* notes 260-265 and accompanying text.

[312] *Isaacks*, 146 S.W.3d at 160.

[313] 811 A.2d 1169 (R.I. 2002).

[314] *Id.* at 1171. The court described the cartoon:

> [T]he cartoon depicts two goofy-looking pest control workers. One of them wears a shirt with the words "Budget Pest Control" on it. This worker is grinning maniacally while holding a gas can in his hand. Behind him a house is all ablaze. His fellow co-worker (with his shirt partially obscured so only "Pest Control" can be seen) is assuring a distraught woman standing in front of them as follows: "Easy, now, ma'am. This is Billy Bob's first day on the job and them carpenter ants can be real stubborn."

Id.

[315] This was an alternative ground. The court first held that the defamation claim was

cartoon "was not capable of a defamatory construction because the statements . . . were not assertions of fact but rather 'rhetorical, exaggerated means of expressing opinions' that did not imply the existence of undisclosed defamatory facts about plaintiff."[316] Furthermore, the cartoon's "appearance in the comics section of the Sunday newspaper effectively dispelled any reasonable perception that it could be viewed as an assertion of objective fact."[317] Thus, the obvious comic nature of the publication and the preposterous events depicted could have supported neither a claim that the events described had actually occurred nor that any other specific type of defamatory events could reasonably be implied or inferred from the parody.

Even if a parody may arguably imply new matters, the court will still also have to decide whether those new matters are "factual" rather protected opinion. For example, in the *Bay Guardian* case,[318] irrespective of whether or not a fake letter to the editor attributed to the plaintiff in the April Fool's Day edition of the defendant-newspaper could have conveyed that the defendant held a general unfavorable impression of the plaintiff, it did not express or reasonably imply specific conduct, and thus was not factual.[319] The court reached a similar result in *Patrick v. Superior Court*, where the defendant-legal newspaper circulated a phony legal memo attributed to plaintiff-judge to the judges and employees of the court in which plaintiff-judge presided.[320] There was a preexisting "running feud"[321]

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not actionable because it failed to satisfy the reference to the plaintiff element. *Id.* at 1172.

[316] *Id.* at 1174.

[317] *Id.*

[318] S.F. Bay Guardian, Inc. v. Superior Court, 21 Cal. Rptr. 2d 464 (Cal. Ct. App. 1993).

[319] *Id.* at 467–68. The court explained:

> Real party . . . contends that even if the letter were recognized as a parody, it would be defamatory because it would convey the implication that real party was an unscrupulous landlord and an insensitive human being.
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> . . . .
>
> If a parody could be actionable because, while recognizable as a joke, it conveyed an unfavorable impression, very few journalistic parodies could survive. The butt of the parody is chosen for some recognizable characteristic or viewpoint which is then exaggerated. It is not for the court to evaluate the parody as to whether it went "too far." As long as it is recognizable to the average reader as a joke, it must be protected or the rather common parody issues of newspapers and magazines must cease to exist.

Id.

[320] Patrick v. Superior Court, 27 Cal. Rptr. 2d 883, 883 (Cal. Ct. App. 1994).

[321] *Id.* at 889; *see also* RESTATEMENT (SECOND) OF TORTS § 566 cmt. d (1977) ("If all that the communication does is to express a harsh judgment upon known or assumed facts,

between the parties, thus suggesting that the parody communicated nothing new. But, even if new matters were implied, any conduct implied would itself have not been reasonably believable as implying *actual specific events* in light of its "sheer ludicrousness"[322] and unverifiable nature.[323]

Or, let us revisit the situation in *Budget Termite & Pest Control, Inc. v. Bousquet*.[324] One of the defendant-cartoonist's pieces was published in a local newspaper. In the cartoon, a pest control worker wore a shirt with the words, "Budget Pest Control;" the defendant's company was "Budget Termite and Pest Control."[325] In his deposition, the defendant-cartoonist said that he had not heard of plaintiff-company when he composed the cartoon, that he had no particular reason to use the name "Budget Pest Control," and that it "just came into my head."[326] He also admitted that he had done cartoon work for a competitor of plaintiff's during the six year period prior to the publication of the allegedly defamatory cartoon.[327]

The ultimate outcome in the *Budget Termite* case is perhaps justifiable. The events expressly depicted in the cartoon were preposterous and not reasonably believable as actual events, especially given the medium as a cartoon. While the cartoon may have impliedly imparted a negative impression of the plaintiff company, it was probably not sufficiently focused or specific to be deemed implied facts. Anything negative implied by the cartoon was not sufficiently verifiable or provably false to be potentially actionable under a *Milkovich*-type analysis.[328]

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there is no more than an expression of opinion of the pure type, and an action of defamation cannot be maintained. For maintaining the action it is required that the expression of ridicule imply the assertion of a factual charge that would be defamatory if made expressly.").

[322] *Id.* at 888.

[323] *Id.* at 888–89. No events depicted would imply other similar conduct that would be sufficiently narrow to be verifiable or provably false. Thus, the fake memo warning judges to conduct their "amorous escapades" off-site does not imply any specific misconduct by the plaintiff that is sufficiently narrow to be verifiable or provably false. *Id.* at 884.

[324] 811 A.2d 1169, 1174 (R.I. 2002).

[325] *Id.* at 1171. Plaintiff's president "testified that 'virtually everyone refers to us as Budget Pest Control,' he admitted that 'all company advertising, signs, and uniforms listed the name as "Budget Termite & Pest Control."'" *Id.*

[326] *Id.* at 1171.

[327] *Id.* at 1171 (noting that defendant "admitted, however, that he had done some cartoon work for New England Pest Control, a competitor of plaintiff's, between 1993 and 1999; that is, he drew cartoons or submitted his previous artwork for use in New England Pest Control's advertising during this period"). Defendant also stated that in at least one cartoon, he had portrayed the competitor in a negative light. *Id.* And, apparently none of his work for the competitor "referred to plaintiff or cast any negative aspersions on its employees or the quality of its work." *Id.*

[328] Technically, the claim here, if not a matter of public concern, might arguably not be subject to constitutional scrutiny. *See supra* notes 205–206 and accompanying text. Nevertheless, the parody could still be deemed protected opinion if the state had adopted

Having said this, a variation of the facts in *Budget Termite* discussed later raises some interesting questions about the exclusivity of the defamation theory of liability.[329]

There remain, however, some cases decided solely on the basis of whether the depicted events could reasonably be understood as having actually occurred, that may involve circumstances in which the question of implied defamatory facts should have demanded greater scrutiny. In *Hamilton v. Prewett*,[330] you will recall, plaintiff was in the water conditioning business, and a Website allegedly portrayed him as "a manipulative individual both personally and professionally."[331] The plaintiff claimed that the Website defamed him and his business.[332] The court held that the web item was a parody based on its disclaimer and tongue-in cheek "Customer Testimonials."[333] Those, the court said, proved the Website's facetious nature, noting that "[i]t is not reasonable to believe that merely drinking a specific kind of water can attract women, cure severe facial disfigurement, or raise a low intelligence quotient to the level of a rocket scientist."[334] The court's holding came despite the fact that the Website also had the following "quotation" allegedly falsely attributed to the plaintiff:

> I am known for my ability to seduce women with my quick wit. I have several methods of attracting women as well as socializing skills, which are in the book I am writing . . . .
>
> When my employees are installing a unit at a place where their [sic] is a woman at home, I like to get the target alone and tell her that she doesn't have to "pay for this." A couple of winks and boom, you have another sucker hooked.[335]

That drew the following response from the concurring opinion of Judge Najam:

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the provably-false-verifiability test as a matter of state law, or under some other state construct defining protected opinion. *See* SMOLLA, *supra* note 46, §§ 6:22, :26, :44–:56 (referring to some courts' fact-opinion rules after *Milkovich* as being "adopted as a matter of state law," noting "the independence that state courts retain after *Milkovich* to craft their own broader approaches to the fact/opinion distinction," and describing various state law formulations).

[329] *See infra* Part III.C.

[330] 860 N.E.2d 1234 (Ind. Ct. App. 2007).

[331] *Id.* at 1238.

[332] *Id.*

[333] *Id.* at 1246.

[334] *Id.*

[335] *Id.* at 1238–39.

> But I do not find [the defendant's] website entirely humorous. The suggestion that [the plaintiff's] female customers are his targets and that he routinely offers to exchange professional services for sexual favors is potentially libelous. On a properly designated record, an issue of fact on the questions of defamatory imputation and actual malice might well preclude summary judgment.[336]

Unlike *Isaacks*, there were no disclosed, assumed, or generally known pre-existing circumstances to which the parody could be tied as merely responsive. And the suggestion of sexual improprieties with female customers was not inherently improbable, nor preposterous. Thus, an argument can be made that merely because this writing was deemed a parody should not *ipso facto* have precluded further analysis. I believe that the court's analysis was incomplete, and should have included an examination of the whether the parody reasonably implied undisclosed defamatory facts.

Another case in which the court should arguably have considered whether the parody implied undisclosed defamatory facts is *Couch v. San Juan Unified School District*.[337] A high school newspaper published a satirical multiple-choice "test" that included a question allegedly about the plaintiff-school security guard.[338] The possible "answers" to Question 5 allegedly would accuse the plaintiff of being a murderer, drug dealer, or bully.[339] In affirming summary judgment for the defendant, the court held that even if the nonfactual character of the "test" might not have been obvious at first sight, the adjoining material should have clarified its satirical, nonfactual nature.[340] Although one sentence in the court's opinion held open the possibility that, in theory at least, a parody might be actionable for implying undisclosed defamatory facts,[341] the court brushed past such a possibility here, and focused narrowly on the question of whether the events depicted in the

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[336] *Id.* at 1252.

[337] 39 Cal. Rptr. 2d 848 (Cal. Ct. App. 1995).

[338] *Id.* at 851.

[339] *Id.* Question 5, containing the material giving rise to this lawsuit, read as follows:

> *5. What's the story behind the new narc?* [¶] (a) They felt that we needed someone who's actually committed murder to hand out discipline at Rio. [¶] (b) They wanted to find someone who blends in well with the students. [¶] (c) He's a part of Rio's new motto, 'We're gonna kick some ass!' [¶] (d) I don't know his story, but he sells primo drugs, cheap too!"

Id.

[340] *Id.* at 855.

[341] The court stated that "[s]tatements intended as humor or parody 'may in certain circumstances convey a defamatory meaning and be actionable even if the words used could not be understood in their literal sense or believed to be true.'" *Id.* at 854 (quoting Polygram Records, Inc. v. Superior Court, 216 Cal. Rptr. 252; 258 (Cal. Ct. App. 1985)).

parody were reasonably understandable as actual facts. The court not only considered the entire satire's "parodistic purpose," but went even further and essentially reasoned that the entire context of the piece neutralized any possibility that Question 5 could be read literally.[342] Pointedly, the court said, "'[o]nly a viewer that read only [Question 5], accepted it at face value . . . , and looked at nothing else could miss the joke in this case, and that is not the average reader.'"[343]

The *Couch* case illustrates both a monolithic and a one-dimensional approach to parody. The court's analysis is monolithic because although it is proper to examine the allegedly defamatory statements in the context of the parody, the fact that the overall tenor of the "test" was parodistic should not exclude the possibility that some parts of it might be reasonably understood as imputing actual misconduct. The court's reasoning also appears too narrow and one-dimensional for not adequately addressing whether parts of the parody may have implied embedded undisclosed defamatory facts that could reasonably be believed. Unlike *Isaacks*, there were no relevant preexisting known circumstances that inspired this parody.[344] In addition, the plaintiff's position at the school was the only position identifiable in the quiz.[345]

C. Intentional Interference with Prospective Relations: A Caveat

Although the outcome of the defamation claim of the *Budget*[346] case is explicable under the principles for distinguishing fact from protected opinion,[347] a hypothetical variation on the facts poses some intriguing questions. Although the cartoonist admitted that he had done some cartoons or artwork for a competitor of the plaintiff-pest control company,[348] he also swore that he had never heard of the

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[342] *Id.* at 855.

[343] *Id.* at 856 (quoting and extrapolating from S.F. Bay Guardian, Inc. v. Superior Court, 21 Cal. Rptr. 2d 464, 467 (Cal. Ct. App. 1993).

[344] Although the publication occurred shortly after the plaintiff had returned after a leave of absence, the student authors stated that the "new narc" reference in the question was actually to another monitor who worked at the school earlier in the month when the article was written, but before it was published. *See id.* at 850–51 & n.4.

[345] *See id.* app. at 858.

[346] Budget Termite & Pest Control, Inc. v. Bousquet, 811 A.2d 1169 (R.I. 2002), discussed *supra* notes 313–317, 324–329.

[347] *See id.* at 1174. The court also held in the alternative that the reference-to-the plaintiff element had not been satisfied. *Id.* at 1173.

[348] *Id.* at 1171 (noting that defendant "admitted, however, that he had done some cartoon work for New England Pest Control, a competitor of plaintiff's, between 1993 and 1999; that is, he drew cartoons or submitted his previous artwork for use in New England Pest Control's advertising during this period"). Apparently none of his work for the competitor "referred to plaintiff or cast any negative aspersions on its employees or the quality of its work." *Id.*

plaintiff-company when he composed the cartoon.[349] For the sake of argument, however, let us explore some questions that might arise hypothetically if instead, we had a different set of facts. Assume that a plaintiff were able to establish that a hypothetical defendant-cartoonist had intended, without disclosure of such ulterior interest, to negatively parody a plaintiff in order to serve the interests of a competitor of that plaintiff by interfering with that plaintiff's prospective pest control business in a way that redounded to the benefit of the competitor. Let us also assume for the sake of argument, that our hypothetical situation involved a matter of public concern and that First Amendment restrictions would apply with respect to potential defamation liability. Should the First Amendment *ipso facto* preclude potential liability for tortious interference with prospective economic relations based on a defendant's use of a parody to achieve the undisclosed ulterior purpose of interfering with the prospective economic relations of the plaintiff to benefit a competitor, solely because the parody might be deemed protected opinion for defamation purposes?

The broad question of the application of First Amendment restrictions beyond defamation to other tort theories arising from allegedly false statements is complex and will not be examined here. Moreover, the tort of interference with prospective economic relations is labyrinthine[350] and beyond the scope of this article.[351] I will only comment briefly and preliminarily on the narrow matter of whether such a claim, when based on hypothesized parody, should (irrespective of whether otherwise actionable) be precluded because the parody-conduct would be deemed protected opinion for defamation purposes. A number of cases have held that a claim for interference with prospective economic advantage based on alleged injurious false statements about the plaintiff is generally subject to First Amendment restrictions.[352] In *Nanavati v. Burdette Tomlin Memorial Hospital*,[353]

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[349] *Id.* at 1171. Defendant also said at least one cartoon he drew portrayed the plaintiff's competitor in a negative light. *Id.*

[350] Justice Mosk has complained that the "law on the tort of intentional interference with prospective economic advantage, both in American jurisdictions generally and in California specifically, is fast approaching incoherence." Della Penna v. Toyota Motor Sales, U.S.A., Inc., 902 P.2d 740, 752 (Cal. 1995) (Mosk, J., concurring).

[351] *See generally* Alex B. Long, *The Business of Law and Tortious Interference*, 36 ST. MARY'S L.J. 925 (2005).

[352] *See, e.g.*, Blatty v. N.Y. Times Co., 728 P.2d 1177, 1184–85 (Cal. 1986) (stating that claims for interference with prospective economic advantage that have "as their gravamen the alleged injurious falsehood of a statement . . . must satisfy the requirements of the First Amendment"). The court in *Blatty* reasoned that "[i]f these limitations applied only to actions denominated 'defamation,' they would furnish little if any protection to free-speech and free-press values: plaintiffs suing press defendants might simply affix a label other than 'defamation' to their . . . claims." *Id.* at 1184. The question also arises with claims for injurious falsehood whether such claims should be precluded when a defendant's communication would be deemed protected opinion for defamation purposes. *See* 2 ROBERT D. SACK, SACK ON DEFAMATION: LIBEL, SLANDER & RELATED PROBLEMS § 13.1.4.4 (3d ed. 2008) (stating that "[i]t follows, insofar as it does in the law of defamation,

the court held that statements that were not actionable because, inter alia, they were deemed protected opinion so as to preclude defamation claims, were likewise not actionable under the interference with business relations tort.[354] Moreover, although the holding in *Nanavati* was based exclusively on state law,[355] the court also stated in dicta that *Falwell* "indicated that the constitutional guarantees protecting speech against libel claims retain their full force regardless of the nature of the cause of action."[356]

What effect, then, should *Falwell* have on an interference claim if a defendant not only intentionally interferes with a plaintiff's economic prospects through allegedly false statements about the plaintiff, but at the same time fraudulently misrepresents to the recipients of the communication the absence of an ulterior economic purpose for interfering, or at least fails to disclose such ulterior purpose under circumstances that amount to a tacit misrepresentation that there was none? Importantly, *Falwell* was addressing claims for defamation and intentional infliction of emotional distress. Specifically, the Court reasoned that "[a]n 'outrageousness' standard . . . runs afoul of our longstanding refusal to allow damages to be awarded because the speech in question may have an adverse emotional impact on the audience."[357] The case, even as applied to claims for intentional infliction of emotional distress, was specifically addressing claims by a "public figure."[358] The Court also spoke in terms of communications "on matters of public concern"[359] in the form of "debate about public affairs"[360] and "public debate about public figures."[361] It also acknowledged that the First Amendment is subject to limitations and is not an absolute bar.[362]

Admittedly, some cases like *Nanavati* read *Falwell* broadly as supporting the extension of First Amendment limitations applicable to defamation and intentional infliction of emotional distress to other communication-based theories of liability

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that opinion is protected"); *see also id.* §§ 13.1.4.2, 13.1.4.5. The subject of injurious falsehood is beyond the scope of this article. *See* RESTATEMENT (SECOND) OF TORTS § 623A (1977); SACK, § 13.1.4.

[353] 857 F.2d 96 (3d Cir. 1988) (applying New Jersey tort law).

[354] *Id.* at 109 (stating that "the defenses applicable to defamation claims retain their full status for tortious interference claims if such tortious interference claims are based on verbal conduct" and not on "allegations beyond those in the slander claim").

[355] *Id.* at 106 n.11.

[356] *Id.* at 109 (citing Hustler Magazine v. Falwell, 485 U.S. 46 (1988)).

[357] *Falwell*, 485 U.S. at 55.

[358] *Id.* at 51.

[359] *Id.* at 50.

[360] *Id.* at 53.

[361] *Id.*

[362] *Id.* at 56 ("Admittedly, these oft-repeated First Amendment principles, like other principles, are subject to limitations.").

"regardless of the nature of the cause of action."[363] More recently, the Supreme Court has expressed reluctance to extend *carte blanche* First Amendment dispensation to conduct that allegedly included fraudulent communications. In *Illinois, ex rel. Madigan v. Telemarketing Associates, Inc.*,[364] the Court held that "[c]onsistent with our precedent and the First Amendment, States may maintain fraud actions when fundraisers make false or misleading representations designed to deceive donors about how their donations will be used."[365] Noting the requirements for establishing fraud, including defendant's knowledge and intent to mislead, the Court explained that "[e]xacting proof requirements of this order, in other contexts, have been held to provide sufficient breathing room for protected speech."[366]

Granted, the interference tort does not categorically depend on fraud as an essential element since the interference-plaintiff is not suing for detrimental reliance, but for interference. Nevertheless, the hypothetical illustration may arguably come within the spirit of *Madigan*. As in fraud claims, the interference with prospective economic relations tort has exacting requirements, including proof that the defendant intentionally interfered with the plaintiff's economic prospects by inducing or causing others not to enter or pursue relations, and that the interference was improper.[367] Furthermore, one way that the improper

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[363] Nanavati v. Burdette Tomlin Mem'l Hosp., 857 F.2d 96, 109 (3d Cir. 1988); *see, e.g.*, Walko v. Kean Coll., 561 A.2d 680, 688 (N.J. Super. Ct. Law Div. 1988) (holding with respect to claims for false light invasion of privacy that "*Hustler* must logically stand for the proposition that a publication which no reasonable person could interpret as an allegation of fact, is the equivalent of an expression of opinion that is fully privileged under the First Amendment," and that "[b]ehavior that is so constitutionally privileged cannot be grounds for a damage award under any other theory, or the constitutional shield would be pierced by numerous lesser torts").

[364] 538 U.S. 600 (2003).

[365] *Id.* at 624 (remanding for further proceedings); *cf.* Reynolds v. Murphy,188 S.W.3d 252, 263–64 (Tex. Ct. App. 2006) (stating with respect to a claim alleging investment losses based on the recommendations in the newsletter, that if a person "authored and published an investment newsletter of general circulation," he was "entitled to First Amendment protection from negligent misrepresentation claims," but noting that "the First Amendment does not protect fraudulent or deceptive speech," and that a duty to disclose may arise if a plaintiff could prove that "one party knows that the other party is ignorant of the true facts and does not have an equal opportunity to discover the truth").

[366] *Id.* at 620–21 (citing N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279–280 (1964)). Of prime importance to the Court were that the State bears the burden of proving by clear and convincing evidence that a defendant knowingly made a false material representation with intent to mislead, and succeeded in doing so. *Id.* at 620. The Court also noted that an appellate court could independently review the findings (*id.* at 621), and that its holding was limited to possibly alleged affirmative misrepresentations. *Id.* at 608, 618-24.

[367] *See* RESTATEMENT (SECOND) OF TORTS § 766B cmt. a (1977); *cf.* Esposito-Hilder v. SFX Broad. Inc., 665 N.Y.S.2d 697, 699–701 (N.Y. App. Div. 1997) (holding that the allegations were sufficient to state a claim for intentional infliction of emotional distress

requirement might ordinarily be satisfied is by proof that the defendant used fraud to induce others to eschew relations with the plaintiff.[368]

Even for defamation, it has been suggested that there is an arguable question whether an otherwise protected evaluative[369] opinion should nevertheless be potentially actionable when the defendant "did not believe in his own professed evaluative opinion."[370] At common law, proof of an ulterior motive in expressing an opinion was a "familiar ground[] for defeasance of the privilege of fair comment."[371] The *Milkovich* Court itself noted that at common law, for a comment to be generally privileged it must have inter alia "represented the actual opinion of the speaker."[372] Admittedly, the scope of Constitutional protection of opinion under *Milkovich* is not clear.[373]

In *Falwell*, the plaintiff contended that an "outrageousness" standard should be a sufficient basis for liability for parody (a political cartoon).[374] Chief Justice Rehnquist lamented that "[i]f it were possible by laying down a principled standard to separate the one from the other, public discourse would probably suffer little or no harm."[375] In the end, the Court rejected an "outrageousness" test.[376] Moreover, in context of claims for defamation, the Court has emphasized repeatedly that ill will or a purpose to injure another's interests will not satisfy the constitutionally-mandated state of mind requirements with respect to the truth or falsity of an allegedly defamatory statement.[377]

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even though the statements were protected opinion for defamation purposes, and attaching "particular significance" to "the fact that the parties are business competitors.").

[368] *See id.* § 767 cmt. c. Moreover, the Restatement also comments that "[o]ne may be subject to liability for intentional interference even when his fraudulent representation is not of such a character as to subject him to liability for the other torts." *Id.*

[369] *See supra* notes 175–178 and accompanying text.

[370] SMOLLA, *supra* note 46, at § 6:37 (articulating a rule whereby a defamation claim would be permissible when there was "hard evidence" that the defendant did not really believe his opinion). Dean Smolla elaborates, stating: "When, as suggested here, there is proof available to demonstrate that the statements couched as opinion are not in fact the sincere opinions of the defendant, honestly held, there is no sound basis for providing the statements with protection." *Id.*

[371] Hill, *supra* note 46, at 1230. Hill, however, seemed to retreat from that position, writing that "the nature of the problems arising in an attempt to prove dishonesty make it constitutionally unsound to allow liability on this ground, save possibility in rare cases." *Id.* at 1230 n.128.

[372] Milkovich v. Lorain Journal Co., 497 U.S. 1, 13 (1990).

[373] *See supra* notes 175–210 and accompanying text.

[374] Hustler Magazine v. Falwell, 485 U.S. 46, 55 (1988).

[375] *Id.*

[376] *Id.* ("But we doubt that there is any such standard, and we are quite sure that the pejorative description "outrageous" does not supply one.").

[377] *See* Old Dominion Branch No. 496, Nat. Ass'n of Letter Carriers v. Austin, 418 U.S. 264, 281 (1974) ("Instructions which permit a jury to impose liability on the basis of the defendant's hatred, spite, ill will, or desire to injure are 'clearly impermissible.'"

In the hypothetical cartoon situation above, although there was no misrepresentation of actual facts (since the depicted events were not reasonably believable), might there arguably have been misrepresentation of the hypothetical defendant's ulterior economic motive in ridiculing the plaintiff's business, or at least a failure to disclose that purpose that was tantamount to a tacit misrepresentation that there was none?[378] It is true that the Court in *Madigan* did seem to draw a distinction between possibly alleged affirmative misrepresentations—not subject to First Amendment constraints—and a failure to disclose a fundraiser's fee arrangements up front, which might be protected.[379] However, it appeared that the Court's reluctance to include failure to disclose in its First Amendment holding was based on concerns related specifically to the fund raising context.[380]

Perhaps in the end the First Amendment will prevail, and an interference claim arising out of parodic communications when a defendant had an undisclosed ulterior economic motive will be subject to the same First Amendment restrictions on parodies that are applicable for defamation purposes.[381] It seems an intriguing question all the same, and of course, even if the First Amendment were not a bar, the plaintiff would still face the daunting challenge of satisfying the elements of the interference tort.

(quoting Beckley Newspapers Corp. v. Hanks, 389 U.S. 81, 82 (1967)); *cf. Falwell*, 485 U.S. at 53 (stating that "while such a bad motive may be deemed controlling for purposes of tort liability in other areas of the law, we think the First Amendment prohibits such a result in the area of public debate about public figures. . . . .Were we to hold otherwise, there can be little doubt that political cartoonists and satirists would be subjected to damages awards without any showing that their work falsely defamed its subject.").

[378] *Cf.* RESTATEMENT (SECOND) OF TORTS § 551(1) (1977) (discussing fraudulent misrepresentation, and stating that "[o]ne who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question").

[379] Illinois, *ex rel.* Madigan v. Telemarketing Assocs., Inc., 538 U.S. 600, 624 (2003) (stating that for the purposes of fundraising, "mere failure to volunteer the fundraiser's fee when contacting a potential donee, without more, is insufficient to state a claim for fraud").

[380] The Court worried about what might happen if fundraisers were compelled to make upfront telephone disclosure of the fundraiser's fee, the "[a] potential contributor might simply hang up." *Id.* 616–17.

[381] The Court has said that "the most prominent example of reduced protection for certain kinds of speech concerns commercial speech. Such speech, we have noted, occupies a "subordinate position in the scale of First Amendment values." Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 758 n.5 (1985) (quoting Ohralik v. Ohio State Bar Ass'n, 436 U.S. 447, 456 (1978)).

IV. CONCLUSION

In some types of communication, the author contends that her words were not intended to be understood as representing that the events portrayed actually occurred. Such communications commonly take the form of parody, cartoons, caricature, or similar types of communication. Sometimes parodies and similar types of speech will be the bases of claims for defamation. The problem is that while a parody may often exact a severe emotional toll on its victim, it may or may not adversely affect the victim's reputation. A victim's reputation can be harmed only if falsely depicted or implied events change the recipients' perception of the events that make up the victim's life history that determines the victim's standing. Whether parodies should be potentially actionable as defamation depends on whether the statement is deemed factual and thus potentially actionable, or is a matter of protected opinion and not actionable. Under the prevailing trends in the cases, and based on constitutional and/or state substantive defamation law principles, four core bases have in general emerged for classifying statements as protected opinion. A statement will usually be deemed protected opinion if it does not contain a provably false factual connotation; if it cannot reasonably be understood as suggesting the occurrence of actual events; if it consists of rhetorical hyperbole or an obvious epithet; or, if it does not express or imply undisclosed, unassumed, or unknown (or not generally well known) defamatory facts.

A number of courts seem to follow a monolithic analysis in parody cases and many courts also apply a one-dimensional analysis. By monolithic I mean some courts seem to reason that if the overall tenor of the article is deemed parody, then *ipso facto*, they need not consider whether some events depicted could reasonably be interpreted as having actually occurred. By one-dimensional I mean that the courts usually seem to focus simply on whether the events featured in the parody were reasonably understandable as suggesting that the events described actually happened as depicted. While such an analysis may be appropriate as far as it goes, it may be incomplete for some parody cases. Thus, even if a parody is not believable as representing the actual occurrence of the depicted events, it may nevertheless present a credible issue as to whether it implied that there were other defamatory events that actually did occur. This kind of one-dimensional analysis overlooks the possibility that even if the parody is not believable as actual events, it may imply other facts that are believable as actual facts.

I have proposed a framework and approach for deciding when a statement that a defendant asserts was not intended to be interpreted as representing that the portrayed events actually occurred should be deemed potentially liability-supporting fact and when it should be protected opinion. I suggested that the courts use the matrix of four core bases under which an allegedly defamatory statement may be deemed protected opinion. Then, with this four-pronged grid or framework, I propose that the courts examine both of the potentially defamatory dimensions of parodies. First, with respect to the *specific events expressly described in the parody*, the court should determine whether the allegedly defamatory events expressly depicted in the parody were protected opinion. This

inquiry will focus on whether the parody reasonably suggested that at least some of the defamatory events expressly described actually occurred. Thus, even if the overall tenor of the piece is deemed a parody, the court should nevertheless still consider whether, giving due consideration to the full context and the fact that the overall piece is a parody, there nevertheless are selected events depicted that are reasonably believable as describing actual events and that do not fall within any of the categories of protected opinion. Secondly, and irrespective of the outcome on the first step, the court should also examine the possibility that imbedded defamatory facts were *implied in the parody*. Furthermore, the outcome under both steps should not depend conclusively on whether or not the overall tenor of the writing conveys to a reasonable reader that it is parody rather than a depiction of actual events.

Finally, I briefly commented on whether potential liability for tortious interference based on the use of parody for the undisclosed ulterior purpose of interfering with the prospective economic relations of the plaintiff in order to benefit a competitor should be precluded solely because the parody might be deemed protected opinion for defamation purposes.

KELO, *PARENTS* AND THE SPATIALIZATION OF COLOR (BLINDNESS) IN THE *BERMAN-BROWN* METROPOLITAN HETEROTOPIA

Tom I. Romero, II, J.D., Ph.D.*

Table of Contents

I. INTRODUCTION: THE MISSING LINK BETWEEN THE TAKINGS AND EQUAL PROTECTION CLAUSES OF THE CONSTITUTION

This article examines the relationship between eminent domain and school integration jurisprudence in relation to the spatial reorganization and containment of multicentered color lines in the metropolitan United States in the years and decades after World War II. Many are no doubt familiar with a highly visible and controversial aspect of this story: the impact of eminent domain on the nation's Black community. Indeed, no less an authority than Justice Clarence Thomas, in his dissent in the now infamous *Kelo v. New London* case,[1] highlighted this much-

 This article has benefited from the many questions I received while presenting different aspects of this analysis at the Fourth Annual Gloucester Law Conference, the Thirteenth Annual LatCrit Symposium, the Annual Meetings of the American Studies Association and American Society for Legal History, the Hamline School of Law Faculty Colloquium, and the University of Minnesota Legal History Workshop. I also want to thank Bethany Clark for her tremendous amount of work in compiling much of the research and data as well as Brian Rochel for helping me think

researched and well-understood narrative. According to Justice Thomas, "[p]ublic works projects in the 1950's and 1960's," for example, urban renewal of blighted communities and interstate highway construction, displaced and "destroyed [Black] communities from St. Paul, Minnesota to Baltimore, Maryland." As Justice Thomas made clear, "[i]n cities across the country, urban renewal came to be known as 'Negro removal.'"[2]

The authority to effectuate such a result, as Justice Thomas and the other dissenting justices note in the *Kelo* case, was rooted in the Court's 1954 *Berman v. Parker* decision, which upheld the ability of a legislative body—in this case the United States Congress—to vest in a municipal redevelopment authority the power to condemn private property in favor of private developers to "redevelop" a specifically bounded area.[3] Because the "area" at issue in *Berman* and other portions of the development area housed a predominately African American community, urban renewal promised to displace hundreds of Black families, property owners and entrepreneurs.[4] Given concerns about housing and central city decentralization as well as deterioration, however, Justice Douglas in *Berman* emphasized that "[i]t is not for the courts to oversee the choice of the boundary line."[5]

The color-blindness of the Court in *Berman* was all the more surprising because the case was argued "just four months after the Supreme Court's

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about the various ways that Michel Foucault's voluminous writings could be used to further the analysis. I wish to extend a significant amount of gratitude to Keith Aoki, Richard Delgado, Barbara Welke, Jonathan Kahn, Laura Gomez, Rose Cuizon Villazor, Mehmet Konar-Steenberg, and Marie Failinger for fleshing out some of the core elements of the arguments I make.

[1] Kelo v. City of New London, Conn., 545 U.S. 469, 489 (2005) (holding that eminent domain to effectuate private to private title transfers for purposes of economic development satisfied the "public use" clause of the 5th Amendment).

[2] *Id.* at 522 (Thomas, J., dissenting) (alteration in original) (quoting Wendell E. Pritchett, *The "Public Menace" of Blight: Urban Renewal and the Private Uses of Eminent Domain*, 21 YALE L. & POL'Y REV. 1, 47 (2003)).

[3] Berman v. Parker, 348 U.S. 26, 28–31 (1954). The Act allowed the National Capital Planning Commission "to make and develop 'a comprehensive or general plan' of the District, including 'a land-use plan' which designates land for use for 'housing, business, industry, recreation, education, public buildings, public reservations, and other general categories of public and private uses of the land.'" *Id.* at 29. Specifically, Section 6(b) of the Act authorized the Planning Commission to adopt redevelopment plans for "specific project areas." District of Columbia Redevelopment Act of 1945, Pub. L. No. 79-592, 60 Stat. 790 (1946). In 1950 the Planning Commission produced a comprehensive plan for Washington, D.C. *Berman*, 348 U.S. at 30. This plan identified the initial project as "Area B" in Southwest Washington, D.C.—an area of especially critical need. *Id.* at 31.

[4] *See Berman*, 348 U.S. at 30; *see also* Benjamin Ginsberg, *Berman v. Parker: Congress, the Court & the Public Purpose*, 4 POLITY 48, 65–66 (1971) (discussing the effects of redevelopment on Black families in Washington).

[5] *Berman*, 348 U.S. at 35.

monumental declaration on American race relations in *Brown v. Board of Education*."[6] As Professor Wendell Pritchett points out,

> [t]he irony is that, at the same time it was deciding *Berman*, the Court was deciding *Brown*, which reflects a distrust of government (particularly local government) to protect the interests of minority groups and to treat all citizens equally. Douglas's opinion in *Berman* reflects a[n opposite] faith in the political system's ability to operate in a non-discriminatory manner. Urban renewal, however, was an economic development program with profound racial implications that were ignored by all parties to the litigation.[7]

During the same term, a Court that had committed itself to racial justice by demolishing the color boundaries that kept White and non-White students segregated, made the goal all the more unattainable because in *Berman* it failed to connect, much less comprehend, the interdependent operation of discrete and seemingly isolated public and private decision makers in shaping and reshaping the spatial racial geography of the nation's metropolitan core and peripheral areas.

In an equally dissonant, though not quite as coterminous vein, the same Justice Thomas who decried the color blindness of local decision makers in using eminent domain to effectuate economic development plans joined a majority of the Court in summer of 2007 in the *Parents Involved in Community Schools v. Seattle School District No. 1* case prohibiting public K–12 schools from being color conscious in attempting to desegregate their schools.[8] Distinguishing between the deliberate "segregation" of students by school boards as fundamentally different from "racial imbalance . . . [caused by] any number of *innocent private decisions*, including private voluntary housing choices," Justice Thomas in his concurrence to the majority decision argued that "because racial imbalance is not inevitably linked to unconstitutional segregation, it is not unconstitutional in and of itself."[9]

Though there are obvious incongruities in Justice Thomas' own logic in both cases, on one level he has a point. The power of eminent domain, as it came to be conceptualized in *Berman* and its progeny through interstate highway construction, public housing, and urban redevelopment and renewal, was undoubtedly a racial project of displacement and removal.[10] And precisely because it acted as such, it masked a profound and fundamental spatial re-organization and subsequent re-structuring of the meaning of color and inequity in the modern American

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[6] *See* Wendell E. Pritchett, *The "Public Menace" of Blight: Urban Renewal and the Private Uses of Eminent Domain*, 21 YALE L. & POL'Y REV. 1, 44 (2003).

[7] *Id.* at 46 (footnote omitted).

[8] 127 S.Ct. 2738, 2741 (2007) (Thomas, J., concurring).

[9] *Id.* at 2769 (emphasis added).

[10] A demonstrative example of this process across the United States is found in JON C. TEAFORD, THE METROPOLITAN REVOLUTION: THE RISE OF POST-URBAN AMERICA 59–67 (2006). One extremely revealing case study is found in THEODORE J. LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES 238–56 (2d ed. 1979).

metropolis; one, as must be pointed out, that was becoming increasingly non-White and non-Black in its demographic orientation. As a result, questions of social inequality were explained away as the product of rational choice or individual initiative rather than the consequence of state-sanctioned racial concentration.

I suggest that one way to read Justice Thomas's dissonance and tension between color blindness and color consciousness book-ended and inverted by the 1950s *Berman-Brown* cases and more recent *Kelo* and *Parents* decisions is found in Michel Foucault's concept of the heterotopia and the application of this concept to metropolitan space. As Foucault tells us, any definition of a heterotopia necessarily begins with a utopia: "Utopias are sites with no real place. They are sites that have a general relation of direct or inverted analogy with the real space of Society. They present society itself in a perfected form . . . ."[11] There are also, Foucault argues, places "which are . . . counter-sites, a kind of effectively enacted utopia in which the real sites, all the other real sites that can be found within the culture, are simultaneously represented, contested, and inverted."[12] According to Foucault, one paradigmatic example of a heterotopia is the mirror because, although the reflection itself is a "placeless place"—a utopia—it "makes this place that I occupy at the moment when I look at myself in the glass at once absolutely real, connected with all the space that surrounds it, and absolutely unreal, since in order to be perceived it has to pass through this virtual point which is over there."[13] Critically, a heterotopia functions "in relation to all space that remains" in two extreme senses:

> Either their role is to create a space of illusion that exposes every real space [as] the sites inside of which human life is partitioned . . . [o]r else, on the contrary, their role is to create a space that is other, another real space, as perfect, as meticulous, as well arranged as ours is messy, ill constructed, and jumbled.[14]

What makes a heterotopia so salient in understanding the relationship of eminent domain and school integration is its ability to "juxtapose[e] in a single real place several spaces, several sites that are in themselves incompatible."[15] Like the mirror, the urban redevelopment and school boundary decisions in *Berman-Brown* and *Kelo-Parents* gaze at but never really interact with each other across both time and space. Particularly in the sprawling metropolitan world that emerges during this same time, the adjudication of these cases and their subsequent application veiled the interrelationship between urban retrenchment, suburban expansion, and

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[11] MICHEL FOUCAULT, OF OTHER SPACES: HETEROTOPIAS (1964), *available at* http://foucault.info/documents/heteroTopia/foucault.heteroTopia.en.html.

[12] *Id.*

[13] *Id.*

[14] *Id.* at 9.

[15] *See* FOUCAULT, *supra* note 11, at 7.

structural mechanisms of color exclusion and containment. As this article will demonstrate, the consequence of this relationship for law and politics was uniquely a product of economic, social, political, and jurisprudential restructuring of property and racial relations that emerged most prominently in Northern and Western cities in the 1950s and 1960s. On the one hand, urban redevelopment and other large-scale public-works projects reinforced powerful multiracial stereotypes about inner-city pathology that were reflected as the antithesis of the exploding suburban developments and edge-cities that sprouted like weeds in metropolitan peripheries. The vigorous use of eminent domain in particularly the urban core, authorized by *Berman*, responded to this reflection by envisaging a postracial, non-Southern urban America. On the other hand, attempts to transgress urban versus suburban as well as Southern versus non-Southern regional boundaries and their color inequities, especially in school desegregation plans, provoked bitter and often fierce opposition. This opposition was premised, in significant part, on the idea that racial integration was fundamentally incompatible with an ideology centered around property-rights-oriented meritocratic individualism. Embracing the syllogism of "color-blindness," parents, politicians and judges responded to the challenge of racial school integration, particularly in the metropolitan North and West, by creating and endorsing the "metro-zonal" fragmentation of the metropolitan landscape.[16] In direct self-reference to the large-scale deployment of eminent domain, it made multiracial inequity more complete by spatially concentrating and thereby containing and inequitably serving non-White communities.

At the level of law and jurisprudence, however, the metro-zonal heterotopia that emerged initially in the metropolitan North and West and was subsequently distinguished from its Southern manifestation as de facto as opposed to de jure segregation, was not so much self-referential or self-reflective as it was seemingly incompatible with judicial and political spatial imagery concerning property rights,

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[16] There are many ways to describe and distinguish the core attributes of metropolitan areas in the United States. For a nice contemporary overview of such terminology and definitions, *see generally* William H. Frey, Jill H. Wilson, Alan Berube, & Audrey Singer, *Tracking Metropolitan America in the 21st Century: A Field Guide to the New Metropolitan and Micropolitan Definitions*, THE LIVING CITIES CENSUS SERIES, Nov. 2004, at 1, *available at* http://www.brookings.edu/~/media/Files/rc/reports/2004/11demographics_frey/20041115_metrodefinitions.pdf. I use the term "metropolitan" or "metropolis" throughout the article to describe generally "an economically and socially linked collection of large and small communities" in a given geographical area. *Id.* at 2. In contrast, I specifically use the term 'metro-zone' to describe metropolitan areas "made up of *multiple cities*, suburban development in the unincorporated interstices among the cities, and open spaces now subsumed into the metropolitan landscape." WILLIAM R. TRAVIS, NEW GEOGRAPHIES OF THE AMERICAN WEST: LAND USE AND THE CHANGING PATTERNS OF PLACE 35 (2007) (emphasis added). Indeed, the metropolitan spatialization of multi-color lines that I describe in this article was facilitated by the emergence and explosion of "metro-zones," particularly but not exclusively in the American West, in the second half of the twentieth century.

civil rights, and the transition to a multicolor or postracial America. Government efforts to redevelop "blighted" neighborhoods, to promote growth in suburban periphery, or to provide equality of educational opportunity for Whites, Blacks, Latinos, Asians, and American Indians often became reduced to a particular parcel of property, a municipality's own home-rule powers, the specific boundaries of a school district or neighborhood school, or to a region's own distinct pathology. In every case, a powerful de facto mythology in politics and law failed to consider the state's role in constituting a new landscape of multiracial apartheid. To be sure, the jurisprudence that emerged around these issues failed to act as a mirror in which to reflect upon how a metro-zone's color-conscious and color-blind anxieties reinforced and inverted themselves in volatile ways. Though the issues were heavily informed by color and history, the analysis of each operated in ostensibly different and remarkably ahistorical bodies of judicial authority and political control. In this important sense, land use and equality of educational opportunity jurisprudence refracted fundamentally different premises about the state's role in creating and containing multicolor lines in metropolitan areas dealing head-on with the challenges of multiracial change, hyper-segregation and color tension.

This article will describe the manner by which legally enforced color lines on a local scale became paradoxically proscribed, yet essential to metro-zonal multicolor spatialization in the period between *Berman-Brown* and *Kelo-Parents*. As Professor Robert Self's groundbreaking work on the post–World War II Oakland, California metropolitan area highlighted, *space* is the "processes through which markets, property, communities, and . . . race are constituted within capitalist urbanization."[17] Though this definition of space is one rooted in an early-modern and modern "Western experience,"[18] this article details the ways it became dramatically reconfigured beginning in the 1950s with the rise of the state-managed capitalist and increasingly multiracial metropolis.[19]

The relationship between real property, municipal land use, and municipal incorporation law is at the crux of conceptualizing metro-zonal spatialization because each worked to produce and perpetuate capital. Thus, in the metropolitan America that comes to be configured in the 1950s, real property comes to have added value as a result of increasingly complex and active urban and suburban localities drawing "[b]oundaries . . . around [real] property—in the form of corporate city limits[,] . . . zoning codes[,] . . . highway rights-of-way," special service districts, school attendance boundaries, public housing sites, and urban renewal zones in order to "signal where to invest and where not invest."[20] The effects of such marking, however, are more than just about capital accumulation for a "rational" market. Rather, these property boundaries, as Professor Self argues, "structure all kinds of interactions—from where one can buy a home to

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[17] ROBERT O. SELF, AMERICAN BABYLON: RACE AND THE STRUGGLE FOR POSTWAR OAKLAND 17 (2003).

[18] *See* FOUCAULT, *supra* note 11, at 1.

[19] *See infra* text and accompanying notes 24, 197–199, 207, 332–334.

[20] SELF, *supra* note 17, at 18.

where politics is organized, from how police interact with neighborhoods to where children go to school."[21] And in the context of the United States, all such exchanges are informed to some degree by color considerations.[22]

Analytical emphasis on the period from *Berman-Brown* through the *Kelo-Parents* is especially important for two reasons. First, this era dramatically perfected what Edward Soja, Rebecca Morales, and Goetz Wolff describe as the *State-Managed Capitalist Metropolis*, whereby the state became the primary conduit through which to both define as well as manage property and race relations.[23] A coherent vision of well-ordered and sufficiently contained metropolitan space—represented through eminent domain and other municipal land use powers, as well as through school desegregation—both propelled and sustained this order. Connected, as well, is this article's argument that the counters of the state-managed capitalist metropolis emerged initially and most robustly in the rapidly growing metropolitan areas of the American West. Largely because neither migrants nor boosters to these metropolitan areas perceived these areas to be burdened by economic or social histories of either the South or the North, they became the greatest sites of land use innovation and the home to some of the most intense resistance to school integration. Second, and intricately related, is the paradox of color consciousness and color blindness during this period. Particularly as the nation's racial anxieties played themselves out on a global and increasingly multiracial scale through school integration battles, "boundary line" drawing through land use law and jurisprudence obscured the multicolor de jure segregation taking place in many of the nation's fastest growing metro-zones. Together, each of these put into question the viability of a de jure–de facto distinction that became sacrosanct in school integration as well as contemporary "racial" jurisprudence when applied to such postmetropolitan American cities.[24]

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[21] SELF, *supra* note 17, at 18.

[22] I use the terms "color" and "color lines" throughout this article to describe legally enforced boundaries between Whiteness and non-Whiteness. Race and color are used in contemporary nomenclature to distinguish between Whites, Latinos, Asians, American Indians, and Blacks in the post-World War II United States. To be sure, explicit in the analysis of this article are the ways that multicolor spatialization, as opposed to racialization of space, in the post-World War II United States both reinforced and reified race and color at the same moment that these terms were coming to be used interchangeably. The point, however, is that both terms in the contemporary United States define the boundaries between Whiteness and non-Whiteness. I explore the interchangeability of race and color in the post-World War II United States as well as the importance of being precise about the meaning of color as opposed to race in Tom I. Romero, II, *¿La Raza Latina?: Multiracial Ambivalence, Color Denial and the Emergence of a Tri-Ethnic Jurisprudence at the End of the Twentieth Century*, 37 N.M. L. REV. 245, 249–55 (2007).

[23] *See* Edward Soja, Rebecca Morales, & Goetz Wolff, *Urban Restructuring: An Analysis of Social and Spatial Change in Los Angeles,* 59 ECON. GEOGRAPHY 195, 198 (1983).

[24] The de jure-de facto distinction in school integration jurisprudence was constitutionalized in the 1973 case, Keyes v. Sch. Dist. No. 1, Denver, Colo., 413 U.S. 189,

In order to chart out this argument, the remainder of this article will develop along three lines. It first examines contemporary accounts and historical and legal scholarship on the use of eminent domain as well as land use and municipal boundary law in the "redevelopment" and reimagination of American cities in the second half of the twentieth century. Though understandings of race animated the early use and deployment of exclusionary measures by cities, developers, and municipal citizens in the nation's urban and industrial core, dramatic demographic shifts to the urban and multicolor American West in the wake of World War II, in unison with sharpened ideological priorities that emerged during the Cold War, inverted the racial question in the analysis. Especially as Western cities became exemplars of the postracial and "truly" democratic American city of capital accumulation, the protection of individual property rights obscured both the removal and containment of non-Whites in developing and redeveloping metro-zones.

The analysis then turns to the contemporary and historical fascination and fetishizing of desegregating the nation's schools in the years and decades after *Brown*. Largely because the story took place in the American South during its formative years, school desegregation jurisprudence served to unbind multiracial communities far removed from this region from a multiracially segregated cityscape.

The third part examines the precise role and impact of Northern and Western cities in effectively decoupling land use and civil rights jurisprudence. Particularly as an ill-defined understanding of de jure and de facto discrimination takes hold, the Northern and Western trajectory of school integration battles worked to make the multiracial heterotopia complete. Together, the specter of "negro removal" and "massive resistance" worked not only to contain the breadth and scope of social, jurisprudential, and constitutional inquiry, but it rendered inconsequential and thereby invisible or (in the words of Justice Thomas) "innocent" the multicolor lines of the American postmetropolis.[25] Simply, the land use policies and school desegregation battles in the urban North and West, established the legal terms and conditions to develop the contemporary metropolitan heterotopia throughout all of the United States.

II. IMAGINING THE POSTRACIAL AMERICAN CITY THROUGH EMINENT DOMAIN AND LAND USE

In 1959, Allan Nevins, Columbia University history professor and longtime contributor to the *New York Times*, narrated a fictional conversation among many

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208–14 (1973). One year later, in Milliken v. Bradley, 418 U.S. 717, 720, 750–51 (1974), this distinction thus became the basis in which to effectively contain and water down integration in metropolitan areas comprised of multiple jurisdictions. As I argue in this article, this became a critical feature of the global, "postmetropolitan" landscape. *See also* EDWARD W. SOJA, POSTMETROPOLIS: STUDIES OF CITIES AND REGIONS (2000). I explore the emergence and significance of the de jure/de facto distinction in Part IV.

[25] 127 S.Ct. 2738, 2769 (2007) (Thomas, J., concurring).

of the luminaries of American history about the United States in 1970.[26] For many of Nevins's characters, urban decay and suburbanization posed a troubling theme.

> 'If I ever saw a nation headed for trouble,' squeaked [Nevin's imaginary] Horace Greeley, "'it is that republic of mine . . . . How can a nation so top-heavy with city dwellers keep its stability? When I said "Go West," I meant go to farming. Instead, they have gone to Los Angeles, the largest city in the most populous state.'[27]

Sounding an equally despondent tone, Nevins's Benjamin Franklin lamented: "I'll tell you *my* idea of the greatest shortcoming of the United States in the last decade or so . . . . What disturbs me is the failure to keep up with urban and suburban growth in town planning, in housing, in roads and parks, and above all, in schools."[28]

Two of Nevins's historical characters, however, challenged such nay saying. Nevins's Henry Ford, for instance, boasted that "[t]he whole trend has been just what I predicted in [the] Model T days, away from the cities and into the suburbs . . . . Out of those 210 million [predicted to live in the United States in 1970], we've got a good third in . . . [these] *subtopias*."[29] Perhaps adding substance to this point, Nevins's Booker T. Washington interjected:

> What strikes me most . . . is the remarkable rise in the homogeneity of the population . . . . [T]he line between countryman and city man [is] completely blurred . . . . But the great gain is the Negro's. So many have moved into the North and *West*, so many have gotten into industry on the same assembly lines with [W]hites, so many have pushed into business and lately even the professions, that *the color line begins to blur, too.*[30]

Like many of his contemporaries, Allan Nevins anticipated the metropolitan heterotopia by recognizing through refractive imagery both the dysfunction and the promise of the modern American metropolitan landscape. In a nation where nearly 60 percent of the nation's population lived in dramatically expanding metropolitan areas,[31] the inconsistent meanings and anxieties ascribed to the form and function of a transforming urban geography highlighted the seemingly incongruous utopias and dystopias that most Americans were calling "home."

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[26] *See* Allan Nevins, *The U.S. in 1970—Three Forecasts*, N. Y. TIMES MAG., May 17, 1959, at 25.

[27] *Id.*

[28] *Id.* (quotation marks omitted).

[29] *Id.* (quotation marks omitted) (emphasis added).

[30] *Id.* (quotation marks omitted) (emphasis added).

[31] *See* U.S. BUREAU OF THE CENSUS, U.S. DEP'T OF COM., CIVILIAN POP. OF THE UNITED STATES, BY TYPE OF RESIDENCE MARCH 1956 AND APRIL 1950, CURRENT POP. REP.: POP. CHAR. (SER. P-20) 1 (1956) (noting the remarkable fact that between 1950 and 1956, 85 percent of the United States' population growth occurred in metropolitan areas).

What is most noticeable in Nevins's account, however, is the way in which all of his characters articulated profound transformations in America's urban form. From Horace Greeley and Henry Ford's discordant views of urban and suburban or exurban life to Benjamin Franklin and Booker T. Washington's disparate understandings over the power of local and color boundaries, it was becoming evident that the paradigmatic American city—places like Chicago and Manhattan, where space was identified by easily discernible central jurisdictional boundaries, shared work, and sometimes leisure spaces and urbane lifestyles[32]—was being both decentered and deemphasized as a metropolitan norm.

A. Property, Land Use, and the Decline of Neighborhoods in Maintaining the Urban Color Line

By the middle of the twentieth century, the United States was an "urban nation, dominated by clearly defined urban places with an anatomy familiar and comprehensible" to many Americans.[33] As urban historian Jon Teaford notes, "the core of each of these urban places was a single central business district, the undisputed focus of the metropolitan area . . . . Metropolitan Americans not only perceived a single dominant focus for urban life, but also shared common space"—often, for example, in the collective need for public transit.[34] Moreover, there was

> a common vested interest in urban governmental institutions. Although there were upper-middle-class suburban municipalities, the largest central cities still comprised a full range of neighborhoods from skid row to elite. The central city-government and central-city school administration had to accommodate a socially and culturally diverse constituency, one that included all elements of the metropolitan social mix. Even residents of independent suburban municipalities . . . [spent] much of their lives within [city] boundaries. Their safety while shopping or working depended on central-city police and firefighting forces; the viability of their businesses depended on central-city tax-rates and regulations."[35]

Historians have documented extensively the dramatic demographic changes that fundamentally altered the "metropolitan" mix of the American city from the late-nineteenth-to-twentieth century; spurred first by large-scale immigration by Southern and Eastern Europeans to the Eastern seaboard of the United States,[36] the

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[32] *See* TEAFORD, *supra* note 10, at 2.

[33] TEAFORD, *supra* note 10, at 1.

[34] TEAFORD, *supra* note 10, at 2.

[35] TEAFORD, *supra* note 10, at 2–3.

[36] The literature on the European immigration to the United States is vast. Some representative recent works include RUSSELL A. KAZAL, BECOMING OLD STOCK: THE PARADOX OF GERMAN-AMERICAN IDENTITY (2004); THOMAS A. GUGLIELMO, WHITE ON ARRIVAL: ITALIANS, RACE, COLOR, AND POWER IN CHICAGO, 1890–1945, at 5–8, 14–58

migration of African Americans from the Jim Crow South to industrial Midwestern and Northeastern cities,[37] and Latin Americans and Asians to the West Coast.[38] Though urban Americans lived in shared multicultural and oftentimes polyglot cities, their experiences were critically informed by the private and public erection of legal boundaries to maintain perceptible racial and color "edges" in the nineteenth and early twentieth century city.[39] For the most part, neighborhoods served to identify such racialized space. Though many neighborhoods lacked "formal" legal boundaries, their lines were marked by a variety of extralegal (violent) and privately-enforced means (e.g., racially restrictive covenants).[40] Most of us, for instance, are familiar with the story of restrictive covenants, particularly the fact that it barred African Americans from a vast majority of housing.[41] Though Blacks faced the worst restrictions, Asians and Latinos confronted similar problems in Southwestern and Western cities.[42] The experiences of the Irish, Italians, and Jews differed markedly from these other groups since racial covenants

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(2003); and MATTHEW FRYE JACOBSON, SPECIL SORROWS: THE DIASPORIC IMAGINATION OF IRISH, POLISH, AND JEWISH IMMIGRANTS IN THE UNITED STATES (2002).

[37] This literature is equally as voluminous as the literature on European immigration, *supra* note 36. Two of the best works remain JAMES R. GROSSMAN, LAND OF HOPE: CHICAGO, BLACK SOUTHERNERS, AND THE GREAT MIGRATION (1989), and NICHOLAS LEMANN, THE PROMISED LAND: THE GREAT BLACK MIGRATION AND HOW IT CHANGED AMERICA (1991). A still relevant collection of essays is also found in THE GREAT MIGRATION IN HISTORICAL PERSPECTIVE: NEW DIMENSIONS OF RACE, CLASS, AND GENDER (Joe William Trotter, Jr. ed., 1991).

[38] The number of studies looking at migration from Latin America and the Pacific Rim to the urban United States has grown exponentially in recent years. Two of the more important studies are EIICHIRO AZUMA, BETWEEN TWO EMPIRES: RACE, HISTORY, AND TRANSNATIONALISM IN JAPANESE AMERICA (2005) and GEORGE J. SÁNCHEZ, BECOMING MEXICAN AMERICAN: ETHNICITY, CULTURE, AND IDENTITY IN CHICANO LOS ANGELES, 1900–1945 (1993).

[39] The distinction between race and color in the late nineteenth and early twentieth centuries and its impact on urban neighborhood boundaries is detailed in GUGLIELMO, *supra* note 36, at 5–8, 14–58.

[40] *See, e.g.*, GUGLIELMO, *supra* note 36, at 35, 59–75.

[41] The literature on this point is quite extensive. For informative overviews of the issues involved, see THOMAS J. SUGRUE, THE ORIGINS OF THE URBAN CRISIS: RACE AND INEQUALITY IN POSTWAR DETROIT 209–29 (1996); and Carol Rose, *Property Stories:* Shelley v. Kraemer, *in* PROPERTY STORIES 169 (GERALD KORNGOLD & ANDREW P. MORRISS eds., 2004).

[42] *See, e.g.*, SHANA BERNSTEIN, BUILDING BRIDGES IN A DIVIDED WORLD: INTERRACIAL CIVIL RIGHTS COOPERATION IN WORLD WAR II AND COLD WAR LOS ANGELES (forthcoming 2009) (manuscript at ch. 6, on file with author); SCOTT KURASHIGE, THE SHIFTING GROUNDS OF RACE: BLACK AND JAPANESE AMERICANS IN THE MAKING OF MULTIETHNIC LOS ANGELES 13–63 (2008); SÁNCHEZ, *supra* note 38, at 77; and Tom I. Romero, II, Of Race and Rights: Legal Culture, Social Change and the Making of a Multiracial Metropolis, Denver 1940–1975, at 1–40, 148, 478–79 (Apr. 2004) (unpublished Ph.D. dissertation, University of Michigan–Ann Arbor) (on file with author) (addressing, among other things, racial issues in schools).

inconsistently applied to them, and as a result, they were able to live in more dispersed areas of American cities.[43] While there is little doubt that either Irish, Italians, or Jews suffered greatly for their racial undesirability in most American cities during the late nineteenth and early twentieth centuries, they were not legally constrained either in access to property or neighborhoods in the same ways as those that the law defined as non-White.[44] What this difference suggests is the importance of White and non-White color lines in the construction of America's urban spaces.

Nevertheless, the individual, "quasi-private," and by extension haphazard nature in the enforcement of racial covenants, particularly its application to non-White and non-Black groups such as Latinos and Asian Americans prior to World War II, made neighborhood boundaries as enforceable color boundaries in urban America, soft, fuzzy, uncertain and subject to penetration, transition, and inversion.[45] Though the United States Supreme Court declared in 1948's *Shelley v. Kraemer* case that racially restrictive covenants could not be enforced,[46] uneven understandings about their meanings and their effect on the alienation of property and the formation of neighborhood communities persisted unevenly into the latter half of the twentieth century. Accordingly, many cities themselves attempted to use the full force and authority of the state to accomplish by city ordinance what private covenanting could only unevenly achieve through "quasi-private" means.[47] At first, industrial cities such as Baltimore passed racially restrictive ordinances to enforce and maintain color segregation in their cities.[48] Such explicit practices were proscribed by the United States Supreme Court in 1917's *Buchanan v.*

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[43] *See* BERNSTEIN, *supra* note 42, at ch. 6; KAREN BRODKIN, HOW JEWS BECAME WHITE FOLKS & WHAT THAT SAYS ABOUT RACE IN AMERICA (1998).

[44] Literature surrounding the importance of Whiteness to these groups in conjunction with a different process of racialization is quite extensive. For the best overview of this argument and this literature, see GUGLIELMO, *supra* note 36, at 3–11.

[45] *See, e.g.*, STEPHEN GRANT MEYER, AS LONG AS THEY DON'T MOVE NEXT DOOR: SEGREGATION AND RACIAL CONFLICT IN AMERICAN NEIGHBORHOODS 87–96 (2000); GREGORY R. WEIHER, THE FRACTURED METROPOLIS: POLITICAL FRAGMENTATION AND METROPOLITAN SEGREGATION 34 (1991).

[46] *See* 334 U.S. 1, 20–21 (1948).

[47] The line between "public" and "private" action is not as precise as later Courts would have one believe. See cases on de facto versus de jure segregation, *infra* note 226-226; 294-297; and 304. Indeed, as the *Shelley* Court indicated, a whole host of public action—from court enforcement of private covenanting agreements to police surveillance and enforcement practices—implicates the state at variety of levels in establishing and reinforcing social bias and discrimination. *See Shelley*, 334 U.S. at 14–18. An interesting recent take on *Shelley* and the public versus private nature of the decision is found in Mark D. Rosen, *Was Shelley v. Kraemer Incorrectly Decided? Some New Answers*, 95 CAL. L. REV. 451 (2007).

[48] *See generally* Garrett Power, *Apartheid Baltimore Style: The Residential Segregation Ordinances of 1910–1913*, 42 MD. L. REV. 289 (1983) (examining racially restrictive ordinances in Baltimore).

Warley,[49] but a city's ability to segregate its urban space and effectively enforce its racial and color boundaries persisted through the constitutionalization of comprehensive zoning in the 1926 *Village of Euclid v. Ambler Realty Co.* case.[50]

Scholars have heavily documented the relationship between land use laws—particularly, but not exclusively zoning—and the racialization of urban communities.[51] The period from 1920 to 1950 proved to be critically important, however, in highlighting the manner by which color consciousness and color blindness became embedded in land use law. Beginning in the 1920s,

> American cities witnessed a construction boom that surpassed all previous decades of growth . . . . [S]everal million units of housing were built during the decade [and also in the years following World War II] allowing second generation immigrants to escape the slums. But while these were healthy changes . . . the expansion of the suburbs drew the rich and middle-class out of the city. At the same time, the combination of slowed immigration and economic mobility resulted in increased vacancy rates in working class districts.[52]

Most importantly, though "[t]he number of residents in the industrial urban core declined,"[53] African Americans and Latinos, in particular, took up residence in those neighborhoods being abandoned by second generation Southern and

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[49] 245 U.S. 60, 81 (1917). *See generally* Richard A. Epstein, *Lest We Forget: Buchanan v. Warley and Constitutional Jurisprudence of the "Progressive Era,"* 51 VAND. L. REV. 787 (1998) (commenting on the historical context and significance of *Buchanan*, especially with regard to property rights).

[50] *See* 272 U.S. 365, 397 (1926). *See generally* Richard H. Chused, Euclid's *Historical Imagery*, 51 CASE W. RES. L. REV. 597 (2001) (examining and critically evaluating *Euclid* and its results).

[51] The seminal works in this regard are DOUGLAS S. MASSEY & NANCY A. DENTON, AMERICAN APARTHEID: SEGREGATION AND THE MAKING OF THE UNDERCLASS (1993) and Richard Thompson Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841 (1994). Professor Calmore, moreover, provides one of the most compelling and cogent understanding of this process in John O. Calmore, *Racialized Space and the Culture of Segregation: "Hewing a Stone of Hope from a Mountain of Despair,"* 143 U. Pa. L. Rev. 1233, 1235–38 (1995). More recent scholarship includes SHERRY LAMB SCHIRMER, A CITY DIVIDED: THE RACIAL LANDSCAPE OF KANSAS CITY, 1900–1960 (2002); Susan Bickford, *Constructing Inequality: City Spaces and the Architecture of Citizenship*, 28 POL. THEORY 355 (2000); Xavier de Souza Briggs, *More* Pluribus, *Less* Unum*? The Changing Geography of Race and Opportunity*, *in* THE GEOGRAPHY OF OPPORTUNITY: RACE AND HOUSING CHOICE IN METROPOLITAN AMERICA 17 (Xavier de Souza Briggs ed., 2005); Rachel D. Godsil, *Viewing the Cathedral From Behind the Color Line: Property Rules, Liability Rules, and Environmental Racism*, 53 EMORY L.J. 1807 (2004); and Lisa C. Young, *Breaking the Color Line: Zoning and Opportunity in America's Metropolitan Areas*, 8 J. GENDER RACE & JUST. 667 (2005).

[52] Pritchett, *supra* note 6, at 13–14.

[53] Pritchett, *supra* note 6, at 14.

Eastern European immigrants, a development that accelerated after World War II.[54]

Prior to World War II, such neighborhoods were unambiguously racialized. The "discovery of blight" by progressive era reformers in urban neighborhoods and the subsequent biologic and sterile definition of "slums," which related real estate condition and market value to the racial characteristics of a neighborhood's inhabitants, provided the primary means by which to rationalize a much more robust land use strategy directed against a variety of groups.[55] Like inconsistent and changing conceptions of race at the time,[56] however, the term "blight" was subject to "vague generali[zations]" that allowed cities (now in collaboration with large-scale real estate developers) to incompletely remake and "renew" their aging cities for a more "modern age."[57] Nonetheless, an "objective" and "rational" property discourse emphasizing "efficiency" and "value" increasingly justified and obscured (most noticeably at a policy making and a judicial level), outright and intentional bias and discrimination applied almost exclusively to non-Whites living in most American cities.[58]

B. The Rise of the Property State in the Myrdallian Metropolis

World War II and postwar economic growth; a dramatic demand for housing; massive urbanization fueled by diasporic movements of Southern and Midwestern Whites, Southern Blacks, Puerto Ricans, Mexicans and Mexican Americans, reservation American Indians, and interned Japanese and Japanese Americans, and of capital—particularly to cities in the Midwest, Rocky Mountain West, Southeast, and Pacific—fundamentally transformed urban America. As one contemporary noted in 1949, "approximately seventy million people are not living in the houses which they occupied in 1940. Twelve million have changed their state of residence; this is probably the largest population movement in history."[59] At the same time, the horrors of Nazi Germany compelled policy makers, judges,

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[54] *See* BERNSTEIN, *supra* note 42; KURASHIGE, *supra* note 42; Romero, *supra* note 42, at 1–40; SÁNCHEZ, *supra* note 38, at 72–78.

[55] *See* Pritchett, *supra* note 6, at 13–21. For a fascinating multiracial and multiethnic account of this discourse see generally NATALIA MOLINA, FIT TO BE CITIZENS?: PUBLIC HEALTH AND RACE IN LOS ANGELES, 1879–1939 (2006). It is also important to indicate the relationship here to Michel Foucault's concept of biopower whereby the modern state, in the guise of bettering the public interest, used science and the language of biology to manage effectively and efficiently inequitable social relations. MICHEL FOUCAULT, THE HISTORY OF SEXUALITY 135–59 (1977).

[56] *See, e.g.*, GUGLIELMO, *supra* note 36, at 59–75.

[57] Pritchett, *supra* note 6, at 18; *see also* SÁNCHEZ, *supra* note 38, at 81–83.

[58] *See* Pritchett, *supra* note 6, at 13–21, 26–34; *see also* Audrey G. McFarlane, *The New Inner City: Class Transformation, Concentrated Affluence and the Obligations of the Police Power*, 8 U. PA. J. CONST. L. 1, 18 (2006).

[59] Edwin A. Cottrell, *Problems of Local Government Reorganization*, 2 W. POL. Q. 599, 600 (1949).

lawyers, and participants in many American cities to rethink the concept and value of race.[60] Dubbed by sociologist Gunnar Myrdal as "America's Dilemma," race relations emerged as an unresolved and unsightly stain on the United States' moral claims.[61] This Myrdallian turn in American political, social, and legal thought only accelerated as the United States became locked in the Cold War with the Soviet Union. As scholars such as Mary Dudziak and Mark Tushnet have shown, the legal and political efforts of African Americans to end racial discrimination in the immediate postwar years greatly weakened any claims about the superiority of the American concept of the "rule of law."[62] In fact, future Supreme Court Justice Thurgood Marshall highlighted the relationship of civil rights to international foreign policy in the same year *Brown* and *Berman* were argued and decided: "You tell us of forced labor in Russia—what about the lynchings of Negroes in Alabama? You tell us about undemocratic elections in Bulgaria—what about the poll tax in Mississippi?"[63] Such arguments, in turn, forced jurists and policy makers to be color conscious in their decision making. Domestically, the issue crystallized around school desegregation and "massive resistance" in the South, and internationally through the United States' active involvement in Africa, Asia, and Latin America.[64]

Equally important was the explosion of these issues in America's industrial urban citadels. To be sure, the American industrial city and the racially unstable and permeable neighborhood spaces it had developed in cities like Chicago, Cleveland, Detroit, Newark, New York, and Boston could no longer effectively

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[60] Two contemporary accounts highlighted the saliency of these concerns by examining the degree to which various municipalities across the United States attempted to protect human rights through ordinances and other measures. *See generally* Pamela H. Rice & Milton Greenberg, *Municipal Protection of Human Rights*, 1952 WIS. L. REV. 679 (1952) (discussing impact municipal ordinances have on human rights); Alex Elson & Leonard Schanfield, *Local Regulation of Discriminatory Employment Practices*, 56 YALE L. J. 431 (1947) (examining effects of state and local regulations on protection of human rights).

[61] *See* GUNNAR MYRDAL, AN AMERICAN DILEMMA: THE NEGRO PROBLEM AND MODERN DEMOCRACY xlv–lix (1944). Legal historian, Michael Klarman notes that the "changes in racial attitudes and practices that occurred in the 1940s, were more rapid and fundamental than any that had taken place since Reconstruction." MICHAEL J. KLARMAN, FROM JIM CROW TO CIVIL RIGHTS: THE SUPREME COURT AND THE STRUGGLE FOR RACIAL EQUALITY 288 (2004).

[62] *See, e.g.*, MARY DUDZIAK, COLD WAR CIVIL RIGHTS: RACE AND THE IMAGE OF AMERICAN DEMOCRACY 3–17 (2000); MARK V. TUSHNET, MAKING CIVIL RIGHTS LAW: THURGOOD MARSHALL AND THE SUPREME COURT, 1936–61, at 188 (1994).

[63] TUSHNET, *supra* note 62, at 188 (quotation marks omitted).

[64] For U.S. concerns about its racial image in Africa and Asia, see, e.g., DUDZIAK, *supra* note 62, at 152–202; PENNY M. VON ESCHEN, RACE AGAINST EMPIRE: BLACK AMERICANS AND ANTICOLONIALISM, 1937–1957, at 1–6 (1997). For somewhat similar connections in regards to Latin American countries, see generally Richard Delgado, *Rodrigo's Roundelay: Hernandez v. Texas and the Interest-Convergence Dilemma*, 41 HARV. C.R.-C.L. L. REV. 23 (2006).

play out the anxieties of color blindness and color consciousness of a postwar and Cold War age. Race riots in Detroit and Harlem in 1943 and in the Chicago and Miami metropolitan areas in 1951 only served to underscore the potential "urban crises" affecting American cities precisely because neighborhoods and existing land use law proved so poor at containing racial segregation and thereby, protecting the value of private property and investment.[65]

For reform-minded business, government, and legal elites, whose goal since the turn of the twentieth century was to protect the urban investments of private enterprise, American cities were at the vanguard in the fight against communism. As one scholar of the period notes, "[t]o these men reform meant government-supported economic growth and an end to depression and class [and race] warfare; it meant a corporatist cooperation among government, business, farmers and labor."[66] This cohort understood that both domestic and foreign policy measures were necessary in order to address domestic problems.[67] In these terms, neither could be addressed by the individual self-interest nor by humanitarian or progressive activists for social change.[68]

Widespread reimagination of the post–World War II American city among this cohort compelled mayors, journalists, as well as lawyers and judges, to dream of "grand schemes to revitalize the nation's cities. Artists' renderings of slick glass and steel skyscrapers set in sunny plazas appeared in metropolitan newspapers and city planning reports and nurtured the hopes of a golden future."[69] One core of this vision was the opportunity for "every American family to acquire a good home."[70] This vision, articulated most clearly by President Dwight D. Eisenhower, indicated that "good housing in good neighborhoods is necessary for good citizenship" while a "high level of housing construction and vigorous community development are

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[65] The race riots in each of these cites and their connection to neighborhood boundaries and metropolitan growth are respectively analyzed in ARNOLD R. HIRSCH, MAKING THE SECOND GHETTO: RACE AND HOUSING IN CHICAGO 1940–1960 (1998); DOMINIC J. CAPECI, JR., THE HARLEM RACE RIOT OF 1943 (1977); MEYER, *supra* note 45, at 123–27; and SUGRUE, *supra* note 41, at 29–31. As early as 1947, commentators were recognizing the "crisis proportions" affecting these cities, but failed to connect the issue of national housing and redevelopment policy, land use law, and race. *See, e.g.*, E.R. Latty, *Forward*, 12 LAW & CONTEMP. PROBS. 1, 1 (1947).

[66] David W. Eakins, *Business Planners and America's Postwar Expansion*, *in* CORPORATIONS AND THE COLD WAR 143–44 (David Horowitz ed., 1969).

[67] *Id.* at 167-68.

[68] *Id.* at 143. For a compelling account of how such policies played out on a local level in relation to real property ownership and taxation, see Michael A. Dover, The Social System of Real Property Ownership: Public and Nonprofit Property Tax Exemptions and Corporate Tax Abatements in City and Suburb, 1955–2000, at 215–19 (2003) (unpublished Ph.D. dissertation, University of Michigan) (on file with author).

[69] Jon C. Teaford, *Urban Renewal and Its Aftermath*, 11 HOUSING POL'Y DEBATE 443, 443 (2000).

[70] President Dwight D. Eisenhower, Special Message to the Congress on Housing (January 25, 1954), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=9952&st=&st1=.

essential to the economic and social well-being of our country."[71] In fact, with the lead and power of the state, "cites were supposedly to be cleansed of their ugly [racial] past and reclothed in the latest modern [color-blind] attire."[72] Critically important to this entire vision was an expansive and more robust role in the use and deployment of eminent domain for urban redevelopment, catalyzed most prominently by the federal government's passage of the Housing Acts of 1949[73] and 1954,[74] and the Federal-Aid Highway Act of 1956.[75] While cities already possessed the power of eminent domain prior to the passage of such legislation, they did not enjoy the millions of dollars necessary to put this vision into practice.[76] Importantly, urban renewal's vision "appeared 'all things to all men'":

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[71] *Id.*

[72] Teaford, *supra* note 69, at 443. In his annual State of the Union Address on January 7, 1954, President Eisenhower's message highlighted efforts to "eliminate inter-racial difficulty." President Dwight D. Eisenhower, Annual Message to the Congress on the State of the Union (January 7, 1954), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=10096&st1=. Yet, it was what Eisenhower called "a modern industrial society" that necessitated a more robust and active role of "all levels of government, including the federal government" in the "banishment of destitution and cushioning the shock of personal disaster." *Id.* Accordingly, housing and private property home ownership played a prominent role. One contemporary scholarly account made this point evidently clear. *See* Shirley Adelson Siegel, *Relation of Planning and Zoning to Housing Policy and Law*, 20 LAW & CONTEMP. PROBS. 419, 419–20 (1955).

[73] Housing Act of 1949, Pub. L. No. 81-171, 63 Stat. 413 (codified as amended at 42 U.S.C. § 1441 (2000)).

[74] Housing Act of 1954, Pub. L. No. 83-560, 68 Stat. 590 (codified as amended in scattered sections of 12 U.S.C.).

[75] Federal-Aid Highway Act of 1956, Pub. L. No. 84-627, 70 Stat. 374. The vision of this progressive cohort could not help but see these acts, particularly the Housing Acts, as charges for racial justice and equity. Frank Horne, then Director of the Housing and Home Finance Agency's Racial Relations Service, for instance, interpreted "well-planned, integrated, residential neighborhoods" in the 1949 Housing Act to mean racial integration. Arnold R. Hirsch, *Searching for a "Sound Negro Policy": A Racial Agenda for the Housing Acts of 1949 and 1954*, 11 HOUSING POL'Y DEBATE 393, 403 (2000) (quoting Housing Act of 1949; *see supra* note 73). According to Horne, "[w]e are becoming convinced . . . that the energetic and skillful application of objective community planning requirements by HHFA officials can do more to avert the rise of racial problems and to insure effectuation of sound racial policy than any other one device." *Id.*

[76] For scholars and policy makers of the time, such laws were the "beginning of a new, comprehensive and effective means of attack against the existence of slums and blighted areas throughout the country." Philip H. Hill, *Recent Slum Clearance and Urban Redevelopment Laws*, 9 WASH. & LEE L. REV. 173 (1952). Also important was the expansive use of eminent domain to modernize with the nation's highways as connected to the belief that freeways would lead to the progress and efficiency of the modern age. *See generally* TOM LEWIS, DIVIDED HIGHWAYS: BUILDING THE INTERSTATE HIGHWAYS, TRANSFORMING AMERICAN LIFE (1997) (examining, as explained in the preface, "the story of the creation and consequences of the greatest and the longest engineered structure ever built, the Interstate Highway System."). Like urban renewal, however, highway progress

> To the city's humanitarians, urban renewal seemed an effective weapon forged by aid of the police power to eliminate slums and blight—and their accompanying health, safety, and moral hazards. To hardheaded, somewhat skeptical taxpayers, it justified itself by proposed exchange of slums, which drain off city tax dollars, for modern redeveloped areas, providing substantial new property values and accompanying tax revenues. To civic promoters, urban renewal promised a means to resuscitate the downtown business area, already woefully weakened by suburban shopping centers; to provide prime commercial and industrial sites with which to lure new business; to revise and remove horse-and-buggy traffic patterns; and, generally, to enhance the city's attractiveness. To builders, the availability under urban renewal of new construction opportunities, together with unique financial assistance, afforded ample incentive to push the program. To some property owners, it presented an unexpected market for their run-down properties. To pump primers generally, urban renewal's appeal of new jobs and more money in circulation was well-nigh irresistible. *And, last but certainly not least, to persons—mostly members of minority groups—living in the blighted areas, the program appeared to offer a federally paved escape route from long-experienced squalor into a promised land of decent housing.*[77]

Subsequent changes in law and jurisprudence not only gave municipalities a line of credit from which they could draw to put this vision into practice,[78] but also compelled fourteen state courts and ultimately the Supreme Court to conflate "slum clearance" and "redevelopment" as coterminous "public use" terms to satisfy inherent authority to condemn private property.[79] New York University

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means displacement, disruption, and effective containment of communities of color. *See* SUGRUE, *supra* note 41, at 47–51; F. James Davis, *The Effects of a Freeway Displacement on Racial Housing Segregation in a Northern City*, 26 PHYLON 209, 209-215 (1965).

[77] Robinson O. Everett, *Forward to Symposium on Urban Renewal*, 26 L. & CONTEMP. PROBS. 1, 1–2 (1961) (emphasis added).

[78] *See* Note, *Urban Renewal: Problems of Eliminating and Preventing Urban Deterioration*, 72 HARV. L. REV. 504, 511–13 (1959).

[79] Adams v. Hous. Auth., 60 So.2d 663 (Fla. 1952) (one of only two cases finding redevelopment unconstitutional prior to 1954). Beginning in the late 1940s and early 1950s, seventeen state courts considered the constitutionality of redevelopment statutes, with fifteen upholding their constitutionality. The only two cases that found redevelopment unconstitutional prior to 1954 are *Adams* and Hous. Auth. v. Johnson, 74 S.E.2d 891 (Ga. 1953). For an analysis of these decisions, see Daniel R. Mandelker, *Public Purpose in Urban Redevelopment*, 28 TUL. L. REV. 96, 102–06 (1953). Moreover, by 1955, forty states and territories had statutes providing for redevelopment of blighted or slum areas. *See* Note, *Public Use as a Limitation on Eminent Domain in Urban Renewal*, 68 HARV. L. REV. 1422, 1423 (1955).

Law Professor Gardner Cromwell declared that such developments, particularly in light of *Berman v. Parker*, "suggest that no court need believe itself bound by traditional conceptions" of the takings for public use power in putting a vision of a more robust land use policy into practice.[80]

For racial progressives in particular, eminent domain and other land use powers sanctioned by federal policy and jurisprudence were unambiguous charges for racial justice and equity. Frank Horne, then Director of the Housing and Home Finance Agency's Racial Relations Service, for instance, interpreted "well-planned, integrated, residential neighborhoods" in the 1949 Housing Act to mean racial integration.[81] According to Horne, "[w]e are becoming convinced . . . that the energetic and skillful application of objective community planning requirements by HHFA officials can do more to avert the rise of racial problems and to insure effectuation of sound racial policy than any other one device."[82] This meant for some that local bureaucrats needed to be extremely color conscious in their decision making, but in ways that attempted to ameliorate the disparate racial impact of land use and property law.[83] Harvard University Law School Professor Charles Haar, for instance, was particularly critical about state planning laws that were "cast in broad, amorphous terms."[84] Therefore, a basic statutory checklist was required in order to diminish "the problems of discrimination, granting of special privileges, and the denial of equal protection of the laws."[85] One researcher studying the Eastwick Redevelopment Project in Philadelphia, a "Northern" city with a substantial non-White population, argued that the entire public policy underlying urban redevelopment was the "establishment of racial integration," and therefore, the local agencies involved needed to be especially attuned to the project's impact in creating or perpetuating even worse racial segregation.[86] Yet,

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[80] Gardner Cromwell, *Condemnation and Redevelopment*, 28 ROCKY MTN. L. REV. 535, 548 (1955).

[81] Arnold R. Hirsch, *Searching For a "Sound Negro Policy": A Racial Agenda for the Housing Acts of 1949 and 1954*, 11 HOUS. POL'Y DEBATE 393, 403 (2000).

[82] *Id.*

[83] Horne himself developed a list of racially conscious principles that allowed for humane and equitable treatment of all the populations that land use law and policy would impact and require for anti-racially restrictive covenants on property acquired through the use of federal funds. *Id.* at 399.

[84] Charles M. Haar, *The Master Plan: An Impermanent Constitution*, 20 L. & CONTEMP. PROBS. 353, 354 (1955). At the time of Haar's writing, all but three states (Florida, Mississippi, and Wyoming) had passed enabling legislation for municipal planning. *Id.* at 353 n.3.

[85] *Id.* at 365–66. While Haar's own admittedly non-comprehensive checklist did not include a specific category for direct or disparate impact of the plan on racial and ethnic communities, his non-discrimination principle suggests that it would be an important factor. *Id.* According to Professor Haar, "[o]bviously it would be impertinent to attempt to list all such factors here," but one of the "specifications" of the master plan "should be [a requirement] to state conclusions as to anticipated future population." *Id.* at 368.

[86] Leonard Blumberg, *Urban Rehabilitation and Problems of Human Relations*, 19 PHYLON Q. 97, 103–04 (1958).

this researcher qualified this statement by suggesting that the "conditions of minority communities" did not deserve special consideration, but rather, a focus on the "community 'as a whole'" should drive "urban rehabilitation."[87]

A more general consensus, accordingly, anticipated and argued in favor of urban renewal and other federal efforts' more "neutral" metro-zonal implications. For instance, one study embraced the possibility that urban renewal "will become oriented more about *metropolitan areas than cities or neighborhoods*."[88] Particularly important was the symbolic importance that urban renewal bureaucrats and other government agents placed on local, state, and federal cooperation in highly fragmented and growing metropolitan areas. Of the 168 metropolitan areas in existence in 1952, there were a total of 3,164 separately incorporated municipalities, nearly 8,000 school districts, 256 counties, 2,328 townships and 2,598 metropolitan special use (water, sanitation, sewage, etc.) districts.[89] According to one contemporary study, rapid metropolitan growth and fragmentation "raise[s] all of the problems connected with the narrow constriction of municipal boundaries and the consequent inability of the central city to plan for and to govern the entire complex surrounding it."[90] Though municipal boundary line was substantively different than takings law, the close relationship of both to metropolitan residential, commercial, and industrial development suggested the demand and desire for innovative and forward thinking both in law and politics.[91]

For many, it was the "end" promised by urban renewal that justified the means. Largely because "the statutes are concerned in part with the removal of buildings, structures, and habitations, which because of obsolescence or the impact of lessened values have become 'breeding places' of disease, crime, and delinquency and social decay," many state courts indicated that the robust use of eminent domain by local municipal authorities would be subject only to minimal review once a court determined its "public use."[92] The Missouri Supreme Court, for example, argued that "[t]he necessity, expediency and propriety of exercising the right of eminent domain, either by the state or by the corporate bodies to which the right has been delegated, are questions essentially political in their nature and not judicial."[93] The Missouri Supreme Court subsequently quoted liberally from one eminent domain treatise to absolve itself of all responsibility to review boundary-making decisions of local government: "The courts cannot inquire into

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[87] *Id.* at 105.

[88] Note, *supra,* note 78, at 551 (emphasis added).

[89] BUREAU OF CENSUS, LOCAL GOVERNMENT IN METROPOLITAN AREAS 5–7 (1964).

[90] William C. Havard & Alfred Diamant, *The Need for Local Government Reform in the United States*, 9 W. POL. Q. 967, 973 (1956).

[91] *See, e.g.*, Ashley A. Foard & Hilbert Fefferman, *Federal Urban Renewal Legislation*, 25 L. & CONTEMP. PROBS. 635, 667 (1960).

[92] *Id.* at 535, 539–45; *see also* Mandelker, *supra* note 79, at 99–102.

[93] City of Kirkwood v. Venable, 173 S.W.2d 8, 11 (Mo. 1943).

the motives which actuate the authorities to enter into the propriety of making the particular improvement."[94]

The racial implications in the implementation of these programs did not go uncontested, yet they were ignored or constrained in a variety of ways. In the early 1950s, officials in the Racial Relations Service (RRS) "warned prophetically that 'the way in which these programs are conceived and carried out will . . . largely determine the physical framework' and 'socio-psychological atmosphere' within which the civil rights struggle would be played out."[95] To be sure, RRS officials feared, in particular, long-rooted racial localism throughout the United States and its potential adverse consequences on Black and other "minority" communities.[96] Such fears came to light in the 1959 testimony before the recently formed United States Commission on Civil Rights when Reginald A. Johnson, President of the National Urban League, highlighted the disparate impact of local politics and federal law in the selective use of the power of eminent domain:

> of 138,171 families involved in their relocation program . . . . [m]ore than 50% of these families are non-[W]hite. Many of these families will not be eligible for relocation into the 108,489 dwelling units proposed in the plans . . . . [because the] housing supply will be too expansive for the families displaced and a goodly percentage of this supply will prohibit occupancy because of race.[97]

Five years later, one scholar estimated that nearly two-thirds of all those displaced by urban renewal were non-White, with many of the projects taking place in the nation's industrial and oftentimes non-Southern urban core.[98] Yet, by effectively "making the elimination of blight" and a discourse of constant improvement "vital to the survival of the city," the metropolitan area and the nation, this reform cohort avoided sustained and persistent "questions about who benefited from the condemnation processes and who bore the costs."[99]

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[94] *Id.* at 12 (cited in JOHN LEWIS, A TREATISE ON THE LAW OF EMINENT DOMAIN IN THE UNITED STATES § 370 (3d ed. 1909)).

[95] Hirsch, *supra* note 81, at 395.

[96] *Id. at* 393–419 (noting distinctions between its use between industrial Northern and Southern cities).

[97] *Hearings Before the United States Comm. on Civil Rights*, Housing, Part I, at 310.

[98] *See* MARTIN ANDERSON, THE FEDERAL BULLDOZER 6–8 (1964). New York, Philadelphia, Chicago, Detroit, and Cleveland were some of the most active cities in urban renewal and public housing and concomitantly, sites of some of the most intense amounts of segregation between Whites and non-Whites in such projects. *See, e.g.*, LOWI, *supra* note 10, at 246.

[99] Pritchett, *supra* note 6, at 31.

III. TURNING A BLIND EYE TO THE RACIALIZED METROPOLITAN LANDSCAPE

In July 1948, Hubert Humphrey, the mayor of Minneapolis, Minnesota, took direct aim at the White-supremacist bloc of the Democratic Party at the Democratic National Convention. On the third night of the Convention, Mayor Humphrey called on delegates to add a civil rights agenda to the Democratic Platform. As he finished his speech, Humphrey emphatically declared:

> There will be no hedging—no watering down—of the instruments of the civil rights program. To those who say that we are rushing this issue of civil rights—I say to them, we are 172 years late! To those who say that this bill of rights program is an infringement on states rights, I say this—the time has arrived for the Democratic Party to get out of the shadow of states' rights and walk forthrightly into the bright sunshine of human rights.[100]

Mayor Humphrey was no doubt emboldened by a "wave of tolerance and understanding [that] swept over Minnesota's civic consciousness" in the years surrounding World War II.[101] From Republican Governor Edward Tyne's creation of an interracial commission to educate Minnesotans on racism directed at Blacks, Mexicans, and American Indians, to his own well-regarded work on "human relations,"[102] Humphrey perfectly embodied the vision of a postracial urban America. A little over a decade later, however, the federal urban redevelopment and transportation policy that he supported effectively destabilized, and in some cases destroyed, the Twin Cities' small, but vibrant middle- and working-class Black and Latino communities.[103] Simultaneously, urban renewal as well as recently enacted American Indian relocation policy related to private housing and employment discrimination effectively contained these communities from future economic or spatial growth.[104] For example, one study on the effects of freeway

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[100] HUBERT H. HUMPHREY, THE EDUCATION OF A PUBLIC MAN 458–59 (1991).

[101] JENNIFER A. DELTON, MAKING MINNESOTA LIBERAL: CIVIL RIGHTS AND THE TRANSFORMATION OF THE DEMOCRATIC PARTY 40 (2002).

[102] *Id.* at 40–60, 119.

[103] Though this happened in both Minneapolis and St. Paul, the effects were most clearly seen in St. Paul. Davis, *supra* note 76, at 209–10; DIONICO NODÍN VALDÉZ, BARRIOS NORTEÑOS: ST. PAUL AND MIDWESTERN MEXICAN COMMUNITIES IN THE TWENTIETH CENTURY 173–76 (2000).

[104] *See, e.g.*, ARTHUR M. HARKINS & RICHARD G. WOODS, INDIAN AMERICANS IN ST. PAUL: AN INTERIM REPORT 1 (1970); ALBERT MANN, SURVEY OF INDIANS IN THE TWIN CITIES (1956); VALDÉZ, *supra* note 103, at 173–76; Davis, *supra* note 76, 211–15. According to a report prepared by the St. Paul Urban League in 1958, of the nearly 24,000 new homes constructed in St. Paul or surrounding suburbs from 1953 to 1958, "fewer than 35 units have been made available to non-white families . . . . Virtually all recently constructed privately owned multiple dwelling units in St. Paul are close to the non-white home seeker." *St. Paul's Urban Renewal Program at it Relates to Non-White Citizens*,

displacement, which was "made through the most non[-W]hite part" of St. Paul's Black community, echoed a national report about the institutionalization of discrimination in even some of the nation's most enlightened non-Southern cities.[105] To be sure, local implementation of federal policy contributed not only to the selective, massive, and disproportionate dislocation of non-White communities, but it contributed to segregated resettlement patterns even more extreme than before.[106]

This section examines the ways that political, intellectual, and jurisprudential divergence over the meaning of property and civil rights reinforced the fragmented distribution of power, resources, and racial consciousness, as well as concentration in the metropolitan heterotopia. To be sure, the contemporary fixation on *Brown* and its fact patterns as a regional, as opposed to national phenomenon, served to efface the state's role in the concentration of multiracial communities outside of the South. At the same time, the failure or refusal of politicians as well as jurists to connect property rights to spatial inequity and civil rights only served to endorse normative and self-reflective understandings about urban racial pathology and property-oriented suburban meritocracy. Along with a dramatic rise in the creation and enforcement of local government boundaries, color consciousness and color-blindness shared the same metropolitan space, but in extraordinary isolation from the root causes and interconnected nature of the metropolitan heterotopias' most glaring color and other social inequities.

A. The Resurrection of Real Property and the (in)Significance of Race and Region

As the "race issue" was both locally and nationally framed as either Southern or rural or both, it recast attention away from systemic racial tension and animus in industrial Northeastern and certain Midwestern cities. Such a trend was most evident in the attempts by particularly legal and political scholars to establish clear and "neutral" principles of law to balance the competing interests generated by central city decay, suburbanization, discrimination, segregation, group oppression, and totalitarian thought. According to Professor Morton Horwitz, this effort led to "the persistent pressure of professional orthodoxy to restore a sharp distinction between law and politics."[107] In terms of balancing the competing political claims of many groups, legal theorists believed that law should "serve a . . . purer function. Horse trading might happen in the legislature or executive, but they saw

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Urban Renewal Institute, 1 Minnesota State Archives (May 20, 1958) (statement of Ernest C. Cooper, Executive Secretary of St. Paul Urban League).

[105] Davis, *supra* note 76, at 209 (referencing the study, DAVIS MCENTIRE, RESIDENCE AND RACE: FINAL AND COMPREHENSIVE REPORT TO THE COMMISSION ON RACE AND HOUSING (1960)).

[106] *See* Hirsch, *supra* note 81, at 415, 428–29.

[107] MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1870–1960 247 (1992).

little place for it in the judiciary. They viewed the notion of 'judicial politics' as normatively oxymoronic."[108]

This criticism in legal and political thought coalesced together when the United States Supreme Court issued its historic 1954 decision, *Brown v. Board of Education*.[109] In declaring separate schools for "Blacks" and "Whites" "inherently unequal," the *Brown* Court catalyzed an intense debate about the rights of "racial minorities" in the Cold War United States.[110] Troubling to many was the Supreme Court's privileging of such rights in relation to other constitutional guarantees. Indeed, many postwar legal and political theorists attacked *Brown* because it did not adhere to so-called neutral principles of judicial restraint.[111] Perhaps most important, Cold War legal theorists fixated on the impact that *Brown* would have on the concept and privileging of civil rights over property rights in American law. Judge Learned Hand in 1958, for example, critiqued *Brown* because it failed to account for the impact of such "civil rights" decisions on private property.[112] According to Judge Hand, this "'would have seemed a strange anomaly' to the framers of the Constitution."[113] Indeed, Hand further noted that "[w]hy property rights were not also personal rights 'nobody took the time to explain.'"[114]

In spite of such criticism, however, judges and policy makers erected a bright line between property rights and civil rights by the 1960s. Framed more generally as the inherent conflict between liberty and equality or security and opportunity,[115] *Brown*, unlike much commentary regarding *Berman*, indicated a threat to both. Many legal contemporaries lamented this distinction because it undermined one of the legacies of the realist challenge to classical legal thought: the rejection of *Lochner v. New York* and the limitation of property rights in American law and

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[108] LAURA KALMAN, THE STRANGE CAREER OF LEGAL LIBERALISM 26 (1996).

[109] 347 U.S. 483 (1954).

[110] *Id.* at 495.

[111] While historians disagree about the extent that postwar legal and political theorists actually rejected *Brown*, their analysis about the efforts of these theorists to resolve the Supreme Court's decision revealed the centrality of race to the decision. Both Morton Horwitz and Gary Peller indicted postwar legal commentators for their "sharply critical" attacks on *Brown*. *See* HORWITZ, *supra* note 107, at 258; Gary Peller, *Neutral Principles in the 1950s*, 21 MICH. J. OF L. REFORM 561, 563–67 (1988). Laura Kalman, on the other hand, argues that such an impression is overly harsh. According to Kalman, acceptance of *Brown* was an "admission ticket for entry into mainstream constitutional dialogue." KALMAN, *supra* note 108, at 30–31. For an account on how the law and politics distinction played out in the Supreme Court, see KLARMAN, *supra* note 61, 292–312. A more recent critique of *Brown* is powerfully argued in DERRICK BELL, SILENT COVENANTS: BROWN V. BOARD OF EDUCATION AND THE UNFULFILLED HOPES FOR RACIAL REFORM (2004).

[112] HORWITZ, *supra* note 107, at 259.

[113] *Id.*

[114] *Id.* at 263.

[115] For a brief outline of this distinction, *see* Richard B. Wilson, *The Merging Concepts of Liberty and Equality*, 12 WASH. & LEE L. REV. 182, 182–83 (1955).

jurisprudence.[116] What makes this development even more interesting is the role of *Lochner* in justifying the logic about the structural as well as spatial form of the nineteenth and early-twentieth century industrial American city. The decision, situated as it is around working conditions, labor rights, employer prerogatives, and free will in one of the United States' most exemplary urban settings, stands as a testament to hyper-urbanization and the concomitant transformation this had on American understandings of property and ownership.

Most acutely, the *Lochner* Court at the time of its decision implicitly recognized that real property no longer served as the primary source of either wealth or prestige in the United States.[117] Instead, the ability to freely contract one's own skills and labor was the only property asset one had at "his" disposal despite any adverse impact on one's health or sanitation.[118] For the Court, the New York legislature's attempt to regulate this asset under the guise of protecting the health, safety, welfare or morals of the community, was patently false and deceiving.[119] The Court then argued

> [t]he purpose of a statute must be determined from the natural and legal effect of the language employed; and whether it is or is not repugnant to the Constitution of the United States must be determined from the natural effect of such statutes when put into operation, and not from their proclaimed purpose.[120]

Because of its disparate application to all those who possessed "new property" in the industrial urban United States, the *Lochner* Court found suspect the state's attempt to regulate property relations among a socially stratified urban core.[121]

In a little over two decades, *Lochner*'s logic lay in shambles. Particularly as the intensity of world-wide depression shook the values and ideals of laissez-faire capitalism and unchecked property accumulation to its core, policy makers and

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[116] *See* Lochner v. New York, 198 U.S. 45 (1905). For many legal scholars, the *Lochner* Court's unambiguous protection of this new property undermined the "neutral" role of the law in American social and economic life. HORWITZ, *supra* note 107, at 263–65.

[117] The transformation in the meaning of property during this time, especially the idea of the right to contract as a property right, is assessed in Kenneth J. Vandevelde, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325, 358 (1980).

[118] The similarities to the "blighted" property discourse in relation to the New York Legislature's attempted justification for the legislation is striking. *Lochner*, 198 U.S. at 53, 59–62. While noting that this right was not absolute in *Lochner*, the Court in subsequent cases failed to extend this right to women in *Muller v. Oregon*, 208 U.S. 412, 423(1908).

[119] *Lochner*, 198 U.S. at 64 ("It is impossible for us to shut our eyes to the fact that many of the laws of this character, while passed under what is claimed to be the police power for the purpose of protecting the public health or welfare, are, in reality, passed from other motives.").

[120] *Id.*

[121] *Id.* at 59-65.

jurists recognized the necessity of the state taking the lead role in managing property and human relations.[122] The *Euclid* decision thus served as a precursor to a much more compliant and less skeptical attitude about the state in most contexts.[123] Race relations in the American South, most visibly the widespread use of Jim Crow laws by local government and state legislatures in perpetuating White supremacy, however, served as a tragic and often violent reminder of deeply rooted social bias and inequality policed and enforced by local government.[124] Yet, because Jim Crow and racial tension was conceptualized and almost exclusively litigated as a "Southern" phenomenon, it suggested a different trajectory for non-Southern as well as non-industrial cities. In early 1951, for instance, William Mahoney, a White civil rights lawyer in one of the nation's fastest growing cities in the American Southwest, made the following observation about the future role of race relations and local government: "[T]he die is cast in the South, or in an old city like New York or Chicago, but we here [in the urban American West] are present for creation. We're making a society where the die isn't cast. It can be for good or ill."[125] Accordingly, in context both of an explosion of housing and consumer demand after the belt-tightening years of the Great Depression and World War II mobilization propped up and supported by federal government housing law and policy, access to and accumulation of real (as well as personal) property in the new postracial American metropolitan landscape reemerged as a primary social, if not constitutional good.[126]

Brown v. Board of Education's primary emphasis on the absolute threat of racial inequality, however, exposed deep cleavages about the meaning of property

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[122] The literature on this era is voluminous. Though somewhat dated, one of the best essays of the rise of Great Depression's role in catalyzing a new and more robust role for government remains Alan Brinkley, THE NEW DEAL AND THE IDEA OF THE STATE, THE RISE AND FALL OF THE NEW DEAL ORDER, 1930–1980, at 85 (Steve Fraser and Gary Gerstle eds., 1989).

[123] Vill. of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926).

[124] For a comprehensive overview of these issues and subsequent relationship to law and jurisprudence, see KLARMAN, *supra* note 61, at 171–289.

[125] MATTHEW C. WHITAKER, RACE WORK: THE RISE OF CIVIL RIGHTS IN THE URBAN WEST 5 (2007). Mahoney's statement also indicates the emergence of the as yet to be articulated differences between "de jure" Southern segregation and "de facto" Northern segregation. *See supra* notes 24 and 47. The rapidly growing urban and metropolitan American West, as Mahoney clearly suggests, was sui generis. WHITAKER, at 5.

[126] The literature linking federal housing and fiscal policy to metropolitan growth and spatialization is quite extensive. The best synthesis on these issues still remains KENNETH T. JACKSON, CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES 190–218 (1985). Two of the most influential community studies of this phenomenon are found in SUGRUE, *supra* note 41, at 181–229 and Hirsch, *supra* note 81. A growing body of scholarship focusing particularly on the metropolitan American West highlights the problematic ways city boosters imagined their cities, its growth and race relations in connection to an increasingly coherent property rights discourse. *See* BECKY M. NICOLAIDES, MY BLUE HEAVEN: LIFE AND POLITICS IN THE WORKING CLASS SUBURBS OF LOS ANGELES, 1920–1965, at 185–326 (2002); SELF, *supra* note 17, at 24–34, 96–131.

to the protection of civil rights. For instance, just five years before *Brown*, Housing and Home Finance Agency director Frank Horne highlighted how property rights contributed to inequality in ways actually more pernicious than the "separate but equal" principle applied to public education or public accommodations. Because "no two residential districts are equal," he argued, the "denial of a right to purchase or occupy property is an injury that is not redressed merely by the opportunity to exercise that right elsewhere."[127] What Horne's analysis suggests is the manner by which the acquisition, aggregation, and service to clusters of real property made evident the color line between Whiteness and non-Whiteness in American cities. While the racially restrictive practices of private property owners, real estate agents, and lenders had long served to create and perpetuate such inequity,[128] newly expansive public power (from urban renewal and zoning) in the service of private investment during the age of *Brown* served to harden the color line. As Horne clearly understood and anticipated post-*Brown*, property was Whiteness in the United States; and the only way to undermine this was to become extremely color conscious about the relationship and deep interconnection between property and civil rights.[129]

Despite such a critique, legal commentators failed to make such a connection. Rather, many recentered the issue of human rights and racial equity as a constitutional allegory; privileging the civil rights of racial minorities in legal discourse seemed to them "something strangely akin" to reinvigorating the "discredited attitude" about property rights found in *Lochner*.[130] As a result, these same legal commentators took the lead in undermining the proposition "that racial equality was a value that must prevail against any conflicting interest,"[131] while establishing the notion that the "moral claims of [W]hites and [B]lacks could only be prima facie equal."[132] To be sure, Jim Crow racial segregation and its perpetuation of racial inequality as well as "massive resistance" by Southerners to the Supreme Court's systemic dismantling of this system could no longer be reconciled either in relation to the nation's equality or rule of law commitments. Nevertheless, the criticism and containment of *Brown* to public education did not reflect the massive racial distribution and concentration, managed most directly by local government, on color spatialization in exploding metro-zones.[133]

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[127] Hirsch, *supra* note 81, at 399.

[128] *See, e.g.*, discussion on racially restrictive covenants, *infra* notes 171-72.

[129] *See, e.g.*, Hirsch, *supra* note 81, at 399–400.

[130] HORWITZ, *supra* note 107, at 263.

[131] *Id.* at 265.

[132] *Id.* at 268.

[133] This discord also indicates the emergence of a "color-blind" ideology in the metropolitan South and the industrial North that defended residential segregation and "massive resistance" to school integration as the natural outcomes of market forces and individual meritocracy. MATTHEW D. LASSITER, THE SILENT MAJORITY: SUBURBAN POLITICS IN THE SUNBELT SOUTH 29 (2006).

B. Property Principles, Metropolitan Localism, and the Dismissal of Color

One case from St. Louis in 1959 highlights how disconnected and contained questions of racial inequity were becoming in the jurisprudence of the nation's growing metropolitan areas. In *State ex rel. Creve Coeur v. Weinstein*, municipal authorities from the City of Creve Coeur (an incorporated municipality in the western part of the St. Louis Metropolitan area) successfully petitioned the St. Louis Court of Appeals in preventing a trial court judge from hearing allegations and evidence about racial discrimination in an eminent domain action.[134] Under authority granted to it under state law, the city condemned four parcels of real property "for park and playground purposes"[135] in a recently subdivided residential neighborhood.[136] Two of these parcels, which were zoned as residential, were owned by Howard and Katie Venable, and like many of their contemporaries, the Venables were active participants in the postwar housing boom.[137] In fact, on one of the lots, the Venables had begun construction on what can only be assumed was their "dream" home.[138] Prior to the eminent domain proceeding, the Venables alleged a pattern of coercion and mistreatment by the city whereby the city attempted to force the Venables to sell their property to a Citizens-Committee, and when this proved unsuccessful, the city refused to issue to defendants and their building contractor the necessary plumbing permits to complete construction.[139] Finally, according to the Venables, the city "'[h]astily chose a site for alleged park condemnation purposes' [and] 'disregarded the unsuitable topography, location, and cost of the area sought to be condemned.'"[140]

Perhaps most importantly, the Venables were Black.[141] Accordingly, their claim framed all of the city's activity as "[y]ielding to the importunities of citizens of Creve Coeur" who were "*motivated* solely by reason of racial prejudice against Negro residents" and the widespread desire to prevent African Americans from transgressing, through private property ownership, the St. Louis suburb's corporate boundaries.[142] Though the use of neighborhood councils and associations to preserve the Whiteness of neighborhoods and communities had been a fixture of urban and metropolitan life since the 1920s,[143] the Venables' allegations

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[134] 329 S.W.2d 399, 410(Mo. Ct. App. 1959).

[135] *Id.* at 401.

[136] Brief and Appendix of Plaintiff-Respondent at 18, State *ex rel.* Creve Coeur v. Weinstein, 329 S.W.2d 399 (Mo. Ct. App. 1959) (No. 30255).

[137] Weinstein, 329 S.W.2d at 402.

[138] *Id.*

[139] *Id.*; Brief and Appendix of Plaintiff-Respondent, *supra* note 136, at 2.

[140] Weinstein, 329 S.W.2d at 403.

[141] *Id.*

[142] *Id.*

[143] *See generally* KEVIN BOYLE, ARC OF JUSTICE: A SAGE OF RACE, CIVIL RIGHTS, AND MURDER IN THE JAZZ AGE 133–69 (2004) (examining the nationwide implications of neighborhood racial exclusion as it impacted one African American family in suburban Detroit).

highlighted two important transformations both in the scope of the legal and political analysis and the judicial parsing of such activity.

First, the Venables' claim is rooted in the explosion of urban governmental fragmentation that begins during the formative years of the Cold War. While most contemporary scholars have focused their attention and scorn on the federal government's deployment of its eminent domain power to transform the city and race relations particularly among Blacks and Whites, scarcely noticed was a dramatic restructuring of local municipal law and the redistribution of metropolitan power. As one planner noted early in the 1950s, most municipal law was inadequate to deal with the contingencies of a postwar age and as a result, "far-reaching changes in states laws" were required to give cities "adequate legal power . . . to control the use of their land areas."[144]

Beginning soon after the end of World War II, however, the powers of municipalities grew exponentially. Between 1948 and 1963, for instance, more home rule provisions for municipal government were written into state constitutions than all other home rule provisions combined since the advent of the movement in 1875.[145] Indeed, the City of Creve Coeur itself was incorporated in 1949 as a result of the rapid post–World War II growth and demographic changes happening in St. Louis.[146] With home rule power, incorporated municipalities

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[144] Pritchett, *supra* note 6, at 27. Until the 1950s, most municipal power laid vested in the legally incorporated central city as demand for superior central-city services and the desire by suburban residents (and developers) to be annexed by central cities proved a potent counterweight to metropolitan fragmentation and racial spatialization. JON C. TEAFORD, CITY AND SUBURB: THE POLITICAL FRAGMENTATION OF METROPOLITAN AMERICA, 1850–1970, 185 (1979). We know, for instance, that "[s]uburbanites yearned for Cleveland's water, desired Chicago's fire protection, and Boston's sewage system." *Id.* Many suburbanites thus elected to unite with these cities to gain these advantages. *Id.* Though ethnically diverse, these were oftentimes racially homogenous metropolises where patterns of metropolitan boundary fragmentation were reflected in "blight" and deterioration of working-class racially distinct neighborhoods, not cities.

[145] Terrance Sandalow, *The Limits of Municipal Power Under Home Rule: A Role for the Courts*, 48 MINN. L. REV. 643, 644 (1964).

[146] This remarkable account comes from the City of Creve Coeur's own website, Creve Coeur History, http://www.creve-coeur.org/history.htm (Sept. from Oct. 23, 2008).

> By 1950, St. Louis had reached its peak population with 856,000. St. Louis City was filling up, forcing returning soldiers to look for housing in St. Louis County to raise their families. Families wanted bigger houses, more yard space and places to park their new cars. The technological advancements in the automobile industry, along with the construction of Highways 270 and 40, further pushed the westward movement away from the central city.
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> When Creve Coeur was incorporated in December 1949, less than one square mile housed a population of 1,900 citizens. Today, the population of Creve Coeur is 16,759 spanning 11.36 square miles with approximately 7,600 housing units. Currently, Creve Coeur has 80 miles of public streets and 16 miles of private streets. Home to two private colleges, five private high schools,

could effectively engage in the core government functions of land use: planning, zoning, permitting, etc.[147] To be sure, such powers dramatically protected the color line. As one commentator made clear in 1957, these new "suburban" municipalities deployed these powers to full effect "to keep Negroes out."[148]

> Some, for example, have set a minimum of two or more acres for a house site, or required expensive street improvements, and have enforced these regulations against 'undesirable' developments but waived them for 'desirable' ones. A builder in a Philadelphia suburb recently told an interviewer that he would like to sell houses to Negroes, but the town officials would ruin him. He explained: 'The building inspectors would have me moving pipes three eights of an inch every afternoon in every one of the places I was building and moving a pipe three eights of an inch is mighty expensive if you have to do it in concrete!'[149]

Fragmentation was also being catalyzed by the continued expansion of county government throughout the United States as the counties "were supplementing and

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> five private primary schools, two public school districts and approximately fifteen houses of worship, Creve Coeur is a place where everything a resident needs is no more than ten minutes away.

[147] Sandalow, *supra* note 145, at 644. Moreover, contemporary commentators wrote prolifically about the need to restructure local government to serve several societal ends. Some demonstrative accounts are: Charles Abrams, *The Legal Basis for Reorganizing Metropolitan Areas in a Free Society*, 106 PROC. OF THE AMER. PHIL. SOC'Y 177 (1962); Robert C. Wood, *Metropolitan Government, 1975: An Extrapolation of Trends: The New Metropolis: Green Belts, Grass Roots, or Gargantua?*, 52 AM. POL. SCI. REV. 108 (1958); Wilfred D. Webb, *Metropolitan Government: A Challenge of the Twentieth Century*, 35 TEX. L. REV. 995 (1957); William C. Havard & Alfred Diamant, *The Need for Local Government Reform in the United States*, 9 W. POL. Q. 967 (1956); and Harvey Walker, *Toward a New Theory of Municipal Home Rule*, 50 NW. U. L. REV. 571 (1955). A synthesis of the legal and political arguments and ideological positions made in favor of or against a more robust use of home rule and metropolitan government are found in David J. Barron, *Reclaiming Home Rule*, 116 HARV. L. REV. 2255, 2322–34 (2003).

[148] Morton Grodzins, *Metropolitan Segregation*, 197 SCI. AM., OCT. 1957, at 33–34.

[149] *Id.* Also see the observation made by one commentator that

> [n]ew municipal buildings, new roads and highways, urban renewal, and public playground and parks all require the exercise of the power of eminent domain. Consequently, all such activity seems to present means by which a segregation-minded community can improve their municipal facilities, while achieving the intended elimination of Negroes in certain areas.

Note, *Unconstitutional Racial Classification and De Facto Segregation*, 63 MICH. L. REV. 913, 922 (1964). Importantly, the author makes this observation in a note examining so-called "de facto" school segregation of the legal and political issues I explore in Part III, *infra* notes 174–78, and accompanying text.

often supplanting the municipality as providers of public services . . . . County home rule laws in seventeen states allowed counties to draft their own charters [and] frame their own structure of government . . . ." thus "allowing the county to act in place of the municipality."[150] Although cities such as Indianapolis, Kansas City, Denver, San Diego, Phoenix, and Albuquerque successfully utilized annexation to absorb vast tracts of land in the 1950s and early 1960s, jurisdictional boundary lines exploded ironically in response to planners' and cities' concerns with metropolitan cooperation.[151] From 1952 to 1962, nearly 1,200 new municipalities and 5,000 special districts were created in the United States.[152] Indeed, the creation of park boards, sewage and water districts, port authorities, and similar special purpose service units[153] to serve such municipalities or metropolitan areas possessed nearly unequivocal incorporated municipal power and authority,[154] and contributed to even further divisions in the new metro-zones.

Significantly, metropolises in the American West provided the model for radically reimagining the relationship between metropolitan governmental structures and a "confused" and confounding jurisdictional structure.[155] One of the most important examples is found in the so-called Lakewood Plan in 1958, which allowed Los Angeles County to offer to the recently incorporated City of Lakewood in Los Angeles a full package of municipal services. For the first time in the nation's history, a city relied "on the purchase of all of its basic services from a county . . . . [T]his activity lowered previous barriers to municipal incorporation. By 1960, there were twenty-six new cities in the county."[156] In at

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[150] TEAFORD, *supra* note 144, at 174.

[151] *Id.*, at 175–86. There is also strong evidence to indicate that some cities, particularly those in the South, heavily used annexation to prevent explicitly non-Whites from becoming a political majority. *See, e.g.*, Grodzins, *supra* note 149, at 41 (stating that "[t]he use of annexation to curb Negro political power . . . was an explicit argument used in the large-scale suburban annexation to Nashville in 1951").

[152] U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2008, at 263 tbl. 414 (2008), *available at* http://www.census.gov/prod/2007pubs/08abstract/stlocgov.pdf.

[153] "Of the seventy-nine metropolitan wide special-purpose districts existing in 1956, fifty-one had been created since 1930." TEAFORD, *supra* note 144, at 173.

[154] *See generally* Robert W. Tobin, *The Legal and Governmental Status of the Metropolitan Special District*, 13 U. MIAMI L. REV. 129, 130-39 (1958) (discussing the status of the metropolitan special district under state constitutional law); and *see* Wayne A. Brooks, *The Metropolis, Home Rule, and the Special District: A Discussion of the Legal Validity of the Special District in the Solution of Metropolitan Problems in California*, 11 HASTINGS L.J. 110, 112-14 (1959).

[155] *See* Brooks, *supra* note 154, at 111–12.

[156] Martin J. Scheisl, *The Politics of Contracting: Los Angeles County and the Lakewood Plan*, 1952–1964, at 45 HUNTINGTON LIBR. Q. 227, 229 (1982); *see also* GARY J. MILLER, CITIES BY CONTRACT: THE POLITICS OF MUNICIPAL INCORPORATION (1981) (analyzing the purpose and effects of the Lakewood Plan); TEAFORD, *supra* note 144, at 175 (describing the implementation of the Lakewood Plan among Los Angeles area municipalities).

least one documented case, a newly empowered local Water District in Oregon condemned the land of a Black family for the stated purpose of sanitation control and future development.[157] According to the Superintendent of the Water District, *color* and water were the two primary considerations its administrators considered when making its decisions, and for this reason, the acts were unconstitutional.[158] In most cases, however, the multiple acts of the governmental authorities were not so explicit. Nevertheless, the aggregate effects produced even more salient results as transformations in boundary law and jurisprudence and their subsequent impact on the economic and social value attributed to property in and between corporate boundaries made metropolitan color fragmentation even more complete and incapable of being unbound.[159]

Equally important was the impact of metropolitan boundary fragmentation serving as a counterutopia to the vision of proponents of eminent domain and urban renewal who were seeking both security and insularity from their Cold War, multiracial cities. Newly incorporated cities like South Gate in Los Angeles and Edina in the Twin Cities with their respective easy access to Disneyland or the new indoor suburban mall, for instance, only made more secure and evident powerful economic and cultural incentives drawing Whites to newly incorporated cities away from "blighted" and redeveloping "minority" neighborhoods.[160] To be sure, "new housing markets subsidized by the federal government[,] low taxes underwritten by relocating industry[,]"[161] changes in immigration law,[162] and the

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[157] Wiley v. Richland Water Dist., 5 Race Rel. L. Rep. 788, 789-90(D. Or. 1960).

[158] *Id.* at 788-90. One as of yet greatly unexplored aspect in this story is the role of water politics, the rule of prior appropriation, and the development of water special use districts in both the racialization of space and the spatialization of color in the rapidly growing multiracial metropolitan American West. I tentatively begin to explore this in regards to the Denver metropolitan area and the Denver Water Board's institution of a "blue" line in the 1950s. *See* Romero, *supra* note 42, at ch. 4. I argue that this "blue line" was literally a color line that flagged for Denverites emerging spatial differences between Whites and non-Whites in the metropolitan area.

[159] As Becky M. Nicolaides indicates, municipalities such as South Gate in Los Angeles were acting in their own highly racialized self-interest, especially as school integration threatened to pierce the corporate boundaries of the city. NICOLAIDES, *supra* note 126, at 272–327.

[160] To learn more about South Gate in Los Angeles and the importance of its proximity to the fantasy experience of Disneyland, *see* NICOLAIDES, *supra* note 126, at 264–71. To learn more about Edina and the cultural significance of the indoor suburban mall in post-World War II America, *see* TEAFORD, *supra* note 10, at 94–99; and Kenneth T. Jackson, *All the World's a Mall: Reflections on the Social and Economic Consequences of the American Shopping Center*, 101 AM. HIST. REV. 1111, 1114 (1996).

[161] SELF, *supra* note 17, at 16.

[162] A heavily understudied aspect of post-World War II metropolitan fragmentation is the impact of immigration, especially from Mexico, on the spatialization of the metropolitan color line in relation to Latinos. Indeed, one scholarly account in 1956 highlighted problems relating to public health, illiteracy, and crime where there was the highest concentration of "illegal" "wetbacks." Eleanor M. Hadley, *A Critical Analysis of*

containment of public housing and urban renewal to often multiracial urban cores, "signaled [for many Americans] their full assimilation into American life and its celebration of modernity and consumption."[163] Most importantly, by locating such "benefits" within highly contained jurisdictional boundaries, metropolitan fragmentation "rationalized [multiracial] segregation" while conflating "[W]hiteness and property ownership [and its security] with upward social mobility."[164] Because the boundaries were both dispersed and contained, and not the product of an overt racial project,[165] the result was fragmented and highly divisive metropolises that masked fundamental multiracial inequality.

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the Wetback Problem, 21 LAW & CONTEMP. PROBS. 334, 346–48 (1956). The racial impact of Mexican immigration and the importance of erecting color borders are symbolized in a prominent eugenics journal in 1926: "The Mexican peon does more than bring into the United States small pox. With his numerous offspring he tends to dilute our old American blood. Thus he is giving us a *new color problem*." ALEXANDRA MINNA STERN, EUGENIC NATION: FAULTS & FRONTIERS OF BETTER BREEDING IN MODERN AMERICA 91 (2005) (emphasis added). To be sure, such rhetoric likely contributed to the ways in which land use laws—from eminent domain to municipal incorporation—heavily impact the containment and dispersal of growing Latino communities throughout particularly the American Southwest. A suggestive example was the destruction of a largely Mexican American community in Los Angeles's Chavez Ravine to facilitate a "modern" Los Angeles and to lure the Brooklyn Dodgers to the city. *See* DON PARSON, MAKING A BETTER WORLD: PUBLIC HOUSING, THE RED SCARE, AND THE DIRECTION OF MODERN LOS ANGELES 163–86 (2005). For more recent accounts on the impact of immigration from Latin America and Asia in the twenty-first century, *see* Rick Su, A Localist Reading of Local Immigration Regulations, 86 N.C. L. Rev. (forthcoming 2008), *available at* http://ssrn.com/abstract=1126845; and Rick Su, *Notes on the Multiple Facets of Immigration Federalism*, 15 TULSA J. COMP. & INT'L L. 179 (2008) (discussing changes to immigration law).

[163] SELF, *supra* note 17, at 16.

[164] *Id.*

[165] One of the most important cases in this regard is *Gomillion v. Lightfoot*, whereby the United States Supreme Court invalidated the re-drawing of the boundaries of the City of Tuskegee by the Alabama Legislature from a square to a twenty-eight sided geographic configuration. 364 U.S. 339, 348(1960). *See also* Appendix to the Opinion of the Court, *id.* at 348 (illustrating the city boundaries of Tuskegee, Alabama). The effect of the new configuration was to make Tuskegee almost exclusively White. The Court, in a Fifteenth Amendment voting rights case, argued that the absence of "any countervailing municipal function" that would justify this change was overwhelming proof that the change was made to dilute completely the Black vote. *Id.* at 342. Due to its emergence in the South and its relationship to the Fifteenth Amendment, *Gomillion* and its fact patterns seemingly represent the racial anomalies of this region, rather than reflective of the ways that municipal boundary law to could be used to structure residential settlement and power. To be sure, a court in Michigan in 1963 rejected the claim that racial animus was behind the recent incorporation of municipality in the Detroit metropolitan area. Taylor v. Township of Dearborn, 120 N.W.2d. 737, 743-44 (Mich. 1963). As historians have documented, however, the Detroit metropolitan area was embedded with racial tension at almost every level. *See generally* SUGRUE, *supra* note 41 (discussing prevalence of racial tension in

A second critical transformation in the *Creve Coeur* case was the attempt by the Venables to use recent school desegregation cases to question the racially induced motives of local government decision makers. In particular, the Venables cited *Cooper v. Aaron*[166] to highlight how multiple levels of local and state governmental actors "pursued a program to prevent racial desegregation in the schools."[167] As the most visible and notorious flashpoint case for the American South's "massive resistance" to *Brown v. Board of Education*,[168] *Cooper* not only brought the nation to the edge of a constitutional crisis, but highlighted how salient race had become in the everyday decision making of local and state government and its citizenry. In fact, at the time that *Brown* was decided, the St. Louis Board of Education continued to operate the second-largest segregated public school system in the United States.[169] Though *Brown* made this system constitutionally suspect, "local, state, and federal governments all played a part in perpetuating segregation after 1954."[170] In fact, one contemporary noted *Brown*'s effect by reporting that numerous Southern municipalities were using urban renewal and other land use powers to foster school segregation "by moving minority families out of presently integrated neighborhoods."[171] Undeniably, such action was further accentuated by the fact that the United States Supreme Court had made unconstitutional the judicial enforcement of racially restrictive covenants in 1948—a case made all the more prescient because the fact patterns for the primary case took place only miles from the City of Creve Coeur.[172]

What made the use of the school desegregation cases even more compelling in this instance was the emergence of the politics and law debate in context of eminent domain. According to the city, courts could only inquire into the *purpose*, not the motive, of the taking:

> While the words motive and purpose are sometimes used as synonymous terms, yet in their application there is clear distinction between them. 'Motive' is that which prompts the choice or moves the will thereby

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Detroit). Though it is beyond the scope of this analysis, voting redistricting relied upon spatial segregation to articulate a "color-blind" response to voting access. *See, e.g.*, MICHAEL K. BROWN, ET AL., WHITE-WASHING RACE: THE MYTH OF A COLOR BLIND SOCIETY 193–222 (2003) (critiquing "color blindness" as "color-consciousness" in recent voting rights decisions).

[166] 358 U.S. 1 (1958).

[167] State *ex. rel.* City of Creve Coeur v. Weinstein, 329 S.W.2d 399, 409 (Mo. Ct. App. 1959).

[168] 347 U.S. 483 (1954).

[169] *See* GERALD W. HEANEY & SUSAN UCHITELLE, UNENDING STRUGGLE: THE LONG ROAD TO AN EQUAL EDUCATION IN ST. LOUIS 9 (2004).

[170] *Id.* at 16. Heany and Uchitelle document the role of metropolitan development, planning, urban renewal, and land use and housing policy in exacerbating color segregation and reinforcing racial antagonism. *Id.* at 16–20.

[171] Hirsch, *supra* note 81, at 429.

[172] *See* Shelley v. Kraemer, 334 U.S. 1, 1 (1948).

> inciting or inducing action, while 'purpose' is that which one sets before as the end, aim, effort or result to be kept in view or object to be attained. The purpose for which private property is condemned is the very basis of the right to condemn.[173]

According to this argument, as long as the city's taking was for a "public use," it did not matter whether racial animus played any part in the political decision making. In response, the Venables challenged the "narrow and technical position that the face of an ordinance is sacrosanct and that the basis for its enactment may not be judicially inquired into."[174] Such a position, according to the Venables, had never been the law in Missouri and "if it were ever the law anywhere in this country, it is no longer law since" the *Cooper v. Aaron* decision directly questioned the "evasive" and "ingenious" schemes local governments use to perpetuate segregation.[175]

The Missouri Court of Appeals dismissed the Venables' arguments as irrelevant and inapplicable to the legal proceeding.[176] Reinforcing the "property" versus "civil rights" divide that so vexed commentators in their analysis of *Brown*, the court simply noted that "[t]he facts before the [United States Supreme Court in *Cooper*] did not involve the right of a legislative body to condemn property."[177] Indeed, because the case involved the power of eminent domain to take private property for *public* use, the court agreed with the City's contention that a judicial body could never "inquire into the motives" that caused a municipal authority to exercise its power.[178] Rather, the only analysis the court argued it had legal jurisdiction to undertake was whether the purported taking was actually for "public use."[179] Relying both on state and national precedent for this limitation, the appellate court declared that

> once it is established that the use for which private property is appropriated is public, the judicial authority of the court is exhausted. *This means that courts have no authority to pass upon the motives of a legislative body in enacting a statute or an ordinance and are powerless to consider the question of what reasons actuated the legislative body in the passing of the statute or the ordinance . . . .*[180]

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[173] City of Kirkwood v. Venable, 173 S.W.2d 8, 13 (Mo. 1943) (quoting Kessler v. City of Indianapolis, 157 N.E. 547, 549 (Ind. 1927).

[174] Brief of Respondent at 17–18, State *ex. rel.* City of Creve Coeur v. Weinstein, 329 S.W.2d 399, No. 38358 (Mo. Ct. App. Apr. 21, 1959).

[175] *Id.* at 17.

[176] *Id.*

[177] State v. Weinstein, 329 S.W.2d 399, 410 (Mo. Ct. App. 1959).

[178] *Id.* at 405 (quoting JOHN LEWIS, A TREATISE ON THE LAW OF EMINENT DOMAIN IN THE UNITED STATES § 370 (3d ed. 1909).

[179] *Id.*

[180] *Id.* at 406. (emphasis added).

Despite the "seriousness of the charges" made by the Venables, the court could find no exception to this bright-line takings rule.[181] Though the Supreme Court's *Brown* decision ostensibly compelled a thorough examination about the form and consequence of local political decisions, the Missouri case made clear that land use and housing decisions did not require such an examination.[182] Land use policy thus worked as a "revivification—not the rejection—of that now tainted principle" of separate but equal[183] as judicial opinions and "neutral" land use practices accelerated and made normative color segmentation throughout the metro-zone.[184] In the end, the Venables' *only* defense was to prove that their family's dream home, taken by the recently empowered City of Creve Coeur, would not be used as a public park and playground.[185]

A highly myopic and color-blind consideration of "public use" thus emerged out of this jurisprudence. Ironically, a discourse centered on the zealous protection of property rights further effaced the issue of the color line from consideration. In 1958 in Dallas, Texas, for instance, one public hearing about urban renewal drew hundreds of opponents.[186] Some opponents "opposed urban renewal as socialistic."[187] Others worried about its abuse, particularly people of color who worried that Blacks and Mexican Americans had no place to go after being removed from Dallas slum areas. One final argument was made by a developer who warned that urban renewal "essentially gives the city council the key to every

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[181] *See Id.* at 410.

[182] *Id.*

[183] Hirsch, *supra* note 81, at 422.

[184] Cases challenging the racial motives of local municipalities were extremely rare, though some cases were decided with very limited success. *See, e.g.*, Deerfield Park Dist. v. Progress Dev. Corp., 186 N.E.2d 360 (Ill. 1962). In *Deerfield Park Dist.*, the land was condemned for park purposes after a developer proposed to build integrated housing. *Id.* at 362. In a collateral federal case, the court held that proof of a conspiracy to prevent integration by the government body would constitute a valid cause of action. Progress Dev. Corp. v. Mitchell, 286 F.2d. 222, 234-35 (7th Cir. 1961). On remand, however, the federal trial court said the conspiracy issue could not be raised as a result of res judicata and collateral estoppel arising out of the state case. Progress Dev. Corp. v. Mitchell, 219 F. Supp. 156, 161–63 (N.D. Ill. 1963); *see also* Recent Cases, *Civil Rights—Urban Renewal—Allegation of Conspiracy to Use Eminent Domain Power for Racially Discriminatory Purposes in Urban Renewal Program Does Not State a Federal Claim Under Civil Rights Act*, 81 HARV. L. REV. 1568 (1968) (discussing the court's holding in Progress Dev. Corp. v. Mitchell, 219 F. Supp. 156 (N.D. Ill. 1963)). More telling evidence was one urban renewal case that found that even though the city had knowledge that the program would completely displace almost all Black residents from the city altogether, the project was nevertheless valid. Barnes v. City of Gadsen, 174 F. Supp. 64, 68-69 (N.D. Ala. 1958), *aff'd*, 268 F.2d 593 (5th Cir. 1959).

[185] City of Kirkwood v. Venable, 173 S.W.2d 8, 11-13 (Mo. 1943).

[186] Robert B. Fairbanks, *The Failure of Urban Renewal in the Southwest: From City Needs to Individual Rights*, 37 W. HIST. Q. 303, 311–12 (2006).

[187] *Id.* at 313.

front door in Dallas."[188] These last two criticisms, in particular, marked the emergence of eminent domain as a heterotopia in the postmetropolis. On the one hand, eminent domain's effects were disproportionately borne by non-Whites. In urban renewal project after urban renewal project and master plan after master plan in the 1950s and 1960s, non-Whites were effectively removed from significant parts of the urban landscape while metropolitan fragmentation and municipal or county incorporation, racially biased housing policy as well as steering, and subtle racial hostility effectively rendered invisible and contained remaining non-Whites in highly segregated, underdeveloped municipal and urban fringe, unincorporated areas.[189]

On the other hand, the multicolor stratification and inequitable nature of the metropolitan landscape did not matter because it theoretically threatened to destroy the individual property rights of all citizens. This argument emerged most acutely in rapidly growing multiracial Western and Southwestern metropolises where the protection and preservation of private property—represented by the ubiquitous and greatly expansive American suburban home and lifestyle—became the primary panacea to the ills of corrupt, crumbling, and bounded corporate (and increasingly non-White) center-city municipalities.[190] Metropolitan spatial dispersal, reinforced through municipal boundary and land use law put into sharp relief the divide between liberty and equality.[191] The multiracial transformation of the American city in the second half of the twentieth century thus embodied newly emergent, but deeply rooted anxieties about the security of real property ownership in a United States where, only a generation before, private property had lost much of its allure.[192] Such anxieties would become further destabilized with ultimately abortive attempts at metropolitan-wide school integration schemes.

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[188] *Id.*

[189] For a paradigmatic example of this process, *see* LOWI, *supra* note 10, at 238–49. *See also* GERALD E. FRUG, CITY MAKING: BUILDING CITIES WITHOUT BUILDING WALLS 45–53 (1999) (discussing the modern law of municipal corporations and cities as "businesses"); Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. REV. 1115, 1144–64 (1996) (exploring the effects of local boundaries on metropolitan governance); Richard F. Thompson, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173, 1182–94 (1996) (responding to Richard Briffault's arguments). As Thompson pinpoints, city and suburban boundaries "become metaphors for an imagined racial geography" of the metropolitan whole. *Id.* at 1181. Literature on the relationship of the color line to the metropolitan fringe is vastly underdeveloped, but initial explorations are being made. *See* Michelle Wilde Anderson, *Cities Inside Out: Race, Poverty, and Exclusion at the Urban Fringe*, 55 UCLA L. REV. 1095 (2008).

[190] *See, e.g.*, NICOLAIDES, *supra* note 126, at 215–71; SELF, *supra* note 17, at 256–90.

[191] Professor Fairbanks argues that "[s]lum clearance went from a good that addressed a major urban problem (slums) to an evil that threatened individual rights." Fairbanks, *supra* note 188, at 325.

[192] *See* discussion of *Lochner* and the "new property," *supra* text and accompanying notes 116-121.

IV. PERFECTING THE HETEROTOPIA THROUGH THE DE JURE AND DE FACTO DISTINCTION

In 1970, the United States Commission on Civil Rights issued a statement before the Senate Subcommittee on Education.[193] At issue was an emerging and unsettled debate about the relevance of housing segregation to the denial of equal educational opportunities for particularly students of color.[194] According to the Civil Rights Commission, "[e]ven in those instances where school segregation is a result of housing patterns with no apparent complicity of school officials, government at all levels—local, State, or Federal—invariably is heavily implicated."[195] Though the Commission noted that proscribed color-conscious practices such as racial zoning ordinances or racially restrictive covenants continued to resonate in housing patterns, equally nefarious were "various exercises of local governmental authority, such as decision on building permits, location of sewer and water facilities, building inspection standards, zoning and land use requirements, and the power of eminent domain [that] have been used to exclude minority group members from designated neighborhoods and even entire communities."[196] The point, according to the Commission, was that the segregation of schools was "not accidental or purely *de facto*. In many cases, it has resulted in whole or in part from an accumulation of governmental actions."[197]

Importantly, the question of "motive," as in the eminent domain cases, was becoming judicially parsed as a question of de facto versus de jure segregation. The Supreme Court first raised the issue of de facto versus de jure discrimination in the 1970 *Swann v. Charlotte-Mecklenburg Board of Education* opinion,[198] although the distinction itself and the precise constitutional and political issues began to emerge in school desegregation jurisprudence nearly a decade earlier. As the battle to desegregate public schools turned to Northern and Western cities from "Connecticut to California" in the years after *Brown*,[199] color blindness and color

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[193] *Statement of the United States Comm. On Civil Rights Concerning the "Statement by the President on Elementary and Secondary School Desegregation": Hearings Before the Subcomm. on Education of the Comm. on Labor and Public Welfare*, 91st Cong. 347 (1970).

[194] *Id.*

[195] *Id.* at 352.

[196] *Id.* at 352–53.

[197] *Id.* at 354.

[198] 402 U.S. 1, 17–18 (1970). Three years later, in *Keyes v. Sch. Dist. No. 1*, the Court reaffirmed its commitment to the distinction in analyzing the first non-Southern school desegregation case to reach the Court. 413 U.S. 189, 208–13 (1973).

[199] June Shagaloff, *A Review of Public School Desegregation in the North and West*, 36 J. OF ED. SOC. 292, 292 (1963). By 1962, the National Association for the Advancement of Colored People (NAACP) had inaugurated political action and litigation in sixty-nine non-Southern cities and communities, including Phoenix, Arizona; Berkeley, Los Angeles, Oakland, and Sacramento, California; Stamford, Connecticut; Detroit, Michigan; Cleveland, Ohio; Plainfield, New Jersey; New York City, New York; and surrounding

consciousness collided directly in the question of the practical effect courts and municipal authorities should give to the concentration of Whites and non-[W]hites in segregated communities and schools.[200] Accordingly, the multicolor geography of the postmetropolis in conjunction with land use law and policy in contrast to school integration jurisprudence served to create, in Foucault's understanding of the heterotopia, "several spaces, several sites that are in themselves incompatible."[201] The line between de facto and de jure racial space therefore resolved this incompatibly by juxtaposing effectively a problematic distinction between the "perfect" and "meticulous" space of color blindness in contrast to the "messy," "ill constructed," and "jumbled" state of color consciousness.[202]

A. Northern-Western Cities and Color Consternation

The emergence of de facto versus de jure segregation as distinct processes seems to have been a product of the post–World War II, if not post-*Brown* United States.[203] In these formative years, commentators recognized problems in understanding *Brown* and the issue of racial segregation as a regional—as opposed to a nationwide—issue. Will Maslow, Executive Director and General Counsel of the American Jewish Congress, for instance, gave an address before the Villanova Law Forum to discuss public school desegregation outside of the American South in 1961:[204]

> Understandably, the problem of Northern *de facto* segregation has been obscured by the spectacular events in the South in the last six years. The federal troops in Little Rock, the closing of schools in Virginia, the riots in New Orleans—in a word—the massive resistance of the South to the Supreme Court's mandates have preempted the nation's concern.[205]

For Maslow, this was surprising given the fact that nearly half of the nation's Black community lived outside of the South and that New York City's million plus

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municipalities in New York City, New York; Portland, Oregon; and Philadelphia, Pennsylvania. *Id.* at 292 nn.1 & 3.

[200] Hubert Humphrey noted the multiracial component of Northern and Western school integration: "The problem of the North and West . . . is achieving meaningful integration . . . composed almost entirely of Negro, Puerto Rican, or Mexican students." HUBERT H. HUMPHREY, INTEGRATION VS. SEGREGATION 152 (Hubert H. Humphrey ed., 1964).

[201] Foucault, *supra* note 11.

[202] *Id.*

[203] A full legal and intellectual history of the emergence of these terms in political and legal thought is outside the scope of this analysis. Though my analysis is meant to be suggestive in this regard, much more scholarship needs to be done on this precise issue.

[204] Will Maslow, *De Facto Public School Segregation*, 6 VILL. L. REV. 353 (1961) (article based on address).

[205] *Id.* at 353–54.

African American residents, constituted "the largest Negro urban bloc in the world."[206] Moreover, this was not just a Black and White issue. Metropolitan areas similar to New York, San Francisco and Los Angeles, Maslow's address and article pointed out, also contained concentrated and segregated Latino and Asian American communities.[207]

In the immediate years after *Brown*, political and legal commentators understood that the color line between "White and non-White" citizens was becoming, even more than in the South, the "acute" problem of Northern and Western cities.[208] Indeed, in an eighteen-month period from 1961 to 1962, 43 cities in 14 states outside of the American South were actively "agitating against segregation and discrimination."[209] According to the United States Commission on Civil Rights, "numerically, it is doubtful that any single 18-month period since 1954 has seen as much intensive activity, *even in the Southern States*."[210] Yet, many of these same commentators were also indicating that the "color-line"[211] in these growing metropolitan spaces were different not only in degree, but in kind to that experienced in the Southern metropolises. Of primary importance was the general lack of Jim Crow laws and regulations that mandated segregation, particularly in public places, throughout the South. Instead, "new" and for some, much more insidious patterns of racial segregation were manifesting themselves through the meteoric rise of metro-zones in Northern and Western cities.[212] Although more thoughtful commentators recognized the primary role of a legal and political system in structuring the multiracial segregation of metropolitan space,[213] the term *de facto* emerged to distinguish Northern and Western urban and metropolitan segregation from its more celebrated and litigated *de jure* Southern counterpart. Within decades, the Northern-Western and Southern difference in this distinction would disappear as it came to more generally describe and rationalize multicolor segregation in the post–World War II American metropolis.

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[206] *Id.* at 354. Moreover, Maslow noted that Chicago, Philadelphia, Detroit, and Los Angeles all contained larger Black populations than Atlanta, Birmingham, Houston, or New Orleans. *Id.*

[207] *Id.* at 354–55. According to Maslow, New York City's Puerto Rican population was near three quarters of a million residents, many of whom were born in Puerto Rico. *Id.* Schools in San Francisco, Los Angeles, and Pasadena, California contained overwhelming majorities of Asian American or Mexican American children. *Id.* at 354–55 & 355 n.18.

[208] Grodzins, *supra* note 149, at 33.

[209] U.S. COMM'N ON CIVIL RIGHTS, CIVIL RIGHTS USA: PUBLIC SCHOOLS NORTH AND WEST 1962 1 (1962) [hereinafter CIVIL RIGHTS USA].

[210] *Id.* (emphasis added).

[211] *Id.* at 33.

[212] *Id.* at 33.

[213] *Id.* at 33–41. Much of the earlier efforts to begin to dismantle Northern school segregation in the year leading up to *Brown v. Board of Education* is documented in DAVISON M. DOUGLAS, JIM CROW MOVES NORTH: THE BATTLE OVER NORTHERN SCHOOL SEGREGATION, 1865–1954, at 219–73 (2005).

Not surprisingly, school desegregation jurisprudence emerged as a battleground to test the difference between de facto and de jure segregation. As a matter of legal analysis, the de jure and de facto distinction was a term of art, ironically, that had long been used in the law of municipal corporations,[214] though one of its earliest appearances in American law arose in the context of Black slavery.[215] The legal analysis accordingly turned upon the importance of "officially" endorsed "state" action in order to determine both the scope and extent of liability of incorporated de jure as opposed to oftentimes technically deficient de facto bodies;[216] and significantly as well, this same question resonated through much of the body of race cases that predated *Brown*.[217] To be sure, in all these doctrinal areas, commentators, lawyers, and judges were recognizing the limitations of the de jure (e.g., state-public) versus de facto (private) distinction. In the world of business law, for instance, the 1950 Model Business Corporation Act chose to eliminate the de jure versus de facto distinction altogether because of tortured and inconsistent jurisprudence around this issue.[218] In a similar vein, the United States Supreme Court in the 1948 St. Louis racially restrictive covenant case, *Shelley v. Kraemer*, found such covenants, though still privately permissible, not enforceable by a court of law because they violated the Fourteenth

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[214] *See, e.g.*, Daniel R. Mandelker, *Municipal Incorporation on the Urban Fringe: Procedures for Determination and Review*, 18 LA. L. REV. 628, 644–46 (1958) (explaining the significance of de jure versus de facto particularly in municipal corporations).

[215] See, for example, Selectmen v. Jacob, 2 Tyl. 192 (Vt. 1802), an 1802 slave case from Vermont, for one of the earliest explorations in American law of the distinction between de facto and de jure. The defendant purchased a slave in 1783 and that slave continued to serve him, even after slavery was unconstitutional in the state, until the slave became sick and the state then had to bear the cost of the illness. *Id.* at 192. (The action was brought to recoup the money. *Id.* The court stated:

> [T]hough no person can hold a slave *de jure* by our constitution, yet there may exist among us a slave *de facto*. That if a master will hold an *African* in bondage as a slave, contrary to right, and for a succession of years, during which the slave *de facto* spends the vigour of her life in his service . . . there is a moral obligation upon the master to support her when incapable of labour . . . .

Id.

[216] Mandelker, *supra* note 214, at 644–46.

[217] The "White Primary" cases are extremely telling in regards to this point. *See, e.g.*, Smith v. Allwright, 321 U.S. 649, 666 (1944) (concluding that African Americans had as much right to participate in the primary elections of political parties as in general elections and that any rules eliminating their participation violated their constitutional rights); Grovey v. Townsend, 295 U.S. 45, 53 (1935) (holding that a Black resident who attempted to vote in the Democratic party primary in 1935 could not vote because it was a private organization, and the resident was a private citizen who was not subject to state action limitations under the Fourteenth Amendment).

[218] *See, e.g.*, 1 MODEL BUS. CORP. ACT ANN. 199–208 at § 6 (1960). Professor Mandelker, as well, notes the unhelpfulness of the de jure versus de facto distinction in municipal law, *supra* note 214, at 644–46.

Amendment's protection of a citizen's right "to acquire, enjoy, own, and dispose of property."[219] Though commentators now and then recognized *Shelley*'s tepid conclusions,[220] the Court nonetheless understood that when it came to the issue of race and property ownership, a bright line between private color consciousness and public color blindness was nearly impossible to define.[221]

Yet, at the same time that legal commentators were recognizing great limitations in the de jure versus de facto (as conceptualized as public versus private action) distinctions in American law, the concept gained immediate saliency as many struggled to come to grips with political and increasingly legal attempts in Northern and Western metropolises to integrate schools. Just seven years after *Brown*, a district court in New York became the first federal court to explicitly reference the de facto versus de jure distinction, though it never resolved its legal significance.[222] In 1966, the Fifth Circuit in *United States v. Jefferson County Board of Education* revealed how embedded and controversial this distinction had become in school desegregation law.[223] The court, in its review of desegregation plans in Alabama and Louisiana, noted that the "school problem" in these states had always been the product of state action and thus, it never had "to deal with nonracially motivated de facto segregation."[224] Accordingly, the court defined de facto segregation as "racial imbalance resulting *fortuitously* in a school system based on a single neighborhood school serving all [W]hite and Negro children in a certain attendance area or neighborhood,"[225] although its larger opinion suggested that wherever a racially segregated public school existed, such a distinction should not be of legal significance.[226]

The Fifth Circuit's struggle with the de jure versus de facto distinction in the Southern setting, however, highlighted the role of predominantly Northern industrial cities in providing for the conceptual origins of the distinction. One of the most important cases and one that the Fifth Circuit specifically felt compelled

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[219] 334 U.S. 1, 10 (1948). In St. Louis, where the *Shelley* case originated, such racial contracts set aside nearly five square miles of housing from black ownership. *Id.* at 5–6. In 1953 the Supreme Court expanded upon *Shelley* by not allowing damage awards when racial covenants were violated. Barrows v. Jackson, 346 U.S. 249, 260 (1953).

[220] *See* Rosen, *supra* note 47, at 457–58.

[221] *Shelley*, 334 U.S. at 21-23.

[222] *See* Taylor v. Bd. of Educ., 191 F. Supp. 181, 194 (S.D.N.Y. 1961). According to the court, the defendant school board submitted that these terms "must be used" and therefore, "'de jure' should refer to segregation created or maintained by official act, regardless of its form. 'De facto' should be limited to segregation resulting from fortuitous residential patterns. This decision does not purport to determine whether 'de facto' segregation, in this sense, is violative of the Constitution." *Id.* at 194 n.12; *see* discussion *infra* notes 247–279 and accompanying text.

[223] *See* 372 F.2d. 836 (5th Cir. 1966).

[224] *Id.* at 852.

[225] *Id.* (emphasis added).

[226] *See id.* at 861–78. While the Fifth Circuit pointed out that the "central vice" of a de jure system was racial apartheid, it nonetheless indicated that inaction in regards to de facto segregation of public schools was constitutionally proscribed. *Id.* at 867, 873–78.

to address was *Bell v. School City of Gary, Ind*, a 1963 school desegregation case that demonstrated the rationale used among some courts[227] (particularly those reviewing desegregation suits brought in Midwestern cities) to explain the consequential difference between de jure and de facto segregation.[228] Gary, according to one contemporary, presented "an almost classical example of de facto segregation."[229] The municipality was a "rapidly growing industrial city" that had experienced massive demographic and racial change in the years after World War II.[230] Such changes, the court also suggested, were magnified by the unique municipal geography of the city creating municipal boundaries in which the city was shaped like a capital "T."[231] Accordingly, the court highlighted the spatial distribution of the color line to this unique geography:

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[227] 213 F. Supp. 819, 820–22 (N.D. Ind. 1963).

[228] *See* Downs v. Bd. of Educ., 336 F.2d 988, 994-98 (10th Cir. 1964); Sealy v. Dep't of Pub. Instruction, 252 F.2d 898, 900-01 (3rd Cir. 1958); Deal v. Cincinnati Bd. of Educ., 244 F.Supp. 572, 579-82 (S.D. Ohio 1965); Lynch v. Kenston Sch. Dist., 229 F.Supp. 740, 742-46 (N.D. Ohio 1964); Webb v. Bd. of Educ., 223 F.Supp. 466, 467-69 (N.D. Ill. 1963), for cases that follow *Bell*'s rational in relying upon on the school board's good faith, lack of racial motivation, and the propriety of considering transportation, geography, safety, access roads, and other criteria as non-racially motivated bases school districting, even though there existed in each case schools that were almost exclusively White or non-White.

[229] John Kaplan, *Segregation Litigation and the School—Part II: The General Northern Problem*, 58 NW. U. L. REV. 157, 158 (1963).

[230] *Bell*, 213 F. Supp. at 820. According to the Court,

> [t]he population of Gary, according to the United States Census, in 1950 was 133,911 which included 39,326 Negroes. In 1960, the population was 178,320, of which 69,340 were Negroes. The student population in the public schools for the 1951-52 school year was 22,770, of which 8,406 or approximately 37% were Negroes. In the 1961-62 school year there were 43,090 students in the public school system and 23,055 or approximately 53% were Negroes.

Id.

[231] *Id.*

> Its north boundary line is the southern shore of Lake Michigan. The stem of the 'T' extends approximately seven miles from near the shore of Lake Michigan to the southern boundary of the city and is approximately two miles wide. The crossbar of the 'T' is approximately four miles wide and extends east and west a distance of approximately ten and one-half miles. Steel mills and other heavy industrial establishments are located primarily along the shore of the lake. The remainder of the territory is devoted to commercial and residential areas although some industry is located near the east and west portions of the crossbar of the 'T'.

Id.

> The Negro population in Gary is concentrated in what is generally called the "Central District" which occupies roughly the south half of the cross-bar of the "T" from east to west and is bounded on the north by the Wabash Railroad and on the south by the city limits and the Little Calumet River.[232]

Prior to 1949, Gary's schools were unevenly segregated as a result of Indiana state law.[233] After the state legislature repealed this law by "expressly prohibiting" racial segregation, school boards nonetheless had broad discretion, but often limited resources to respond to the massive demographic changes impacting the school district.[234] In fact, the court expressly pointed out the "tremendous effort made by the Board of Trustees and the school administration . . . to keep their students adequately and properly housed."[235] Moreover, the court noted, power and authority in the school district were exercised by a biracial and even multiracial staff and administration.[236] At issue was the decision by the Board of Education to redraw school attendance boundary lines after the completion of several new schools that would keep two preexisting and allegedly inferior all-Black schools segregated.[237] In rejecting the plaintiff's claim that such a decision was racially motivated, the court indicated that the school board's attendance boundaries were established in a "color blind" manner.[238] "[D]ensity of population, distances that the students have to travel and the safety of the children," without any thought or regard given to racial imbalance, according to the court, drove the local school board's decision making.[239] In summing up the issue, the court concluded "the problem in Gary is not one of segregated schools but rather one of segregated housing. Either by choice or *design*, the Negro population of Gary is concentrated in the so-called central area, and as a result the schools in that area are populated by Negro students."[240]

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[232] *Id.* at 822.

[233] *Id.*

[234] *Bell*, 213 F. Supp. at 822.

[235] *Id.* at 823.

[236] *Id.* at 825–26. It was significant for the court that the board of school trustees president, the assistant superintendent of schools in charge of the bureau of research and publication, the coordinator of secondary education, the supervisor of special education, the mathematics consultant in charge of the mathematics program in secondary education, the food services department coordinator, an elementary supervisor and a member of the Special Services Department—who devoted a large part of his work to the problem of proper boundary lines for attendance areas—were all Black. *Id.* Moreover, according to the court, "[t]here are 18 Negro principals and 38 white principals. The teaching staff consists of 798 [part-time] Negro teachers, 833 [part-time] white teachers and 3 orientals [sic]." *Id.*

[237] *Id.* at 827.

[238] *Bell*, 213 F. Supp. at 827.

[239] *Id.*

[240] *Id.* (emphasis added).

Other commentators and courts, however, were not so willing to give Northern municipal school boards such broad deference. Though school boards and other municipal agents in most Northern and Western municipalities had long been prevented from the deliberate racial segregation of school children under state law,[241] thoughtful commentators recognized that "it is immaterial that the word 'race' or 'Negro' is scrupulously avoided in official declarations."[242] To be sure, municipal authorities often acted in ostensibly "color-blind" ways (e.g., through the changing or manipulation of school attendance boundaries as well as transfer zones, the site selection of new schools, or the differential utilization as well as different curriculums between [W]hite and non-[W]hite schools) to create or perpetuate the color line in public schools.[243] In one of the earliest post-*Brown* cases, a school board in the border state of Ohio, where segregated schools had been outlawed since 1887, immediately closed three White schools after a handful of Black children enrolled and were assigned seats in these classrooms.[244] Such an action was made even more problematic because it occurred in the first school semester since *Brown* had been decided in May of 1954. After several days, the Board for the first time ever, "divided the city into three school zones" in order to integrate the district's elementary schools, but the practical effect was to maintain the preexisting school segregation of neighborhood schools.[245]

Perhaps no case, however, raised more consternation or provoked more controversy over the possibilities of non-Southern school desegregation than *Taylor v. Board of Education*.[246] According to the United States Commission on Civil Rights, "New Rochelle is important not only because it became the 'Little Rock of the North,' but because its case presented in microcosm so many of the vital moral, constitutional, and education questions facing the United States today,"[247] not least of which was its explicit reference to the de jure versus de facto distinction. On many levels, New Rochelle was emblematic of the spatial redistribution and the corresponding legal as well as social reimagination of the color line in post–World War II metropolitan America. Though incorporated prior

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[241] At the time *Brown v. Board of Education* was decided, four non-Southern states—Arizona, Kansas, New Mexico, and Wyoming—had statutes that permitted segregation. *See* JACK GREENBERG, RACE RELATIONS AND AMERICAN LAW 245 (1959). It is interesting to note that the prototypical Southern desegregation case, *Brown*, had fact patterns in the heart of a multiracial American West. *See* Tom I. Romero, II, *"Our Selma is Here": The Political and Legal Struggle for Educational Equity in Denver, Colorado, and Multiracial Conundrums in American Jurisprudence*, 3 SEATTLE J. SOC. JUST. 73, 103 (2004).

[242] Maslow, *supra* note 204, at 357–58.

[243] *Id*, at 357.

[244] Clemons v. Bd. of Educ., 228 F.2d 853, 855 (6th Cir. 1956).

[245] *Id.* at 855.

[246] 191 F. Supp. 181 (S.D.N.Y. 1961) (also referred to as the *New Rochelle* case).

[247] CIVIL RIGHTS USA, *supra* note 209, at 33. Many of the factual details of the *New Rochelle* case are taken from CIVIL RIGHTS USA, which is reproduced in an updated and slightly altered form in John Kaplan, *Segregation Litigation and the Schools—Part I: The New Rochelle Experience*, 58 NW. U. L. REV. 1, 28 (1963).

to the post–World War II municipal incorporation boom, New Rochelle symbolized the fragmented jurisdictional fault lines of American metropolitan areas. Its corporate boundaries made it a "long thin suburb of New York city . . . extending like a wedge into Scarsdale on the north."[248] Having a population of nearly 77,000 people in 1960, New Rochelle was a segregated suburb with distinct Black (center city), Italian (southwest), and Jewish (north) residential concentrations. [249] The population of the city historically started in the southern half of the town, yet a post-war housing boom spurred rapid development and movement of almost exclusively White ethnics to the northern part of the city.[250] Wedged in between historical White settlement in the southern and northern edges of the municipality was the city's Black population.[251] Moreover, like the post-1949 school system in *Bell*, the public schools operated their school system pursuant to a neighborhood school policy.[252] As a result, schools tended to be overly concentrated by color, and in some cases by ethnicity.[253]

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[248] CIVIL RIGHTS USA, *supra* note 209, at 34. According to the district court, "[t]he city has an elongated shape, its length from north to south being almost four times its average width." *New Rochelle*, 191 F. Supp. at 184.

[249] CIVIL RIGHTS USA, *supra* note 209, at 34.

[250] *New Rochelle*, 191 F. Supp. at 184. In response to this housing boom, moreover, the school board built "two new elementary schools—Ward and Davis" to serve these students. *Id.*

[251] *Id.* According to the district court, "[i]f a line were drawn east to west across the middle of New Rochelle, the area of predominantly Negro population would be found immediately south of that line, in the south central portion of the city." *Id.*

[252] The so-called neighborhood school system has long been a part of American public education, and according to its proponents, such a school served as a hub to the educational, recreational, and cultural needs of the neighborhood. *See* Dr. Carl F. Hansen, *The Role of Educators 1: Preparation for Integration*, 34 NOTRE DAME L. REV. 652, 654 (1959). Critics of the concept, however, challenged such schools for reinforcing and making more precise the spatial distribution of the color line in contemporary American cities. As one scholar argued:

> The modern-day neighborhood school cannot be equated with the common school of yesteryear—the latter constitutes America's ideal of a democratic institution—a single structure serving a heterogeneous community in which children of varied racial, cultural, religious, and socio-economic backgrounds were taught together the—proverbial melting pot. Because of rigid racial and socio-economic stratification, ethnic and class similarity has become the most salient present-day neighborhood characteristic, particularly in urban areas. The neighborhood school, which encompasses a homogeneous racial and socio-economic grouping, as is true today, is the very antithesis of the common school heritage.

Robert L. Carter, *De Facto School Segregation: An Examination of the Legal and Constitutional Questions Presented*, 16 W. RES. L. REV. 502, 506–07 (1965). The Lincoln Elementary School and its attendance district, was at the center of the litigation in New Rochelle because, according to the district court, the school

Beginning sometime in the 1930s, the district court found that the school board began to act in color-conscious ways in regard to the "Negro" school, Lincoln Elementary.[254] Most conspicuous was the constant "gerrymandering" of the school attendance boundaries for this school in response to African American residential growth.[255] Also relevant was a school board policy, in effect as late as 1949, that allowed children to transfer out of the Lincoln school attendance district.[256] According to the court, this "produced the anomaly . . . of children living in adjoining houses attending different schools solely on the basis of their race . . . . The inevitable result of this transfer policy, when combined with the earlier gerrymandering, was that by January of 1949, Lincoln had become a 100% Negro school."[257] Shortly thereafter, "in response to a growing number of complaints from Negro and prointegration [W]hite groups," the New Rochelle School Board "announced a rigid zoning policy whereby transfer out of the zone of residence were in effect prohibited."[258] Though this did increase the non-Black population to 6 percent of the Lincoln school, "few of the area's [W]hite students . . . returned to Lincoln. They either entered parochial and other private schools, or moved out of the Lincoln district within a year or two."[259]

> lies in the center of this Negro area. Bordering Lincoln are five other elementary school districts—Mayflower, Stevenson, Washington, Columbus and Webster—all of which contain a substantial Negro population. Washington school has a Negro enrollment of greater than 50%, while the Negro enrollment of the other four schools varies from approximately 17% to approximately 30%.

New Rochelle, 191 F.Supp. at 184. The neighborhood school policy utilized by New Rochelle's school board compelled it, by the time of the litigation, to divide the city into twelve districts in which attendance was determined by proximity to the school, safety, and school capacity to support educational, recreational, and community needs. Taylor v. Bd. of Educ., 294 F.2d 36, 42, 44 (2nd Cir. 1961) (Moore, J. dissenting).

[253] Moreover, Second Circuit Judge Moore, dissenting in the appeal to this case, highlighted the fact that there were concentrated Italian and Jewish schools in New Rochelle as well. *Taylor*, 294 F.2d at 51. Like many commentators at the time, Judge Moore conflated race and ethnicity and failed to appreciate this distinction in the significance of the color line between White and non-White populations. *See* Romero, *supra* note 22, at 255, 259, 286.

[254] One of the issues pertaining to the school's segregated character was its name. The school was built in 1898 and was named the Winyah Avenue School. Sometime prior to 1930, the name was changed to Lincoln. For some, the change to Lincoln, "as the man who freed the slaves" was evidence of racial cognizance on the part of the school board. CIVIL RIGHTS USA, *supra* note 209, at 33. For others, the name reflected simply the change of Winyah Avenue to Lincoln Avenue because it was easier to pronounce. *Id. at* 35.

[255] *New Rochelle*, 191 F. Supp. at 185.

[256] *Id.*

[257] *Id.*

[258] CIVIL RIGHTS USA, *supra* note 209, at 35.

[259] *Id.*

What followed in the years leading up to the litigation between 1949 and 1960 underscored both the potential and restraints in *New Rochelle* and by implication, *Brown v. Board of Education*, to shape the color geography of the United States's exploding metropolitan landscape. Like hundreds of municipalities across the country, New Rochelle created and supported a municipal Interracial Committee and during the 1950s, one of the school board members, Kenneth Low, was the Interracial Committee's Chair.[260] Though such municipal agencies had very limited power, they nevertheless reflected the Myrdallian turn in American history and the concomitant focus of municipal and state authorities to be acutely concerned about race relations and inequality.[261] As the district court itself noted, such concerns became especially prescient for school boards in the wake of the *Brown*:

> It called for responsible public officials throughout the country to reappraise their thinking and policies, and to make every effort to afford Negroes the more meaningful equality guaranteed to them by the Constitution. The *Brown* decision, in short, was a lesson in democracy, directed to the public at large and more particularly to those responsible for the operation of the schools. It imposed a legal and moral obligation upon officials who had created or maintained segregated schools to undo the damage which they had fostered. And, compliance with the Supreme Court's edict was not to be less forthright in the North than in the South; no double standard was to be tolerated.[262]

In spite of sustained and constant pressure from various groups,[263] however, the Board did little to respond to the issue at Lincoln Elementary. Its most notable response was to hire one of the nation's preeminent human relations experts, New York University human relations professor Dan Dodson, to study the problem. Dr. Herbert Clish, who was Superintendent of the New Rochelle schools—and at the time of the litigation, Dean of Education at St. John's University in New York—also prepared various reports. The Board in 1957 also proposed to rebuild a new Lincoln Elementary, though that proposal was opposed by the local branches of the Urban League and the National Association for the Advancement of Colored People (NAACP) and, partially as a result, was defeated in a municipal funding

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[260] This particular committee was known as the Mayor's Interracial Committee (later to become the Council for Unity) and New Rochelle's close proximity to New York placed it at the center of one of the primary hotbeds in the field of "human relations." CIVIL RIGHTS, USA, *supra* note 209, at 58. One historian notes that "hundreds of public and private intergroup relations agencies proliferated on the local, state, and national levels . . . . The majority of the organizations . . . were founded after 1940 in the industrial centers of the middle Atlantic, Midwestern, and Pacific coast regions." STUART SVONKIN, JEWS AGAINST PREJUDICE: AMERICAN JEWS AND THE FIGHT FOR CIVIL LIBERTIES 28 (1997).

[261] *See supra* notes 59–97 and accompanying text.

[262] *New Rochelle*, 191 F.Supp. at 187.

[263] *See Id.*; CIVIL RIGHTS USA, *supra* note 209, at 36.

election.[264] Despite the Board's alleged commitment to, in the words of the district court, "racial equality and the necessity for equal opportunities . . . it has taken no action whatsoever to alter the racial imbalance in the Lincoln School. It has met the problem with mere words, barren of meaning, for they were never followed by deeds."[265]

Moreover, the court also indicated a more nefarious motive on behalf of the Board when, in May 1960, it again submitted to referendum the issue of whether Lincoln should be rebuilt.[266] The court's analysis of this election speaks directly to the ways in which color spatialization in New Rochelle influenced the issue: "The Board's activities in an attempt to gain public support for the proposal . . . permitted the issue of segregation to be insinuated into the referendum campaign, to the extent that all other factors became obscured. The 'status' fears of persons in the districts bordering Lincoln were fostered."[267] Referencing in particular the stated concerns of a neighboring school's Parent-Teachers Association and administration's concerns about integration,[268] the district court found that the school board had deliberately and intentionally established a segregated school.[269] Arguing, as well, that there was no "legal or moral [distinction] between segregation established by the formality of a dual system of education, as in *Brown*, and that created by gerrymandering of school district lines and transferring of [W]hite children as in the instant case,"[270] the court made New Rochelle the first non-Southern school district to be in violation of the constitutional prohibitions of *Brown*.[271] Perhaps most importantly, the court declared that "it is of no moment whether the segregation is labeled by the defendant as 'de jure' or 'de facto,' as long as the Board, by its conduct, is responsible for its maintenance. *Constitutional rights are determined by realities, not by labels or semantics.*"[272] What this opinion indicated was that the "motives" of the school board and by implication, other municipal authorities, in this post-*Brown* era were, as a mater of morality and law, always subject to close analysis and scrutiny.[273]

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[264] *Id.*

[265] *New Rochelle*, 191 F.Supp. at 187.

[266] *Id.* at 190.

[267] *Id.*

[268] *Id.* at 190–91, n.8; *see also* CIVIL RIGHTS USA, *supra* note 209, at 56–57, 70.

[269] *New Rochelle*, 191 F.Supp. at 192–93.

[270] *Id.* at 192.

[271] Kaplan, *supra* note 247, at 4. As Professor Kaplan also noted, the 1956 case *Clemons v. Bd. Of Educ.*, 228 F.2d 853 (6th Cir. 1956), should not be considered precedent because "Hillsboro, Ohio, located across the Ohio River from Kentucky, was at this time more southern than northern in outlook." Kaplan, *supra* note 247, at 4 n.3. Unsuccessful challenges to segregated schools occurred in the metropolitan Detroit area in *Henry v. Godsell*, 165 F.Supp. 87 (E.D. Mich. 1958) and *Sealy v. Dept of Pub. Instruc.*, 159 F.Supp. 561 (E.D.Pa. 1957), *aff'd*, 252 F.2d 898 (3rd Cir. 1958).

[272] *New Rochelle*, 191 F.Supp. at 194. (emphasis added).

[273] *Id.* at 194–95.

Though the district court in *New Rochelle* was careful to note that it was not holding that there was no constitutional distinction between de jure and de facto segregation,[274] the case in the words of Northwestern University Law Professor John Kaplan, became the "'horrible example' to be brought up when the issue arises in city after city in the North."[275] Yet, Professor Kaplan himself stated that though the case "was undoubtedly correct," it was only of limited application largely because racial motivation cases were "extremely difficult and expensive to establish."[276] In addition, the fact patterns in *New Rochelle* were reflective of only a relatively brief moment of transition and racial conflagration in many of the nation's industrial, oftentimes neighborhood-rooted cities. To be sure, neighborhood and concomitant school attendance boundaries were too porous, too unstable, and too transitory to serve as a color line in the nation's cities. Redlining, block busting, the issue of school integration, and market incentives buttressed by exclusionary public policies were all contributing to the "flight" of White ethnics out of not only these neighborhoods, but to new communities in new, but almost exclusively White municipalities.[277]

Moreover, the concept of race and color itself was in a critical stage of transition. For instance, one issue that vexed the School Board and later, a dissenting Second Circuit judge hearing the case was the existence of majority Italian American and Jewish schools in New Rochelle.[278] Because of this, "the Board maintained," there was "nothing really very wrong in the Lincoln imbalance."[279] However, as the district judge hearing the case himself emphatically declared, the "Constitution *is not this color blind.*"[280] *Brown*'s primary and perhaps ultimate meaning, the judge suggested in this statement, was its explicit attack on

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[274] *Id.* at 194 n.12.

[275] Kaplan, *supra* note 247, at 4.

[276] *Id. at* 157.

[277] *See, e.g.*, DOUGLAS, *supra* note 213, at 265–73; LASSITER, *supra* notes 133, 69–118, 198–221, and 276–323; SUGRUE, *supra* notes 41, 181–258.

[278] *Taylor*, 294 F.2d at 50 (Moore, J. dissenting); Kaplan, *supra* note 247, at 25–26, 30.

[279] Kaplan, *supra* note 247, at 25. Professor Kaplan, in his companion piece, also collapses the color line with ethnic difference; though he does suggest a color line does indeed exist between Whites and Blacks as well as American Indians:

> [U]nless the Negro is claiming a place as the special ward of the Constitution (a status which admittedly has some historical support) it is hard to frame a reason why the same rights should not be extended to other ethnic groups—Mexican Americans, Italian Americans, Jews, and Orientals.
>
> True, the history of the Negro over the past three hundred years had been such as to exert a moral claim on Americans beyond that of any other group with the possible exception of the American Indian.

Id. at 186. Kaplan, begrudgingly conceded however, that the "Puerto Rican and the Mexican American" claim "might be quite similar to that of the Negro." *Id.*

[280] *New Rochelle*, 191 F.Supp. at 196 (emphasis added).

White privilege, which was not "applicable to other minority groups"[281] whose members may have benefited in countless of substantive ways because of their ability to be on the White side of the color line.[282] As Theron Johnson—administrator of the Education Practices Act for the New York State Department of Education and head of the department's Intercultural Relations Division—testified during the case, Jewish and Italian students gained in tangible and meaningful ways from their status as Whites in ways that Blacks and other "minorities" including "Puerto Ricans in New York and Mexicans in the Southwest" did not.[283] While the case could only hint at the scope and breadth of the multicolor metropolitan segregation and fragmentation, it indicated unambiguously the primary importance of the White and non-White color line and the subsequent necessity of "color consciousness" to the constitutional analysis.[284]

B. Color and the Constitution in Metropolitan America

For these reasons, *New Rochelle* represented a direct attack on a "mystique" that had developed in constitutional jurisprudence about whether *Brown* compelled "desegregation" or "integration." Stated another way, the question was whether school boards and other state actors needed to be "color-blind" (which would favor desegregation) or "color-conscious" (which would favor integration) in their decision-making matrix. As various federal courts recognized in the 1960s,[285] this "mystique" originated in one of *Brown*'s companion cases, *Briggs v. Elliott*,[286] during remand. In what would become highly referenced dictum,[287] the federal

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[281] *Id.*

[282] It is interesting to note a nascent analysis emerging out of this era that begins to coalesce about a decade later in a body of historical analysis known as Whiteness studies. Some of the more important studies include MATTHEW F. JACOBSON, WHITENESS OF A DIFFERENT COLOR: EUROPEAN IMMIGRANTS AND THE ALCHEMY OF RACE (1998); IRA KATZNELSON, WHEN AFFIRMATIVE ACTION WAS WHITE: AN UNTOLD HISTORY OF RACIAL INEQUALITY IN TWENTIETH-CENTURY AMERICA (2005); GEORGE LIPSITZ, THE POSSESSIVE INVESTMENT IN WHITENESS: HOW WHITE PEOPLE PROFIT FROM IDENTITY POLITICS (revised ed., Temple University Press 2006); and Eric Arnesen, *Whiteness and the Historians' Imagination*, 60 INT'L LABOR AND WORKING-CLASS HIST. 3 (2001).

[283] Kaplan, *supra* note 247, at 25 n. 30.

[284] In fact, well known federal Judge J. Skelly Wright, in an article on de facto segregation, highlighted the centrality of the color line in "contemporary America" and the various ways, from a "public impression . . . that Negro schools . . . are per se inferior" to the various benefits of Whiteness. J. Skelly Wright, *Public School Desegregation: Legal Remedies for De Facto Segregation*, 40 N.Y.U. L. REV. 285, 292 (1965).

[285] *See, e.g.*, U.S. v. Jefferson County Sch. Bd., 372 F.2d. 836, 846 n.5 (5th Cir. 1966); Blocker v. Bd. of Educ., 226 F.Supp. 208, 220 (E.D.N.Y.1964).

[286] 132 F.Supp. 776 (E.D.S.C. 1955).

[287] *See, e.g.*, Boson v. Rippy, 285 F.2d 43, 48 (5th Cir. 1960); Kelley v. Bd. of Educ., 270 F.2d 209, 228–29 (6th Cir. 1959); Avery v. Wichita Falls Indep. Sch. Dist., 241 F.2d 230, 233 (5th Cir. 1956); Bell v. Sch., 213 F.Supp. 819, 829 (N.D. Ind. 1963); Jackson v. Sch. Bd., 203 F.Supp. 701, 704–05 (W.D. Va. 1962), *rev'd* on other grounds, 308 F.2d 918

court in *Briggs* felt that it was important to "point out exactly what the Supreme Court has decided and what it has not decided" in *Brown*: "[w]hat it has decided, and all that it has decided, is that a state may not deny to any person on account of race the right to attend any school that it maintains . . . . The Constitution, in other words, does not require integration. It merely forbids [segregation]."[288] Although *Brown* never made such a distinction, it became a constitutional reality for many courts that in turn greatly frustrated attempts to desegregate public schools, especially in the South.[289] One federal district judge in 1964 had become so exasperated by the widespread support of this line of reasoning among the judiciary that he questioned the process by which the segregation versus integration "construction draws continuing sustenance . . . in which each case relies upon the preceding one"; thereby stripping *Brown* of both its force and meaning.[290]

Accordingly, the *Briggs* dictum allowed courts in the South to limit and contain *Brown* in extremely pernicious ways. Particularly as courts became more removed both in time and distance from *Brown* and the "massive resistance" it engendered, it masked the fact that this same issue would reemerge in the North and West in the guise of de facto and de jure segregation. To be sure, the *Bell* case was a harbinger of four interconnected arguments made by state and federal courts

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(4th Cir. 1962); Vick v. Bd. of Educ., 205 F.Supp. 436, 439 (W.D. Tenn. 1962); *see also* Dillard v. Sch. Bd., 308 F.2d 920, 926–27 (4th Cir. 1962) (Bryan, J. dissenting) (referencing *Briggs* and saying that integration is not necessarily required simply because segregation is prohibited); Taylor v. Bd. of Educ., 294 F.2d 36, 47 (2d Cir. 1961) (Moore, J. dissenting) (making the same point as the *Dillard* Court); *cf.* Montgomery v. Gilmore, 277 F.2d 364, 368–69 (5th Cir. 1968) (holding that closing public parks rather than enforcing segregation was not unconstitutional); Evers v. Jackson, 328 F.2d 408, 410 (5th Cir. 1964) (holding that the Constitution does not demand integration but only prohibits segregation); Stell v. Savannah-Chatham Cty. Bd. of Educ., 333 F.2d 55, 59 n. 2 (5th Cir. 1964) (stating that integration is not required but segregation is prohibited); Bradley v. Sch. Bd., 317 F.2d 429, 438 (4th Cir. 1963) (holding that a school is not required to integrate students, but must not reject a student based on race); Jeffers v. Whitley, 309 F.2d 621, 629 (4th Cir. 1962) (holding that a school is not required to integrate students, but must not reject a student based on race); Kelley v. Bd. of Educ., 270 F.2d 209, 228–29 (6th Cir. 1959) (holding that students may choose to attend schools only with members of their race); Cohen v. Pub. Hous. Admin., 257 F.2d 73, 78 (5th Cir. 1958) (holding that voluntary segregation in public housing is not forbidden); Sch. Bd. v. Atkins, 246 F.2d 325, 327 (4th Cir. 1957) (stating that although schools may not refuse students based on race, integration is not required); Borders v. Rippy, 247 F.2d 268, 271 (5th Cir. 1957) (stating that integration is not required but segregation is prohibited); County Sch. Bd. v. Allen, 240 F.2d 59, 62 (4th Cir. 1956) (integration not required in schools); Thompson v. County Sch. Bd., 204 F.Supp. 620, 625 (E.D. Va. 1962) (stating that "[t]he *Brown* case does not require complete or enforced integration"); Evans v. Buchanan, 207 F.Supp. 820, 823–24 (D. Del. 1962) (reasoning that segregation for geographic or transportation reasons is not violative).

[288] *Briggs*, 132 F. Supp. at 777.

[289] *See supra* note 287.

[290] Blocker v. Bd. of Educ., 226 F.Supp. 208, 220 (E.D.N.Y. 1964).

used to hold that *Brown* did not apply to what eventually became called "de facto," as opposed to "de jure" racial segregation. First, coming directly out of *Briggs* was the proposition that *Brown* only prohibited racial segregation, it did not compel school boards or other state authorities to respond in their attendance policy to "fortuitous" residential segregation.[291] Second, these courts held that to require integration or color consciousness would violate the principle that the Constitution is "color-blind," and in some cases, could lead to "reverse" discrimination if not applied "equally" to other groups.[292] Third was the argument that *Brown* was limited exclusively to intentional and deliberate segregation on the part of school boards or state authorities, and therefore, was inapplicable to private conduct.[293] Finally, there was the assumption that all of these school boards were acting in "good faith" to implement complicated and sound educational policy, of which the neighborhood school was at the center.[294] To fundamentally disrupt these practices in the service of integration would create more troubling "dangers" and "inconveniences" for students, parents, and school boards.[295] Collectively, all of

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[291] *See supra* note 287.

[292] *See* Lynch v. Kenston Sch. Dist. Bd. of Educ., 229 F. Supp. 740, 743 (N.D. Ohio 1964); Strippoli v. Bickal, 248 N.Y.S.2d 588, 599–600 (N.Y. Sup. Ct. 1964); Balaban v. Rubin, 242 N.Y.S.2d 973, 977 (N.Y. Sup. Ct. 1963); *see also Taylor*, 294 F.2d at 50 (Moore, J. dissenting); Note, *The Constitutionality of De Facto Segregation*, 41 N. D. L. REV. 346, 348–49 (1964) (discussing the "theory that the Constitution is color-blind"). One commentator notes that this argument typified cases by White children and their parents to prevent school boards from voluntarily attempting "remedy racial imbalance." Roger L. Goldman, *Benign Racial Classifications: A Constitutional Dilemma*, 35 U. CIN. L. REV. 349, 354 (1966). Professor Kaplan, moreover, suggested that Polish, Italian, Jewish and the working, regardless of ethnicity, may all have claims if such an argument was allowed to proceed. Kaplan, *supra* note 247, at 186–87. A related argument also concerns whether *Brown* was like *Lochner* and thus, inappropriately privileged racial equity over other constitutional rights. *See* Kaplan, *supra* note 247, at 179–80; *supra* text and accompanying notes 116–121.

[293] *See, e.g.*, Cragget v. Board of Educ., 234 F. Supp. 381, 386 (N.D. Ohio, 1964) (finding no "deliberate design to segregate"); Webb v. Bd. of Educ., 223 F. Supp. 466, 468 (N.D. Ill. 1963) (stating that "the only basis for equitable relief must be found in the form of . . . intentional segregation").

[294] *See, e.g.*, Henry v. Godsell, 165 F. Supp. at 87, 90 (E.D. Mich. 1958) (describing how school board actions served community needs); Northcross v. Bd. of Educ., 302 F.2d 818, 824 (6th Cir. 1962) (stating that the school board "honestly and sincerely desire[d] to comply with the law").

[295] *Taylor*, 294 F.2d. at 51; Evans v. Buchanan, 207 F. Supp. 820, 824 (D. Del. 1962); *see* Note, *The Constitutionality of De Facto Segregation*, *supra* note 292, at 350–51. To be sure, the emergence of "busing" as a remedy to desegregate schools made this argument even more of a flashpoint. The *Clemons* case stands as an interesting testament to a school board who claimed "good faith," but whose policies contributed unambiguously to racial segregation. Clemens v. Bd. of Educ., 228 F.2d 853, 857-58 (6th Cir. 1956). Professor Kaplan, however, indicated that

these arguments operated under the assumption that racial segregation was inevitable and even natural; a point made explicit by the term de facto.

The semantic hurdles that both commentators and courts took to deny the existence of White privilege (or on the flip side, to justify its "natural" consequence), led Federal Judge J. Skelly Wright—himself a prominent and much reviled figure in the battle to give *Brown* actual effect in the South—to observe:

> As I read these de facto segregation cases from the North and West, I must confess to a little amusement. After watching from close range, some of my judicial brethren in the South twisting and turning and reaching a result in race cases that will not upset the status quo or the local power structure, it seems that now I may be treated to what appear to be similar performances by my brethren in other parts of the country.[296]

Referencing in particular the Gary, Indiana *Bell* case and the rationale the court used therein, Judge Wright made two critical observations. First, state action in these cases should not be limited to a myopic focus solely on school boards.[297] Rather, Judge Wright suggested that all facets of the state—from state housing policy to local government—could and should be implicated in the existence of racial segregation.[298]

Second, Judge Wright argued directly that those who "covertly . . . want to maintain the segregated status quo cry: 'The Constitution is color-blind.'"[299] This aphorism and cliché, according to Judge Wright, was not only misunderstood, but flew in the face of not only *Brown*'s aspirational principles, but many states' equally explicit concerns with racial equality in the years after World War II.[300] Simply put, the events of World War II and the civil rights movements and the law resulting therefrom, including *Brown v. Board of Education* as well as the various

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> in view of the enormous variety of local conditions which might influence a school board to adopt one system of school organization instead of another, perhaps the best that we can expect from the courts in this area is to ensure that the political bodies remain neutral as far as race is concerned.

Kaplan, *supra* note 247, at 186.

[296] Wright, *supra* note 284, at 294.

[297] *Id.* at 296–97.

[298] *Id.* at 295–97.

[299] *Id.* at 297.

[300] Judge Wright, in particular highlighted efforts by state actors in New York, New Jersey, and California to take direct and explicit actions to reduce racial imbalance in their schools. Wright, *supra* note 284, at 298. As part of a larger moment in American urban history, however, this was reflected in the hundreds of human relations agencies formed in these and other, particularly Northern and Western states as well. *See supra* notes 260 and accompanying text; *see also* St. Antoine, *Color Blindness, But Not Myopia: A New Look at State Action, Equal Protection, and "Private" Racial Discrimination*, 59 MICH. L. REV. 993 (1961) (discussing the intersection of private and state action).

state civil rights acts, culminating in the Civil Rights Act of 1964, indicated that states were extremely color-conscious. Echoing other courts and other commentators, Judge Wright made clear that color consciousness in the service of responding to inequity on the part of all state actors was not only a moral, but a legal duty[301] irrespective of whether the segregation was the result of a semantically dubious de facto versus de jure distinction.[302]

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[301] *See* Wright, *supra* note 284, at 301, *see also* Robert Allen Sedler, *School Segregation in the North and West: Legal Aspects*, 7 ST. LOUIS U. L.J. 228, 257–60 (1963) (discussing the application of "reasonable alternatives" in fulfilling duties). The Fifth Circuit argued that if "color-blindness" was the rule, the use of race on the census or adoption proceedings, for example, would be unconstitutional. United States v. Jefferson Cty. Bd. of Educ., 372 F.2d 836, 877 (5th Cir. 1966). Judge Wright made this same point in relation to the use of constitutional use of race in the Japanese American internment cases. Wright, *supra* note 284, at 297. Moreover, the Fifth Circuit highlighted that this was rooted in precedent designed to overcome racial inequity, rather than perpetuate it:

> [T]he Constitution is color conscious to prevent discrimination being perpetuated and to undo the effects of past discrimination. The criterion is the relevancy of *color* to a legitimate governmental purpose. For example, jury venires must represent a cross-section of the community. Strauder v. State of West Virginia, 1880, 100 U.S. 303, 25 L.Ed. 664. The jury commissioners therefore must have a 'conscious awareness of race in extinguishing racial discrimination in jury service.' Brooks v. Beto, 5 Cir. 1966, 366 F.2d 1. Similarly, in voter registration cases we have used the 'freezing principle' to justify enjoining the use of a constitutional statute where, in effect, the statute would perpetuate past racial discrimination against Negroes. United States v. State of Louisiana, E.D.La. 1963, 225 F.Supp. 353, *aff'd* 1965, 380 U.S. 145, 85 S.Ct. 817, 13 L.Ed.2d 709. 'It is unrealistic to suppose that the evils of decades of flagrant racial discrimination can be overcome by purging registration rolls of white voters . . . . Unless there is some appropriate way to equalize the present with the past, the injunctive prohibitions even in the most stringent, emphatic, mandatory terms prohibiting discrimination in the future, continues for many years a structure, committing effectual political power to the already registered whites while excluding Negroes from this vital activity of citizenship.' United States v. Ward, 5 Cir. 1965, 349 F.2d 795, 802. 'An appropriate remedy . . . should undo the results of past discrimination as well as prevent future inequality of treatment.' United States v. Duke, 5 Cir. 1965, 332 F.2d 759, 768.

Jefferson Cty. Pub. Sch., 372 F.2d. at 876-77 (emphasis added). *But see* Alexander Bickel, *Busing: What's to be Done?*, THE NEW REPUBLIC, Sept. 30, 1972, at 21–23.

[302] For cases indicating that "fortuitous" private housing segregation did not relieve a school board of its duty to integrate its schools in these formative decades, *see* Olson v. Bd. of Educ., 250 F.Supp. 1000, 1009-11 (E.D.N.Y. 1966); Barksdale v. Springfield Sch. Comm., 237 F.Supp. 543, 547 (D. Mass. 1965), *vacated on other grounds*, 348 F.2d 261 (1st Cir. 1965); Offerman v. Nitkowski, 248 F.Supp. 129, 131 (W.D.N.Y. 1965); Blocker v. Bd. of Educ., 226 F.Supp. 208, 229-30 (E.D.N.Y.1964); Blocker v. Bd. of Educ., 229 F.Supp. 709, 712-13 (E.D.N.Y.1964); Branche v. Bd. of Educ., 204 F.Supp. 150, 153-54 (E.D.N.Y.1962); Jackson v. Pasadena City Sch. Dist., 382 P.2d 878, 881-82 (Cal. 1962) (en

It would not be until the early 1970s that the United States Supreme Court would finally address this distinction, and not surprisingly, it would be in non-Southern school desegregation cases that the Court's post-*Brown* consensus would end. In a case that would challenge the widespread use of neighborhood schools by ordering busing as a remedy to segregation, the Supreme Court in *Swann v. Charlotte-Mecklenburg Board of Education* referenced for the first time "de facto segregation."[303] Defining the term as those situations "where racial imbalance exists in the schools, but with no showing that this was brought about by [the] discriminatory action of state authorities," the Court suggested that neither the Fourteenth Amendment nor statutory law would be able to deal with such situations.[304] Yet, *Swann* also responded directly to the nation's then-current metropolitan reality and the subsequent pervasiveness and spread of metropolitan-wide color segregation by attempting to deal forthrightly with the *Briggs* dictum, which had become a cornerstone of resistance to integration throughout the South, North, and West. Most substantively, the Court made clear that the urban school system of *metropolitan* Charlotte, North Carolina was directly influenced by the "familiar phenomenon in metropolitan areas" of non-Whites being "concentrated in one part of the city" while "Whites" moved and lived to other parts.[305] Though the Court noted that its decision was principally concerned with "a long history of officially imposed segregation" in Charlotte,[306] the Court held that the school board had a duty to integrate its schools in a metropolitan school system with 107 schools comprising over 84,000 students, a decision seemingly focused at

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banc); Guida v. Bd. of Educ., 213 A.2d 843, 844 (Conn. Super. Ct. 1965); Booker v. Bd. of Educ., 212 A.2d 1, 11-12 (N.J. 1965); Morean v. Bd. of Educ., 200 A.2d 97, 100 (N.J. 1964); Vetere v. Allen, 206 N.E.2d 174, 176 (N.Y. 1965); Van Blerkom v. Donovan, 207 N.E.2d 503, 505 (N.Y. 1965); Addabbo v. Donovan, 256 N.Y.S.2d 178, 183-84 (N.Y. App. Div. 1965), *aff'd*, 209 N.E.2d 112 (N.Y. 1965); Balaban v. Rubin, 248 N.Y.S.2d 574, 584-85 (N.Y. App. Div. 1964), *aff'd*, 199 N.Ed.2d 375 (N.Y. 1964); Strippoli v. Bichal, 250 N.Y.S.2d 969, 972-73 (N.Y. App. Div. 1964), *aff'd*, 209 N.E.2d 123 (N.Y. 1965).

[303] 402 U.S. 1, 17–18 (1971).

[304] *See Id.*

[305] *Id.* at 25. One particularly important passage from the opinion makes this point:

> People gravitate toward school facilities, just as schools are located in response to the needs of people. The location of schools may thus influence the patterns of residential development of a metropolitan area and have important impact on composition of inner-city neighborhoods . . . . (Action taken) to maintain the separation of the races with a minimum departure from the formal principles of 'neighborhood zoning' . . . does more than simply influence the short-run composition of the student body . . . . It may well promote segregated residential patterns which, when combined with 'neighborhood zoning,' further lock the school system into the mold of separation of the races. Upon a proper showing a district court may consider this in fashioning a remedy.

Id. at 20–21.

[306] *Id.* at 5–6.

reversing both de jure and de facto segregation.[307] It therefore imposed on metropolitan Southern school districts an affirmative duty, not just to desegregate, but to integrate.[308]

Despite facing cases whose fact patterns were rooted in the metropolitan South, the Court was in many ways addressing a more fundamental nationwide transformation of the city and the suburb in the post–World War II metropolitan United States. Accordingly, one method the Court endorsed to shatter the dividing line between these two spaces was the large scale transportation of students within a growing metropolitan area. [309] This in essence required the Charlotte-Mecklenburg school system to alleviate conditions that could not be characterized by historic, explicit state-imposed de jure segregation.[310] As Justice Powell reflected in a subsequent case,

> the familiar root cause of segregated schools in all the biracial metropolitan areas of our country is essentially the same: one of segregated residential and migratory patterns the impact of which on the racial composition of the schools was often perpetuated and rarely ameliorated by action of public school authorities. This is a national, not a southern, phenomenon. And it is largely unrelated to whether a particular State had or did not have segregative school laws.[311]

The prototypical national case for Justice Powell, in fact, would be decided two years later, when the Supreme Court, in the multiracial "tri-ethnic" Denver public schools case, *Keyes v. Denver School Board, No. 1*, had before it, for the first time, a non-Southern school desegregation fact pattern.[312] According to Justice Powell's concurring and dissenting opinion:

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[307] *See Id.* at 6.

[308] *Id.* at 14–15.

[309] *See Id.* at 29–31. For a history of this decision as well as the racial spatialization of the Charlotte metropolitan area, see Lassiter, *supra* note 133, at 121–221. Lassiter also references a gathering of anti-busing leaders from thirteen states in Memphis in the early 1970s to oppose metropolitan-wide integration plans. *Id.* at 314. One particularly important case study assesses the role of anti-busing and anti-integration sentiments in the metropolitan Boston area public school. RONALD P. FORMISANO, BOSTON AGAINST BUSING: RACE, CLASS, AND ETHNICITY IN THE 1960S AND 1970S (2003).

[310] *Swann*, 402 U.S. at 25–31.

[311] Keyes v. Sch. Dist. No. 1, Denver, Colo., 413 U.S. 189, 222–23 (1973) (Powell, J. concurring in part and dissenting in part).

[312] *See Id.* at 195–98 (majority opinion). For a fuller exploration of the history of this case as well as its implications for a multiracial school desegregation jurisprudence, see Tom I. Romero II, *Our Selma is Here: The Political and Legal Struggle for Educational Equality in Denver, Colorado and Multiracial Conundrums in American Jurisprudence*, 3 SEATTLE J. OF SOC. JUST. 73 (2004).

> The situation in Denver is generally comparable to that in other large cities across the country in which there is a substantial minority population and where desegregation has not been ordered by the federal courts. There is segregation in the schools of many of these cities fully as pervasive as that in southern cities prior to the desegregation decrees of the past decade and a half. The focus of the school desegregation problem has now shifted from the South to the country as a whole. Unwilling and footdragging as the process was in most places, substantial progress toward achieving integration has been made in Southern States. No comparable progress has been made in many nonsouthern cities with large minority populations primarily because of the de facto/de jure distinction nurtured by the courts and accepted complacently by many of the same voices which denounced the evils of segregated schools in the South. But if our national concern is for those who attend such schools, rather than for perpetuating a legalism rooted in history rather than present reality, we must recognize that the evil of operating separate schools is no less in Denver than in Atlanta.[313]

For this very reason, Justice Powell believed that this case, situated as it was in the urban Metropolitan West, was the perfect case to "abandon [the de jure versus de facto] distinction which long since ha[d] outlived its time, and formulate constitutional principles of national rather than merely regional application."[314]

Justice William Brennan's majority opinion in *Keyes*, however, reinforced rather than rejected the importance of the de facto distinction to the legal analysis.[315] Though the Denver school system had never operated under a statutorily imposed racially exclusive scheme, the Court found the school board to have purposefully carried out a plan—through its attendance schemes and administrative decision making—to segregate Black students living and going to school in neighborhoods undergoing racial transition.[316] Despite the majority opinion's willingness to reabandon the de jure versus de facto formulation, the *Keyes* case was indeed national in its orientation, but in two notable ways not contemplated by Justice Powell. First, the scrutiny of the Denver Public School

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[313] *Keyes*, 413 U.S. at 218–19 (Powell, J. concurring in part and dissenting in part). Compelling evidence for Justice Powell was 1971 Department of Health, Education, and Welfare (HEW) data that found substantially more racially homogenous schools in the North and West than the South in cities such as Cleveland, Ohio; Compton, California; Detroit, Michigan; Gary, Indiana; Kansas City, Missouri; Los Angeles, California; Milwaukee, Wisconsin; Newark, New Jersey; and St. Louis, Missouri. *See Id.* at 219 n.4.

[314] *Id.* at 219.

[315] *See Id.* at 201–03 (majority opinion).

[316] *See Id.* at 191, 204–05. For the scope and nature of the transition in the Park Hill and other east and north side Denver neighborhoods, see Romero, *supra* note 312, at 77–90; and Frederick Douglas Watson, Removing the Barricades from the Northern Schoolhouse Door: School Desegregation in Denver 7–114 (1993) (unpublished Ph.D. dissertation, University of Colorado at Boulder).

system in the case only partially reflected the hypermetropolitan fractionalization and segregation occurring in the metropolitan U.S. Indeed, as a result of home-rule powers the City and County of Denver itself had acquired early in the twentieth century, it effectively used its powers of annexation and control of natural resources to prevent fractionalization and some metropolitan growth within, but not outside of its jurisdictional boundaries.[317] Because the boundaries of the Denver Public School District were coterminous with the jurisdictional boundaries of the City-County, it served a much more geographically expansive and racially diverse school population within its borders than many so-called Northern cities.[318]

Second, Justice Brennan's opinion indicates that the de jure versus de facto distinction was not a Southern as opposed to a Northern-Western urban phenomenon.[319] Rather, the opinion proposed that de jure and de facto color lines in the same school district could conceivably coexist. At issue in this regard were the district court's findings that the segregation of Black students in certain neighborhood schools was different in degree and kind to the segregation of Black and Chicano students in so-called "core city" schools.[320] Although Justice Brennan's opinion found that the evidence of discriminatory motive in relation to one set of schools would create a presumption of racial discrimination throughout the entire boundaries of the school district, he nevertheless opened up the possibility that both de jure and de facto segregation could share the same geographic space:

> This is not to say, of course, that there can never be a case in which the geographical structure of, or the natural boundaries within, a school district may have the effect of dividing the district into separate, identifiable and unrelated [de jure versus de facto] units. Such a determination is essentially a question of fact to be resolved by the trial court in the first instance, but *such cases must be rare.*[321]

To be sure, Justice Brennan's opinion qualified this point by arguing that the line between de jure and de facto discrimination would oftentimes not be that precise or easy to define and "that close examination is required before concluding that the connection does not exist."[322] Nevertheless, his opinion put into place the constitutional measures to spatially and functionally resolve within the same metropolitan and jurisprudential spaces the once seemingly incompatible systems of color consciousness (de jure-Southern) and color blindness (de facto–Northern-Western).

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[317] *See* Romero, *supra* note 41, at ch. 4.

[318] *See Keyes*, 413 U.S. at 191–92 (explaining that in 1969, 119 schools served nearly 97,000 students over fifty square miles of space).

[319] *Id.* at 198–205.

[320] *Id.*

[321] *Id.* at 203. (emphasis added).

[322] *Id.* at 211.

At the same time that *Keyes* was decided, however, the scope of the decision and its relevancy to multiracial municipalities and school districts was greatly limited by a case brought by a class that represented a multiracial collection of poor Latino, Black, and White students: *San Antonio Independent School District v. Rodriguez*.[323] The issues of the case turned on whether the "poor" deserved heightened protection under the Equal Protection Clause and whether there was a fundamental right to education in a state where public schools were financed through a largely local property tax.[324] At the center of the controversy were two school districts in the San Antonio Metropolitan Area.[325] One district was

> situated in the core-city sector of San Antonio in a residential neighborhood that ha[d] little commercial or industrial property. The residents [we]re predominantly of Mexican-American descent: approximately 90% of the student population [wa]s Mexican-American and over 6% [wa]s Negro. The average assessed property value per pupil [wa]s $5,960—the lowest in the metropolitan area—and the median family income ($4,686) [wa]s also the lowest.[326]

In contrast, another and much smaller school district was "situated in a residential community . . . [where] the school population [wa]s predominantly 'Anglo,' having only 18% Mexican-Americans and less than 1% Negroes. The assessed property value per pupil exceed[ed] $49,000, and the median family income [wa]s $8,001."[327] Though a distinct color line between Brown and White was evident in the demographic makeup of each school district, neither its existence nor its historical development played any role in the determination or outcome of the case.

Justice Powell, who himself had argued so stridently in *Keyes* for rejecting the de facto versus de jure distinction, wrote the majority opinion in *Rodriguez* that answered in the negative both questions that were before the Court.[328] Critically, his majority opinion indicated an increasing level of deference, if not trust, in local government that had been absent in post-*Brown* school desegregation cases. Particularly in "matters of fiscal policy," Justice Powell indicated that the case involved "the most persistent and difficult questions of educational policy, another area in which this Court's lack of specialized knowledge and experience counsels against premature interference with the *informed judgments* made at the state and local levels."[329] Moreover, in language remarkably similar to those lower federal courts in the 1960s that indicated that *Brown* did not apply to de facto contexts, Justice Powell declared that "[e]ducation, perhaps even more than welfare

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[323] 411 U.S. 1 (1973).
[324] *Id.* at 19-29.
[325] *See Id.* at 11.
[326] *Id.* at 12.
[327] *Id.* at 12–13.
[328] *See Id.* at 23–25, 37.
[329] *Id.* at 42 (emphasis added).

assistance, presents a myriad of 'intractable economic, social, and even philosophical problems.'"[330] Justice Powell accordingly argued that "local control" and the "pluralism" it engenders encourages "experimentation, innovation, and a healthy competition for educational excellence."[331] Of course, the case—involving as it did largely poor Mexican American litigants—was not the type of case that easily fit into the *Brown* framework. Even *Keyes*, which for the first time addressed the segregation of Latino students, did so in reference and relation to the segregation of African American students and the consequence that flowed from such separation.[332] Class disparity, the racial ambiguity of the Latino litigants, and the inequitable tax bases created by local government and its impact on residential settlement were issues too complex for Justice Powell and his majority brethren to unravel in *Rodriguez*.[333]

Just one year later, and on the twentieth anniversary of *Brown v. Board of Education*, the Supreme Court in *Milliken v. Bradley*, made *Rodriguez* a constitutional reality by containing school integration remedies to solely the corporate boundaries of the City of Detroit, though this one time "Arsenal of Democracy" had become one of the most segregated and color-conscious metropolitan areas in the nation.[334] In a contentiously divided five-to-four opinion, Chief Justice Warren Burger held that the district court's desegregation plan could not extend beyond the corporate limits of the school district because "no interdistrict" de jure violation had been found.[335] The question in the case revolved around Federal District Judge Stephen Roth's decision to require two-way busing of over 300,000 students across fifty-four school districts in the Detroit metropolitan area.[336] According to Judge Roth, local, state, and federal government entities "ha[d] combined with . . . private organizations, such as loaning institutions and real estate associations and brokerage firms to establish . . .

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[330] *Id.* at 42 (quoting Dandridge v. Williams, 397 U.S. 471, 487 (1970)).

[331] *Id.* at 50.

[332] *See* Romero, *supra* note 22, at 263–69.

[333] At the end of the opinion, Justice Powell states the following:

> The complexity of these problems is demonstrated by the lack of consensus with respect to whether it may be said with any assurance that the poor, the racial minorities, or the children in overburdened core-city school districts would be benefited by abrogation of traditional modes of financing education . . . . These practical considerations, of course, play no role in the adjudication of the constitutional issues presented here. But they serve to highlight the wisdom of the traditional limitations on this Court's function.

San Antonio, 411 U.S. at 56–58.

[334] 418 U.S. 717, 754-57 (1974). For a history of metropolitan segregation in the Detroit metropolitan area, see generally SUGRUE, *supra* note 41, at 181-208 (describing the effects of racial segregation in metropolitan Detroit).

[335] *Milliken*, 418 U.S. at 744–45.

[336] *See* Bradley v. Milliken, 345 F. Supp. 914, 937-40 (E.D. Mich. 1972); Bradley v. Milliken, 338 F. Supp. 582, 592-95 (E.D. Mich. 1971).

residential segregation throughout the Detroit metropolitan area."[337] Moreover, for Judge Roth, it was no "answer" whether the practices were long abandoned, constitutionally proscribed, or haphazardly applied as "[t]he policies pursued by both government and private persons and agencies ha[d] a continuing and present effect upon the complexion of the community—as we know, the choice of residence is a relatively infrequent affair."[338] In other words, housing policies pursued by all levels of government, more than education policies or pupil placement, created and reinforced racial concentration that itself created vast disparities in wealth.[339] Accordingly, the remedy of metropolitan interdistrict two-way busing would not only respond to racial concentration, but "[m]oney would flow to urban schools, because middle-class children would now be attending them. *Milliken* posed, in short, a way for the Court to soften the fiscal blow dealt by the dispossessed in *Rodriguez*."[340]

Yet, *Rodriguez* rehabilitated the idea of race-neutral or color-blind local government. Accordingly, the *Milliken* majority used this understanding to declare that "local autonomy has long been thought essential both to the maintenance of community concern and support for public schools and to quality of the educational process."[341] For this reason, "school district lines may [not] be casually ignored or treated as a mere administrative convenience," especially if its actions were "innocent" or above racial reproach.[342] Critically, however, this view of local government framed state action not as the sum of its parts (local, state, and federal governments), but rather, as autonomous parts of an unconnected metropolitan sum.

In this latter view, and despite the voluminous findings of the district court, which implicated all levels and many acts of government not related to education in creating and perpetuating racial concentration, Chief Justice Warren Burger held that the district court's desegregation plan was unconstitutional.[343] Retreating from what could be characterized as a broad interpretation of the line between de facto and de jure segregation formulated by Justice Brennan in *Keyes*, Justice Burger's opinion in *Milliken* truncated the constitutional inquiry to the following:

> Specifically, it must be shown that racially discriminatory acts of the state or local school districts, or of a single school district have been a substantial cause of interdistrict segregation. Thus, an interdistrict

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[337] *Bradley*, 338 F. Supp. at 587.

[338] *Id.*

[339] For contemporary understandings of this relationship, see Reynolds Farley, *Population Trends and School Segregation in the Detroit Metropolitan Area*, 21 WAYNE L. REV. 867 (1975) and J. Skelly Wright, *Are the Courts Abandoning the Cities?* 4 J. L. & EDUC. 218 (1975).

[340] J. HARVIE WILKINSON III, FROM BROWN TO BAKKE: THE SUPREME COURT AND SCHOOL INTEGRATION: 1954–1978, at 221 (1979).

[341] *Milliken*, 418 U.S. at 741–42.

[342] *Id.* at 741.

[343] *Id.* at 744–45.

> remedy might be in order where the racially discriminatory acts of one or more school districts caused racial segregation in an adjacent district, or where district lines have been deliberately drawn on the basis of race. In such circumstances, an interdistrict remedy would be appropriate to eliminate the interdistrict segregation directly caused by the constitutional violation. Conversely, without an interdistrict violation and interdistrict effect, there is no constitutional wrong calling for an interdistrict remedy.[344]

Confining the analysis to such a narrow scope obscured completely the complicity, and at times deliberate behavior of other government actors in creating the conditions and incentive for racial concentration across municipal boundaries. Indeed, Justice Potter Stewart, who cast the deciding vote in the majority opinion, ruminated about the "*unknown* and perhaps *unknowable* factors such as in-migration, birth rates, economic changes, or the cumulative acts of private racial fears" in contributing to residential segregation in the Detroit metropolitan area.[345] Just one year after *Keyes* suggested that de facto racial segregation was likely rare, the *Milliken* majority made "de facto" racial concentration the constitutional norm. In so doing, the decision rationalized the inequitable spatial distribution of property and resources along multiracial lines as an "unknowable"[346] fact by failing to appreciate or understand the state's role in pushing and pulling Whites and non-Whites to and from fragmented municipal spaces.

As a result, much as the Court did twenty years earlier in *Berman*, the Chief Justice's opinion reinforced the ability of local government units to exist and operate in isolation from the "messy" issues of race and color.[347] Arguing that "school district lines may [not] be casually ignored or treated as a mere administrative convenience," the majority opinion endorsed the literal maintenance of a color line, but one defined by de facto versus de jure governmental bodies sharing the same metropolitan space.[348] At the same time, the decision absolved any responsibility whatsoever for a local government unit to be color conscious

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[344] *Id.* at 745. Justice Potter Stewart, in his concurrence, took a bit broader reading indicating that "purposeful" racially exclusionary zoning and housing law could trigger a constitutional violation. *Id.* at 755 (Stewart, J., concurring).

[345] *Id.* at 756 n.2 (J. Stewart concurring) (emphasis added).

[346] *Id.*

[347] Importantly, Justice Douglas' dissent in *Milliken* references the economically disadvantaged "Chicano" students in *Rodriguez* and the fact this opinion, along with the *Milliken* majority tended to fundamentally ignore the state's role in maintaining multi-color spatial inequality. 418 U.S. at 759–60 (Douglas, J., dissenting). One fairly recent account of this opinion and aftermath indicates that one response to the local deference given in *Milliken* and *Rodriguez* is through "judicial federalism" whereby color-conscious litigation is pursued through equality provisions in state constitutions and law. Douglas S. Reed, *Twenty-Five Years after Rodriguez: School Finance Litigation and the Impact of the New Judicial Federalism*, 32 LAW & SOC'Y REV. 175, 177 (1998).

[348] *Milliken*, 418 U.S. at 741 (majority opinion).

about racial imbalance, even though such "school district" or other local government boundary lines contributed through countless neutral actions to homogenous color populations.[349]

In dissent, Justice Thurgood Marshall—who himself had successfully argued *Brown* before the Court exactly twenty years earlier—was mystified by the majority's willful ignorance of the role of the color line in perpetuating metropolitan growth. "The rippling effects on [racially segregated] residential patterns," Justice Marshall argued, "do not automatically subside at the school district border. With rare exceptions, these effects naturally spread through all the residential neighborhoods within a metropolitan area."[350] Furthermore, Justice Marshall argued that per the majority opinion, the Fourteenth Amendment now commanded only the "states," and not incorporated cities, suburbs, or other local governmental bodies to provide equal protection.[351] The majority opinion, as the dissent suggested, gave subnational, local government units a privileged constitutional status. The *Milliken* majority therefore rejected *Brown*'s distrust of local government in favor of a more deferential, color-blind *Berman*-type position. This resolved the color tension inherent in each 1954 opinion while giving local government units the authority to be consciously oblivious about color segregation and inequity. Hence, the practical effect of each body of law, post-*Milliken*, was to rationalize as natural or de facto the inequitable distribution of property and resources in the multicolor, highly segregated, metro-zonal United States.[352] Simply put, this jurisprudence effectively stabilized the contemporary American metropolitan heterotopia; ensuring that it would not collapse upon its own racial and class contradictions and inequities.

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[349] *See supra* Part II. The myopic focus on space and its disconnection to history, local government, and spatial inequity had ramifications that extended well beyond school desegregation suits. *See, e.g.*, Peter Charles Hoffer, *"Blind to History": The Use of History in Affirmative Action Suits: Another Look at City of* Richmond v. J.A. Croson Co., 23 RUTGERS L.J. 271, 279–89 (1992); Reginald Oh, *Re-Mapping Equal Protection Jurisprudence: A Legal Geography of Race and Affirmative Action*, 53 Am. U. L. Rev. 1305, 1316–30 (2004).

[350] *Milliken*, 418 U.S. at 806 (Marshall, J., dissenting).

[351] *Id.* at 793–98.

[352] For a critique of *Milliken* in the context of the state's role in perpetuating inequitable spatial segregation, see John O. Calmore, *Spatial Equality and the* Kerner Commission Report*: A Back-to-the-Future Essay*, 71 N.C. L. Rev. 1487, 1509–12 (1993). Most importantly, *Milliken*, along with *Rodriguez*, immunized most suburbs from the opportunities of integration and in turn, ensured that its burdens would fall most heavily on not only communities of color, but poor and working-class White neighborhoods sharing the same school district. *See* Formisano, *supra* note 309, at 237–38; Lassiter, *supra* note 133, at 315–16. In one irony, Professor Lassiter points to the social and legal experiences of Seattle and Louisville—the school districts involved in the 2007 decision, Parents Involved in Community Sch. v. Seattle Sch. Dist. No. 1, 127 S.Ct. 2738 (2007)—as evidence of the ways that "the difficult barriers raised by *Milliken*" could be overcome by coming to grips with the "responsibility of state policies" that created and maintained residential segregation. LASSITER, *supra* note 133, at 316.

In similar ways, the metropolitan heterotopia became even more pronounced through other legal mechanisms. In the Denver metropolitan area in 1974, for instance, anti-integrationists joined together with anti-urban interests in Colorado to encourage all of the state's citizenry to pass the Poundstone Amendment to the Colorado Constitution.[353] Touted by its supporters as a measure to deprive the City and County of Denver of power over the metropolitan area, the amendment greatly limited the ability of the city to acquire land through annexation and use this process to end metropolitan educational segregation.[354] One editorial lamented:

> It is, I think, right to suppose that the primary reason for the easy passage of the Poundstone Amendment was the suburbs fear of busing. If, in other words, there is to be a ghetto, and busing is to relieve the pressures and injustice of the ghetto, let it all be within the City and County—and school district—of Denver.[355]

According to one later study, the amendment allowed "Colorado voters permanently [to] split Denver from its suburbs in the 1974 election. Suburbanites decided that remaining separate from the city would permit them to maintain *racially* and economically segregated communities and schools, and to thereby evade the social and economic problems of the central city."[356] Together, judicial and political restraints on metropolitan-wide school integration and land-use authority made more precise and complete the spatialization of color in this Western, but nationally representative, postmetropolis.[357]

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[353] *See* COLO. CONST. art. XX, § 1, art. XIV, § 3 (1974).

[354] *See* STEPHEN J. LEONARD & THOMAS J. NOEL, DENVER: MINING CAMP TO METROPOLIS 379 (1990).

[355] Franklin J. James & Christopher B. Gerboth, *"A Camp Divided: Annexation Battles, the Poundstone Amendment, and Their Impact on Metropolitan Denver, 1941–1988,"* 5 COLO. HIST. 129, 173 n.87 (2001). James and Gerboth's study noted that Frida Poundstone, the author of the Amendment, "intentionally stoked suburban fears by raising the specter of busing on a metropolitan scale." *Id.* at 158.

[356] *Id.* at 163. (emphasis added).

[357] *See* Keyes v. Sch. Dist. No. 1, 413 U.S. 189, 217–19 (Powell, J., concurring in part and dissenting in part). Justice Powell's concurring and dissenting opinion in *Keyes* is extremely revealing in regard to this point. *Id.* Indeed, his opinion opens by highlighting the importance of the case and of the fact patterns arising out of the multiracial City and County itself in developing those national principles that would guide further school integration jurisprudence. *Id.* Yet, as Professor Lassiter points out, Justice Powell was on a Richmond school board that had long resisted meaningful integration of its schools and furthermore, as a "conservative" Nixon appointment to the Court, his school integration jurisprudence endorsed only "limited remedies that respected 'legitimate community interests in neighborhood school systems.'" LASSITER, *supra* note 133, at 293, 313–14. *See generally* GARY ORFIELD, MUST WE BUS? SEGREGATED SCHOOLS AND NATIONAL POLICY (1978) (detailing fully the impact of such law and policy).

Within a generation of *Berman* and *Brown*, the American metropolitan landscape rapidly developed its own color-blind logic dependent upon the spatialization of color. Even in the South—where its metropolises according to one commentator, "no longer looked like . . . Southern [cities] at all, but like . . . typical Northern" or Western cities defined by metropolitan municipal fragmentation, comprehensive planning, and selective exercise of land-use authority in conjunction with legal and political containment of the school desegregation opinions to effectively segregate Whites and non-Whites.[358] Critically, such developments reinforced color inequality in public schools perhaps more efficiently and effectively than the discriminatory actions undertaken by the school board in *Brown* ever could.

Yet, as in eminent domain law, school desegregation jurisprudence heavily truncated the judicial consideration and the subsequent ability of highly fragmented metropolitan authorities to be color conscious in their decision making; even if their goal was to respond to the spatialization of color inequity in metropolitan America.[359] Collectively, takings and land use law, subsequent developments in school integration jurisprudence, and the robust growth of municipal boundary law effectively contained the gravity and contentiousness of "urban renewal" and "massive resistance" as the peculiar problem of far-removed urban locales; therefore preventing a disruption of those color-blind and idyllic visions of the "good life" in a highly fragmented metropolitan America.[360]

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[358] *See* LOWI, *supra* note 10, at 249.

[359] *See, e.g.*, Washington v. Davis, 426 U.S. 229, 250-52 (1976) (holding that disparate racial impact of a neutral employment policy was not a constitutional violation); and Arlington Heights v. Metro. Hous. Dev. Corp., 429 U.S. 252, 268-71 (1977) (holding that Village's decision not to grant a rezoning request was not made as a result of discriminatory intent or purpose). The issue of discriminatory impact versus discriminatory intent in this body of jurisprudence, much like de facto versus de jure residential and school segregation, rendered the judicial inquiry marginal to the multiple ways that local, state, and federal actors spatialized color inequity in the postmetropolis.

[360] Perhaps no city represented or was more emblematic of this transformation than Los Angeles, California in the decades after World War II. Los Angeles was the planner's exemplary example of the state-managed metropolis and it was where public housing and urban renewal rhetoric was perhaps the most intense. *See* Soja, Morales, & Wolff, *supra* note 23, at 207–08. The city also became the paradigmatic example of the color re-spatialization of the American postmetropolis. Los Angeles, an area circumscribed by a sixty mile radius comprising five counties and hundreds of incorporated municipalities and special use districts, became one of the largest and most segregated urban industrial zones in the world. *Id.* Precisely because "[t]he downtown core, never as dense or as developed as in major eastern cities, substantial regional economic and physical growth masked deepening poverty and intense segregation among African Americans and Latinos in the region as well as emergence of industrial sweatshops worked by Latinos and Asians." *Id.* More recent accounts of this are documented extensively in MYRON ORFIELD, AMERICAN METROPOLITICS: THE NEW SUBURBAN REALITY 28–31, 49–64 (2002); Camille Z. Charles, *The Dynamics of Racial Residential Segregation*, 29 ANN. REV. SOC. 167, 175–76, 197 (2003) ("Patterns of suburban segregation mirror those of the larger metropolitan area of

V. CONCLUSION: BEYOND THE HETEROTOPIA: *KELO*, *PARENTS* AND COLOR AT THE POSTMETROPOLITAN CENTER

This article opened by pointing out what on its face seemed to be inconsistencies between Justice Clarence Thomas's opinions in *Kelo* and *Parents*. As the rest of the article has attempted to demonstrate, however, the color consciousness and color blindness of Justice Thomas in each case was the predictable consequence of the spatial construction of metropolitan space in the period between *Berman-Brown* and *Kelo-Parents*. This era opened diffidently. Whereas *Brown* and subsequent school litigation represented the potential for a fundamental challenge to White supremacy, *Berman*'s color-blind deference to urban and metropolitan fractionalization made it increasingly difficult to overcome the multicolor social and spatial inequity that was becoming even more pronounced in the nation's rapidly growing metropolitan areas.

For these reasons, the jurisprudence spawned by *Berman* and *Brown* became color-blind and color-conscious fulcrums that in turn, empowered local governmental units to structure effectively the multicolor lines in the metropolitan heterotopias that emerged. Though commentators have written incessantly about a "quiet revolution" of federal and state control over land use and local decision making in a variety of contexts, their national prominence as seen in urban renewal or federally supervised school integration served to draw attention away from the cumulative impact of countless local decisions by individuals, communities, and governmental bodies[361] in creating and containing a segregated multicolor metroscape. Yet, these national cases and the events and activities they produced gave local decision makers unprecedented ability to simultaneously create and then at best ignore, or at worst, explicitly deny their contribution in creating color inequity.

Of particular importance is the jurisdictional bright line between property rights and civil rights that emerged out of *Berman* and *Brown* that worked together to reify the de facto versus de jure distinction as a constitutional fact. To be sure,

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which they are a part . . . ."); John A. Powell, *Opportunity-Based Housing*, 12 J. AFFORDABLE HOUS. & COMMUNITY DEV. L. 188, 217 (2003) ("We cannot simply assume that the suburbs will be the location of opportunity or that the central city will be the location of decline. The operative divide, then, is not city versus suburb but opportunity versus isolation."). Professor Orfield indicates that as a result, land use policy needs to become patently color-conscious in the future. Myron Orfield, *Land Use and Housing Policies to Reduce Concentrated Poverty and Racial Segregation*, 33 FORDHAM URB. L.J. 877, 930–36 (2006). Collectively, as Professor Lassiter observes, "[t]he powerful de facto mythology depended upon a fading regional contrast and a false narrative of national innocence, because public policies in the Metropolitan [United States] . . . were still in the process of constructing a more intractable landscape of racial apartheid, *an ultramodern version of de jure segregation*." LASSITER, *supra* note 133, at 16 (emphasis added).

[361] Craig A. Arnold, *The Structure of the Land Use Regulatory System in the United States*, 22 J. LAND USE & ENV. L., 441, 486 (2007).

these seemingly distinct bodies of jurisprudence were self-referential in that they truncated and concealed the saliency if not the necessity of color to the creation and perpetuation of a fragmented metropolitan landscape. To say that "Whites" favored property rights while "non-Whites" supported civil rights; or that school desegregation boundary decisions have nothing whatsoever to do with land use or housing decisions, reduced as irrelevant the complex interplay of color consciousness and color blindness driving housing choice and segregation in a multiracial United States. Largely because eminent domain and school integration served as incompatible sites in the heterotopia that simultaneously looked at and away from one another, they masked an incredible expansion of the powers of metropolitan entities to literally and effectively spatialize multicolor boundaries through redevelopment plans, condemnation hearings, or school board boundary decision meetings.

Moreover, the public-private collusion given sanction in *Berman* and its inversion in the color-blind myopia we see in Justice Thomas's concurrence in the recent *Parents* cases both anticipated and justified the metro-zonal restructuring of American metropolises. Particularly in the American West, a region that had been or was increasingly becoming home to multiracial cohorts of White and non-White Latinos, Asians, Blacks, and American Indians, imprecise understandings of race and the multicolor divide further obscured color segregation and inequity.[362] The Western metropolises, however, were representative of larger trends throughout the United States whereby all levels of the state emerged to specifically define metropolitan form. Largely because the expanding metro-zones of the American West were less encumbered by historical legal boundary decisions and precisely because individual rights and meritocracy emerged as more important than those of the city or racial justice, the Western multiracial metropolises were the first ones in the United States to become both sprawling and edgeless yet undeniably divided by an inequitable multiracial geography. Such details would become essential features of the contemporary metropolitan United States.

The Supreme Court's majority opinion in *Kelo*, however, represented for metropolitan America potentially the end of one color-conscious era and the beginning of a new era more deliberately managed around color-blind "smart" and controlled growth.[363] The power of local government to administer this process

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[362] *See, e.g.*, John O. Calmore, *Race/ism Lost and Found: The Fair Housing Act at Thirty*, 52 U. MIAMI L. REV. 1067, 1108–17 (1998). Calmore, in particular, is responding directly to the argument made by some academics that the multiracial transformation of American cities is reflective of less, rather than more color inequity. *See* STEPHAN THERNSTROM & ABIGAIL THERNSTROM, AMERICA IN BLACK AND WHITE: ONE NATION, INDIVISIBLE 204–23 (1997).

[363] A somewhat dated, but still extremely helpful bibliography of resources related to "smart growth" and "new urbanism" is available at Dhiru A. Thadani, New Urbanism Bibliography (Dec. 23, 1999), http://www.periferia.org/publications/cnubibliography.html. The origins of "new urbanism" and "smart growth" come out of many of the same issues confronting planners, lawyers, local governments and community activists covered in this article. *Id.* Issues such as sprawl, unchecked growth, central city decline, and the

reflected the efforts of not only a "new urbanism," but perhaps one that may more accurately be characterized as a "new metropolitanism" in American land use policy and jurisprudence.[364] While the decision certainly strengthened the power of the state to manage space and property in the postmetropolis in a color-blind way, one of the most underappreciated aspects about the majority's opinion in *Kelo* was its latent color consciousness; particularly the fundamental challenge the decision made to property as Whiteness.[365] By making clear that everyone's property, and not just those of people of color who happened to live in designated "blighted" communities, could be subjected to a government taking, the *Kelo* majority inverted *Berman*'s color-blind logic upon itself by threatening White privilege.

The widespread and highly abrasive reaction to the *Kelo* opinion and the subsequent action of a vast majority of the nation's state legislatures to limit private-to-private takings to exclusively "blighted" situations, however, restored the status quo.[366] The *Parents* majority, moreover, contributed to this process by ironically inverting *Brown*'s most direct attacks on the maintenance of White supremacy by equivocating the struggle of White students and parents in Seattle and Louisville to those of African Americans and other people of color in *Brown* and its progeny.[367] Therefore, the reaction to *Kelo* and the logic of the *Parents* majority on its face, seem to ensure that these cases represent not so much a break from the past as much as the continued perpetuation and growth of pervasive multicolor segregation and inequality inaugurated in the American postmetropolis.

Yet, *Kelo* and *Parents* should be read another way. Literally at the center of each decision and sitting as a "swing" vote in each case are the opinions of Justice

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architectural homogeneity of suburbs coalesced together during the 1980s in a movement to consider metropolitan wide public as well as private solutions to these issues. *Id.* The literature on "smart growth" and the "new urbanism" is vast and is quite beyond the scope of this article, but suffice to say that issues of racial justice play a small role.

[364] "New metropolitanism" is my own term and one that is meant to generally reflect those judicial decisions that challenge the perceived impermeability of municipal boundaries and the fundamental role of the state in managing the property relations of the modern metropolis across jurisdictional space. The implications of this term are outside the scope of this article, but I do want to suggest that apparent "color-blindness" of the *Kelo* majority seems to facilitate less skepticism about the power of the state to manage this process (among some jurists) than those that are color-conscious in the service of responding to class and or racial inequity. The issue, most importantly, is the role and power of municipal entities to facilitate a cohesive metropolitan project of getting property to its highest economic, market value.

[365] Kelo v. City of New London, Conn. 545 U.S. 469 (2005).

[366] For a compelling account of *Kelo* and the specific reactions of state legislatures to the decision, see generally Marcilynn A. Burke, *Much Ado About Nothing:* Kelo v. City of New London, Babbitt v. Sweet Home, *and Other Tales from the Supreme Court*, 75 U. CIN. L. REV. 663, 719–23 (2006) (setting forth examples of state eminent domain legislation in several states).

[367] Parents Involved in Community Sch. v. Seattle Sch. Dist. No, 1, 127 S.Ct. 2738 (2007).

Anthony Kennedy. Although he concurred with the *Kelo* majority and the result reached by the Court, Justice Kennedy nevertheless did

> not foreclose the possibility that a more stringent standard of review than that announced . . . might be appropriate . . . for a more narrowly drawn category of takings. There may be private transfers in which the risk of undetected impermissible favoritism of private parties is so acute that a presumption (rebuttable or otherwise) of invalidity is warranted under the Public Use Clause.[368]

Though he refused to "speculate" as to the type of case in which this would apply, his opinion's focus on the legitimacy of the political process used to effectuate the taking conjure up the infamous fourth footnote in *Carolene Products v. United States*.[369] If this is indeed the case, the opinion suggests the ability to question takings that are disproportionately borne by groups—often non-White—if they have been effectively shut out of the process by political or other means, such as property ownership.[370]

Further, in *Parents*, Justice Kennedy again concurs in the opinion of the Court; [371] but again he makes some important caveats. First, according to Justice Kennedy, he could "not endorse the plurality's conclusion" that "the Constitution requires school districts to ignore the problem of *de facto* resegregation in

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[368] *Kelo*, 545 U.S. at 493 (Kennedy, J., concurring).

[369] 304 U.S. 144, 152 n.4 (1938). This footnote may perhaps be the most renowned footnote in constitutional history. Geoffrey P. Miller, *The True Story of Carolene Products*, 1987 SUP. CT. REV. 397, 397-400 (1987). The footnote became the modern basis upon which a tiered system of judicial scrutiny emerged. Accordingly, Judge Harlan Stone's opinion indicated in the footnote that there may be times when neutral legislation is "directed at particular religious, or national, or racial minorities: whether prejudice against discrete and insular minorities may be a special condition, which tends seriously to curtail the operation of those political processes ordinarily to be relied upon to protect minorities," which in turn "may call for a correspondingly more searching judicial inquiry." *Carolene Products*, 304 U.S. at 152 n. 4 (citations omitted).

[370] Takings and "just compensation" almost always involve those who have title to real property. Given color disparities in property ownership, however, the interests of people of color, who might have less than fee simple ownership, might not be adequately addressed in this legislative or political process that leads to the a "blight" designation. *See, e.g.*, Robert J. Aalberts, *Take From the Poor and Give to the Rich: Eminent Domain Law and the "Reverse Robin Hood" Effect*, 33 REAL ESTATE. L. J. i, i (2004); Paul Boudreaux, *Eminent Domain, Property Rights, and the Solution of Representation Reinforcement*, 83 DENV. U. L. REV. 1, 3 (2005); April B. Chandler, *"The Loss in my Bones": Protecting African American Heirs' Property With the Public Use Doctrine,"* 14 WM. & MARY BILL RTS. J. 387, 403-06 (2005); Audrey G. McFarlane, *The New Inner City: Class Transformation, Concentrated Affluence and the Obligations of the Police Power*, 8 U. PA. J. CONST. L. 1, 43–59 (2006).

[371] Parents Involved in Community Sch. v. Seattle Sch. Dist. No, 1, 127 S.Ct. 2738, 2788 (2007) (Kennedy, J. concurring).

schooling."[372] While indicating that color blindness is an aspirational constitutional goal, Justice Kennedy was quick to point out that such an argument is contextual and that "[i]n the real world . . . *it cannot be a universal constitutional principle.*"[373] Second and related is Justice Kennedy's observation that color consciousness requires more than just a "blunt distinction between '[W]hite' and 'non-[W]hite.'"[374] Rather, one reading of his opinion is that it compels an appreciation and understanding of the multiple color lines that comprise urban and metropolitan space.[375]

Read together, Justice Kennedy's concurring opinions in *Kelo* and *Parents* signify that the color-blind and color-conscious tensions embedded in the *Berman* and *Brown* era will continue to be refracted in struggles to control, organize, and make more equitable space and property in the metropolitan heterotopia. I would suggest that at its most basic level, it compels jurists to revisit and reject the de jure versus de facto distinction.[376] Though Justice Kennedy's opinions are rife with their own limitations, they nevertheless represent an opportunity to place color consciousness at the center of this struggle in *all* contexts. An interesting test case in this regard is taking place in metropolitan Texas.[377] At issue is whether the municipal service district, which serves over 3,500 people in a suburb of Austin, Texas, can be removed from Section 5 jurisdiction of the Voting Rights Act of 1965 because there has been no history of voting rights violations.[378] The district is also challenging the constitutionality of the act because it argues that the racially discriminatory environment that justified its passage no longer exists.[379] The case—involving as it does a fairly new metropolitan special service district

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[372] *Id.* at 2791.

[373] *Id.* at 2792 (emphasis added).

[374] *Id.* at 2791.

[375] *Id.* at 2792–93. For a recent analysis of this process in context of Seattle and the *Parents* case, see Robert S. Chang & Catherine E. Smith, *John Calmore's America*, 86 N.C. L. REV. 739, 748–51 (2008) (assessing the multiracial implications of segregated neighborhoods and schools in Seattle).

[376] The precise argument for this is beyond the scope of this article, but I begin to explore its dimensions in Tom I. Romero, II, "*No Brown Towns: Anti-Immigrant Ordinances and Equality of Educational Opportunity for Latina/os.*" 11 J. GENDER RACE & JUST. (forthcoming 2008).

[377] Nw. Austin Mun. Util. Dist. No. 1 v. Mukasey, No. 06--1384, 2008 WL 4097645 (D.D.C. Sept. 4, 2008).

[378] Known as the "preclearance requirement" of the Voting Rights Act, it requires government units to preclear with the U.S. Attorney or the U.S. District Court for the District of Columbia, those municipal decisions that may lead to voting discrimination. Such decisions include the changing or modification of an election system, the revising of candidate qualifications, annexing neighboring districts, and re-drawing district lines. A government unit can ask to have itself removed from this requirement if it has a ten-year record of no voting rights violations. Voting Rights Act of 1965, Pub. L. No. 89-110 § 5 (codified as amended at 42 U.S. § 1973).

[379] *See* Plaintiff's Motion for Summary Judgment, Northwestern Austin Mun. Util. Dist. No. 1 v. Gonzales, Civil Action No. 06-CV-01384, at 2–5.

servicing a recently incorporated community, rife as it is with assumptions about the irrelevance of the color line to such situations, and in a state where municipalities have been at the forefront of municipal efforts to prevent non-Whites from living and participating in its own political process[380]—epitomizes in many ways inherent tensions at the center of the contemporary, metro-zonal heterotopia and by extension, fundamental limitations of the de jure versus de facto distinction.

In the end, the emergence of eminent domain and school integration to structure color-blind and color-conscious space in the era between *Berman-Brown* and *Kelo-Parents* served to mark and thereby contain deep and increasing multiracial tension in fractured American metropolises. At the same time, the distinction unbound non-White communities in the emerging metropolitan and jurisprudential landscape from jurisdictional consideration. These metropolitan heterotopias will not be seriously disrupted until our politics and our jurisprudence fully understand the relationship and make substantive color-conscious connections between these and related bodies of law.

[380] *See Id.* at 5–10; Defendant Interveners' Joint Statement of Material Facts as to Which There is No Genuine Issue Pursuant to Local Civil Rules 7(H) and 56.1, at 171-78, 322-26, 420-22, Nw. Austin Mun. Util. Dist. v. Mukasey, No. 06-1384, 2008 WL 4097645 (D.D.C. Sept. 4, 2008).

SHARI'AH'S "BLACK BOX": CIVIL LIABILITY AND CRIMINAL EXPOSURE SURROUNDING *SHARI'AH*-COMPLIANT FINANCE

David Yerushalmi, Esq.*

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I. INTRODUCTION

The legal practitioner, motivated by the exorbitant fees awarded the specialist who has acquired expertise in a novel, complex, and highly profitable financial structure, often loses sight of the fundamental threshold issues for such legal structures. This occurs whether the transaction or business model complies with existing civil and criminal statutory and regulatory frameworks, or whether the transaction exposes the client to unique and elevated civil liability, criminal exposure, or regulatory intervention.[1]

Unfortunately, the history of the legal and accounting professions in guiding clients through the hazards of novel and complex transactions has been poor.[2] Perhaps nowhere is this more evident than in the professional treatment of *Shari'ah*-compliant finance (SCF), the practice of investing in conformity with Islamic law. In just the past three decades, financial institutions and finance-driven businesses have entered into countless SCF transactions, facilitated by their attorneys, accountants, and financial advisors. Due in part to the dependence of the SCF industry on *Shari'ah* authorities associated with the call for violent *Jihad* against the West, these transactions could potentially expose the parties involved to

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[1] The post-Enron "Sarbanes-Oxley" world is the recent result of this failure. *See, e.g.*, Harvey J. Goldschmid, Comm'r, Sec. & Exch. Comm'n, Address at the Third Annual A.A. Sommer, Jr. Corporate Securities & Financial Law Lecture: Post-Enron America: An SEC Perspective (Dec. 2, 2002), *available at* http://www.sec.gov/news/speech/spch120202hjg.htm.

[2] Beyond the Enron-era, the financial world is in the midst of the subprime mortgage securitization industry meltdown. *See, e.g.*, Ben S. Bernanke, Chairman, Fed. Reserve, Address at the Economic Club of New York, The Recent Financial Turmoil and its Economic and Policy Consequences (Oct. 15, 2007), *available at* http://www.federalreserve.gov/newsevents/speech /bernanke20071015a.htm. This meltdown is already being compared to the debacle of the savings & loan crisis. *See* Mike Larson, *The New Savings and Loan Crisis*, MONEY AND MARKETS, Nov. 27, 2007, http://www.moneyandmarkets.com/issues.aspx?Savings-and-loan-crisis-special-report-1224; *see also* Amy Waldman, *Move Over, Charles Keating — Causes of The Savings and Loan Scandal*, WASH. MONTHLY, May 1995, *available at* http://findarticles.com/p/articles/mi_m1316/ is_n5_v27/ai_16947718 (providing a retrospective on the "causes" of the savings and loan crisis).

significant civil and criminal liability in areas as diverse as securities fraud, sedition, antitrust, and racketeering. The lesson professionals should have learned from the past—but appear not to have, given what can only be described as the blind exuberance driving SCF—is that huge profits and explosive growth, massive public relations and marketing efforts, and popular appeal in the financial industry do not establish even a minimal baseline for legal compliance.

Whether a new financial product or an innovative structure for an existing business is compliant with the civil, criminal, and regulatory frameworks imposed on a lightning-fast and fully reticulated finance-driven economy is no longer a question for a single professional. Careful analysis and due diligence across several disciplines—conducted in a fully-informed, interactive environment—is not a luxury of the prudent but a necessity for all but the reckless.

This article examines *Shari'ah*-compliant finance in light of existing U.S. law. It highlights and examines areas of civil liability and criminal exposure unique to SCF investments and transactions[3] in the United States as they have been developed and utilized by various financial institutions and facilitated and promoted by legal, accounting, and financial professionals.[4] Part II provides an introduction to SCF and explains why it should be subject to special scrutiny by lawyers, accountants, and other professional advisers. Part III discusses the role of the professional in SCF transactions and suggests an analytical framework for approaching the legal issues surrounding SCF in the U.S. This framework divides the world of potential liability into two groups: liability arising out of elements endogenous to SCF, involving issues about what *Shari'ah* actually is and requires, and liability arising out of elements exogenous to SCF, such as the impact of Western adaptations of *Shari'ah* principles. Part IV focuses in detail on the former, while Part V examines legal concerns related to the latter.

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[3] The distinction made throughout this article between an SCF "investment" and "transaction" is intended and important in this context. SCF expresses itself in fundamentally two ways: (a) "the investment" refers to the kind of investment or business *Shari'ah* is understood to permit (i.e., equity versus debt with interest; asset-based versus intangibles such as derivatives or hedging transactions based upon future contingencies; and commerce in permitted versus prohibited industries), and (b) "the transaction" refers to the way in which a permitted investment or business transaction is structured, typically through the use of nominate contracts (i.e., a loan with interest may be structured as an "interest-free" cost-plus sale or sale/lease back). *See infra* notes 172–174.

[4] This article uses the term "facilitator" (or in some cases "professional facilitator") to mean the range of legal, accounting, and financial advisor professionals who are intimately involved in the promotion and structuring of SCF investments and transactions. An example of this burgeoning cottage industry can be gleaned by looking at the promotional material for the myriad professional and business conferences dedicated to SCF. *See, e.g.*, Arab Bankers Association of North America, Related Events, http://www.arabbankers.org/shared/layouts/section.jsp?_event=view&_id=120130_U127360__132301 (last visited Sept. 12, 2008) (advertising events about Islamic finance).

After examining the multitude of liability issues surrounding *Shari'ah*-compliant financing, this article concludes that SCF exposes the financial institutions and other businesses that attempt to exploit this new industry to a host of disclosure, due diligence, and compliance issues—all of which elevate the civil liability and criminal exposure these companies ordinarily factor into their business risk profiles.[5] Moreover, very little of this increased civil liability and criminal exposure has been recognized, analyzed, or guarded against in any meaningful way.[6]

Several traits of the SCF industry are particularly problematic. First, and most troubling, is the *Shari'ah* "black box" syndrome in which U.S. financial institutions and businesses involved in SCF risk grave consequences by willfully

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[5] While it is not the purpose of this article to detail the legal risks for the professional facilitators, there is substantial legal exposure for the legal, accounting, and financial professionals who provide the knowledge and expertise to develop the financial and legal instrumentalities of SCF. While "scheme liability" under a Rule 10b-5 private right of action has arguably been put to rest by the Supreme Court, to the extent that the lawyers get involved in drafting the "representations," liability will still apply. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770–74 (2008); *see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1329–32 (5th ed. 2004) (discussing "primary liability" for lawyers under Rule 10b-5); *id.* at 1465–69 (discussing the duty to report evidence of a material violation under Part 205 to Title 17 of the Code of Federal Regulations promulgated by the SEC pursuant to Section 307 of the Sarbanes-Oxley Act of 2002).

[6] This conclusion has been reached by a thorough review of the published proprietary and non-proprietary information disseminated by many of the financial institutions and the professional facilitators (i.e., the law firms, accounting firms, and financial advisors who promote SCF as a business model and marketing niche) and of the published academic and trade journals which have treated SCF in some detail over the past decade. *See* Islamic Finance Project, Sponsors, http://ifptest.law.harvard.edu/ifphtml/index.php?module=sponsors (last visited Sept. 12, 2008). Some of this material will be referenced throughout this article as its relevance to disclosure, due diligence, compliance, industry standards, and best practices are examined. Harvard's Islamic Finance Project ("IFP"), housed at the Harvard Law School, is an example of the legal profession's wholesale neglect of the legal risks and exposure associated with SCF. *See* Islamic Finance Project Homepage, http://ifptest.law.harvard.edu/ifphtml/index.php (last visited Sept. 18, 2008). Financially sponsored by various overseas Islamic banks and financial houses, the IFP has held eight separate multi-day forums over an eleven-year period and has produced a myriad of publications considered some of the most erudite on the subject. *See id.*, Islamic Finance Project, Conferences and Seminars, http://ifptest.law.harvard.edu/ifphtml/index.php?module=confsem (last visited Sept. 12, 2008). But not one single article or book produced by IFP or its scholars addresses in any substantive fashion the civil liability and criminal exposure inherent in a financial system built on a theo-legal system with intimate connections to Islamic terrorism and its call for the destruction of Western political and economic systems SCF considers heretical. *See* Islamic Finance Project, Conferences and Seminars, http://ifptest.law.harvard.edu/ifphtml/index.php?module=confsem (last visited Sept. 12, 2008).

ignoring the endogenous elements of *Shari'ah*.[7] Ignoring what *Shari'ah* is—both in theory and in practice—and its intimate connection to Islamic terror and *Jihad* against[8] the non-Muslim world amounts to corporate recklessness. Moreover, placing *Shari'ah* in a black box and treating its prohibitions as if they were benign, secular, and objective "screens" ignores the duty to disclose the most important elements of *Shari'ah*: its purposes and its ultimate methods.[9] Based on the materiality standards of contemporary securities and fraud laws, it is clear that a reasonable post-9/11 investor would consider *Shari'ah*'s connection to the Law of *Jihad* and the advocacy of violence and connection to terrorism by some of the world's leading *Shari'ah* authorities as material to their investment decision.

Second, insofar as U.S. financial institutions participate in and cooperate with the *Shari'ah* authorities' efforts to establish the rules and regulations for the SCF industry, antitrust issues such as rules collusion are likely to present additional exposure for those embracing this new industry. And lastly, the current structure of the SCF industry, in which two dozen of the most influential *Shari'ah* authorities control the way funds go in and out of the largest financial enterprises in the world, creates the paradigmatic pattern of predicate racketeering activity that any aggressive prosecutor or plaintiff's lawyer looks for in a RICO cause of action.

As a result of these troubling characteristics of *Shari'ah*-compliant finance, U.S. financial institutions and businesses have a duty to conduct reasonable due diligence to be certain that their respective *Shari'ah* authorities are neither advocating crimes in the name of *Shari'ah* nor promoting the material support of terror through either legal rulings or the funneling of "purification" funds to terrorists. Failure to conduct such due diligence can lead to catastrophic civil and criminal liability.

This analysis is a first of its kind in the published literature. To date, there has been no focused effort to identify and analyze the implications for civil liability and criminal exposure for U.S. financial institutions and other businesses engaged in any of the various manifestations of SCF. While some of the SCF professional and scholarly writings address broad regulatory concerns,[10] economic risks,[11] and

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[7] *See infra* Part IV.

[8] *Jihad* has a specific meaning in the *Shari'ah* literature. It has been translated as closer to "just war" than to "holy war" but most properly it applies to any political or violent struggle by Muslims to defend their realm or to expand it. *See* RUDOLPH PETERS, JIHAD IN CLASSICAL AND MODERN ISLAM: A READER 27–42 (2d ed. 2005); *infra* note 199.

[9] *See infra* notes 95–96 and accompanying text.

[10] *See generally* JOHN WILEY & SONS, ISLAMIC FINANCE: THE REGULATORY CHALLENGE (Simon Archer & Rifaat Ahmed Abdel Karim eds., 2007) [hereinafter ISLAMIC FINANCE] (discussing regulatory concerns); Ayman H. Abdel-Khaleq, *Offering Islamic Funds in the US and Europe*, INT'L FIN. L. REV., May 2004, at 55, *available at* http://www.iflr.com/?Page=17&ISS=16434&SID=515350 (concluding that "[d]espite regulatory burdens some of the world's most sophisticated commercial and legal jurisdictions are increasingly addressing the needs of Islamic investors").

transactional[12] and market-related hurdles,[13] scant attention has been paid to the specific civil and criminal liability implications of SCF. Necessarily, this is an introductory and preliminary effort.[14] Each specific area identified in this article requires and deserves a detailed treatment by academics and legal professionals, including government attorneys involved in financial regulation and compliance, policy specialists, and—most importantly—practitioners advising their clients on the advisability and the logistics of SCF.

II. OVERVIEW OF SHARI'AH-COMPLIANT FINANCE

A. What Is SCF?

According to the disclosures and representations of the financial institutions currently promoting SCF,[15] *Shari'ah* compliance means that a particular investment or financial transaction has been conducted or structured in a way that is considered "legal" or "authorized"[16] pursuant to Islamic law.[17] Compliance with

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[11] *See generally* EDINBURGH UNIVERSITY PRESS, THE POLITICS OF ISLAMIC FINANCE (Clement M. Henry & Rodney Wilson eds., 2004) [hereinafter POLITICS] (focusing on connections between Islamist finance and political movements); IBRAHIM WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY (2000) (focusing on the political and economic aspects of modern Islamic finance).

[12] *See generally* Michael J.T. McMillen, *Contractual Enforceability Issues:* Sukuk *and Capital Markets Development*, 7 CHI. J. INT'L L. 427 (2007) (discussing the developing Islamic capital market).

[13] *See generally* Jane Pollard & Michael Samers, *Islamic Banking and Finance: Postcolonial Political Economy and the Decentring of Economic Geography*, 32 TRANSACTIONS INST. BRIT. GEOGRAPHERS 313 (2007) (offering a post-colonial critique of Islamic banking and finance).

[14] This article does not address SCF insurance in any meaningful way. This is due in large part to the complex nature of the business of insurance and its regulation and the relatively untested models for *Shari'ah* compliant insurance schemes from within the SCF industry itself.

[15] A good yet basic recitation of SCF is provided by a U.S. Muslim academic who was the "Scholar-in-Residence: U.S. Department of Treasury" on SCF. *See* MAHMOUD AMIN EL-GAMAL, A BASIC GUIDE TO CONTEMPORARY ISLAMIC BANKING AND FINANCE (2000), http://www.ruf.rice.edu/~elgamal/files/primer.pdf.

[16] In classical and traditional Islamic law, extant and in use to this day by the recognized *Shari'ah* authorities, there are essentially five categories of normative assessments: obligatory, recommended, permitted, discouraged, and forbidden. LALEH BAKHTIAR, ENCYCLOPEDIA OF ISLAMIC LAW: A COMPENDIUM OF THE VIEWS OF THE MAJOR SCHOOLS xxxvii–xxxviii (adapted by Laleh Bakhtiar 1996) [hereinafter ENCYCLOPEDIA].

[17] While *Shari'ah* is often referred to as Islamic law, *Shari'ah* is, according to the *Shari'ah* authorities, the divine law of Allah which is articulated directly to man through the *Qur'an* and indirectly through the canonical stories of Mohammed's life as told through the *Hadith*. *See* Bernard Weiss, *Interpretation in Islamic Law: The Theory of Ijtihād*, 26

Shari'ah is achieved by having a *Shari'ah* authority—either an individual or group of individuals possessing authoritative status in matters relating to SCF[18]—approve the particular investment or type of transaction. Most financial institutions retain[19] a *Shari'ah* advisory board, which typically consists of three or more "*Shari'ah* scholars" who profess to be recognized as authorities in SCF.[20]

According to most financial institutions, SCF is achieved by the avoidance of interest,[21] risk (typically understood as uncertainty or speculation),[22] and certain

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AM. J. COMP. L. 199, 199–201 (1978). The jurisprudential rules developed by the *Shari'ah* authorities over time to arrive at finite legal rulings are often referred to as *usul al fiqh* or the roots of the law and *al fiqh* or just *fiqh* is the *corpus* of jurisprudential rules and principles. *See* FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 299, 304 (1998). *Furu'* is the term used for the positive law rulings of individual jurists. *See infra* note 43. For purposes of this article, the word *Shari'ah* is used as a collective term to include all of these elements unless otherwise indicated.

[18] There is no universally recognized degree or examination to acquire the status of an SCF authority. Generally, the discipline in *Shari'ah* related, in part, to commerce is termed *fiqh al muamalat* and, while there are jurists who specialize in this area, the qualifications for such positions are quite varied. While the industry itself is undertaking to create standards and structures for uniformity and transparency, it has not been successful to date. An examination of these issues can be found in Wafik Grais & Matteo Pellegrini, *Corporate Governance and* Shariah *Compliance in Institutions Offering Islamic Financial Services*, 1–3 (World Bank Policy Research Working Papers, Paper No. 4054, 2006), *available at* http://www.wds.worldbank .org/servlet/WDSContentServer/WDSP/IB/2006/11/08/000016406_20061108095535/Rendered/PDF/wps4054.pdf.

[19] The manner in which a *Shari'ah* advisor is employed or contracted for by the financial institution bears on several of the legal complications and risks discussed herein. *See infra* notes 318–325 and accompanying text (discussing criminal *respondeat superior*); *see also supra* note 17 and accompanying text.

[20] *See* VOGEL & HAYES, *supra* note 17, at 48–49. The number of *Shari'ah* scholars sufficiently versed in the disciplines necessary to be gainfully employed by "blue chip" financial institutions engaged in SCF is quite limited. It is generally represented that there are only about 20 competent *Shari'ah* scholars who have mastered *Shari'ah*, finance, and English well enough to be considered both an SCF scholar and employable. Richard C. Morais, *Don't Call It Interest*, FORBES.COM, July 23, 2007, http://www.forbes.com/business/global/2007/0723/104.html. For the general problem of the dearth of qualified *Shari'ah* scholars, see Grais & Pellegrini, *supra* note 18, at 7–8 & nn.17–18.

[21] In Arabic, the term used is *riba*, which literally means "increase." MERVYN K. LEWIS & LATIFA M. ALGAOUD, ISLAMIC BANKING xi (2001). In the past, there has been debate among *Shari'ah* authorities and Islamic academic scholars over the prohibition against *riba* in financial and commercial transactions. *Id.* at 34–38. Some scholars point to the fact that the prohibition against interest in the *Qur'an* is not simple interest but usurious interest and specifically a default interest prevalent in pagan pre-Islamic Arabia. *Id.* Today, the debate is academic because there is broad consensus that interest of all kinds is forbidden by *Shari'ah*. *Id.* For the consensus view of the prohibition against interest, see VOGEL & HAYES, *supra* note 17, at 77–87. *But see* TIMUR KURAN, ISLAM & MAMMON:

types of prohibited industries (relating to activities considered *haram* or "forbidden," such as the pork and alcohol-beverage industries, pornography, gambling, and interest-based financing).[23] In addition, SCF also includes a focus on "purification," which has two separate elements.[24] One is a form of obligatory charitable contribution called *zakat*, where the act of supporting the less fortunate is considered a spiritual purification;[25] the other is the purification of a *Shari'ah*-compliant investment or financial transaction that has been tainted with forbidden

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THE ECONOMIC PREDICAMENTS OF ISLAMISM 14 (2004) (advancing a contrary position that the prohibition on interest was geared more toward social purposes, such as preventing enslavement of debtors, than in fulfilling a prohibition of the *Qur'an*); Alex Alexiev, *Islamic Finance or Financing Islamism?* 6–7 (The Center for Security Policy, Occasional Papers Series No. 29, 2007) (reflecting on the most reactionary elements of Islam and its reflection in *Shari'ah*). For a discussion of how contemporary SCF has perverted the underlying "Islamic" principles of *Shari'ah* relative to social economics, see generally Mahmoud A. El-Gamal, *"Interest" and the Paradox of the Contemporary Islamic Law and Finance*, 27 FORDHAM INT'L L.J. 108 (2003); Chibli Mallat, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, *in* ISLAMIC LAW AND FINANCE 69–85 (Chibli Mallat ed., 1988).

[22] The *Qur'an* forbids gambling or *maysir*; the *Sunna* includes *gharar* or risk in the prohibition. VOGEL & HAYES, *supra* note 17, at 87–88. Since all business includes an element of risk, the jurisprudential task for the *Shari'ah* authorities is to take the specific examples found in the canonical literature, such as "[d]o not buy fish in the sea, for it is *gharar*," and to translate that command into principles, then rules, and finally into finite rulings and contract forms which are considered *halal* or permitted. *See generally* VOGEL & HAYES, *supra* note 17, at 87–95 (discussing the prohibitions related to risk).

[23] NIZAM YAQUBY, FOURTH HARVARD ISLAMIC FINANCE FORUM: HARVARD UNIVERSITY, PARTICIPATION AND TRADING IN EQUITIES OF COMPANIES WHICH MAIN BUSINESS IS PRIMARILY LAWFUL BUT FRAUGHT WITH SOME PROHIBITED TRANSACTIONS 21 (2000), http://www.djindexes.com/mdsidx/downloads/yaquby.pdf. While there is general agreement about most of these industries as absolutely forbidden, some such as the tobacco business and military and defense industries are typically forbidden in SCF in Western countries but not considered an absolute *Shari'ah* prohibition. For an exploration into the *Shari'ah* motives for forbidding defense industry investments in the West, see *infra* notes 323–324 and accompanying text.

[24] YUSUF TALAL DELORENZO, *SHARI'AH* SUPERVISION OF ISLAMIC MUTUAL FUNDS 4–5, http://www.djindexes.com/mdsidx/downloads/delorenzo.pdf (last visited Sept. 13, 2008).

[25] *See id. Zakah* (sometimes referred to as *zakat*), which literally means purification, is a form of religious tax for assisting the less fortunate and those that "struggle for Allah." The amount is between 2.5% and 20%, depending upon the source of the wealth, but it is typically on the lower end (2.5%) of the scale. The amounts also vary based upon which of the four Sunni schools of jurisprudence one follows. Shi'a Muslims also follow their own jurisprudence, which accounts for some of the variation. For a fuller discussion of this religious tax and its use to support those who "struggle for Allah" or fight against non-Muslims in holy war (i.e., *Jihad*), see generally John D.G. Waszak, *The Obstacles to Suppressing Radical Islamic Terrorist Financing*, 36 CASE W. RES. J. INT'L L. 673 (2004).

revenue, whether from interest, illicit speculation, or a forbidden commercial enterprise such as the pork industry.[26] In the latter meaning of purification, the forbidden funds must be disgorged by donating the money to an acceptable charity, but this charitable gift will not count towards a Muslim investor's *zakat* requirement.[27]

A rudimentary understanding of *Shari'ah* is required to grasp the implications of SCF relative to U.S. law. To begin, *Shari'ah*, or the "proper way," is considered the divine will of Allah as articulated in two canonical sources.[28] The first is the *Qur'an*, which is considered the perfect expression of Allah's will for man.[29] Every word is perfect and unalterable except and unless altered by some subsequent word of Allah.[30] While most of the *Qur'an*'s 6,236 verses[31] are not considered legal text, there are 80 to 500 verses[32] considered instructional or sources for normative law. However, the *Qur'an* is only one source of Allah's instruction for *Shari'ah*. The *Hadith*[33]—stories of Mohammed's life and

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[26] For an extended discussion on purification by a well-known American *Shari'ah* authority, see generally DeLorenzo, *supra* note 24 (linking and distinguishing between the charitable tax called *zakah*, which literally means purification, and the spiritual or moral purification of illicit profits).

[27] Yusuf Talal DeLorenzo, Dow Jones University Questions and Answers, Question 32, http://www.central-mosque.com/fiqh/dow.htm (last visited Sept. 13, 2008).

[28] *See supra* note 17.

[29] *See* HARVARD UNIVERSITY PRESS, THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS viii (Peri Bearman, Rudolph Peters & Frank E. Vogel eds., 2005) [hereinafter ISLAMIC SCHOOL OF LAW].

[30] For a thorough discussion from a "moderate" *Shari'ah* authority on the full theological and jurisprudential analysis of *Shari'ah*, see generally MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE (3d ed. 2003). For the specific discussion of "abrogation," which is the juridical view of latter *Qur'an*ic verses that contradict earlier ones, see generally *id.* at 202–27. For an analytical and "objective" analysis of Islamic jurisprudence and its implications for Muslim-non-Muslim relations, see STEPHEN COLLINS COUGHLIN, "TO OUR GREAT DETRIMENT": IGNORING WHAT EXTREMISTS SAY ABOUT JIHAD (WITH APPENDICES) 83–133 (2007), http://www.strategycenter.net/docLib/20080107_Coughlin_ExtremistJihad.pdf.

[31] Because the original Arabic *Qur'an* is not formally numbered and there are no periods in classical Arabic setting off one verse from another, Islamic canon typically breaks the 114 *suras* or chapters into 6,236 *ayat* or verses, but other counts are also used.

[32] WAEL B. HALLAQ, A HISTORY OF ISLAMIC LEGAL THEORIES 3, 10 (1997) (noting that Muslim jurists and scholars generally agree that there are "500 verses with legal content"). There is also a healthy debate over which verses in the *Qur'an* are actually legal sources (*ayat al-ahkam*) such that laws are directly or indirectly derived from them. According to most scholars, the debate centers on the context of the appearance of a verse which has within it a connection to normative or instructional language. Some include all such verses while others only count those verses which are clearly "legal" in that they address authorized or prohibited behavior. *See* KAMALI, *supra* note 30, at 25–27.

[33] *Hadith* is singular for "tradition." *Ahadith* is the plural. This article uses *Hadith* as the collective body of traditions.

behavior—are also considered a legal and binding authority for how a Muslim must live.[34] The *Hadith* were collected by various authors in the early period after Mohammed's death.[35] Over time, Islamic legal scholars vetted the authors for trustworthiness and their *Hadith* for authenticity, and there is now a general consensus across all Sunni schools that there are six canonical *Hadith*.[36] The legal or instructional portions of the *Hadith* together make up the *Sunna*.[37] While the

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[34] *See* MARSHALL G. S. HODGSON, 2 THE VENTURE OF ISLAM: CONSCIENCE AND HISTORY IN A WORLD CIVILIZATION 453 (1974).

[35] *See* KAMALI, *supra* note 30, at 5.

[36] The *Hadith* were not formally collected until approximately 100 to 200 years after the death of Mohammed. *See* ISLAMIC SCHOOL OF LAW, *supra* note 29, at viii–xii (discussing the informal process by which *Hadith* were originally handed down, and the impact on Islamic law and scholarship of collecting the *Hadith*); *see also* Coughlin, *supra* note 30, at 55–56 n.90 (describing the passing on of the *Hadith*).

> Individuals associated with Muhammad in his lifetime were called "companions." Among the numerous companions, the seven most prolific commentators on his life were Abu Hurrairah 'Abdur Rahman bin Sakhar Dasi (5,374 hadith), Abdullah bin Umar bin Khattab (2,630), Anas bin Malik (2,286), Aisha (2,210), Abdullah bin Abbas (1,660), Jabir bin Abdullah Ahsan (1,540), and Sa'ad bin Malik Abu Saeed Khudhri (1,540). The compiled hadith of these companions did not survive in their original creations but were passed down and collected by numerous hadith collectors of varying quality and repute. Six scholars stand out among hadith collectors for the reputed accuracy and authenticity in the selection of hadith they chose to include as a part of their collections. In precedent order, the six "correct" collections of the Sunni, also called the "Six Canonical Collections" (the Sahih Sittah), are the works of Bukhari, Muslim, Abu Dawud, Tirmidhi, Ibn Maja and Nasa'i. Hence, if a story concerning Muhammad is related through one of the six "correct" collections and it reliably cites one of the seven companions, a presumption emerges, verging on irrebuttable, that the texts cited are accurate for the points being made - as matters of both Islamic theology and law. Because those accounts are presumed reliable, the *Sunna* arising from them cannot be construed to contradict the Qur'an but rather are to be understood as doctrinally authoritative explanations of the Quranic verses they support: "*Whatever the Messenger gives you, then take it and whatever he prohibits you, then stay away from it.*" (Qur'an 59:7)

Id.

[37] ISLAMIC LEGAL THEORIES, *supra* note 32, at 1–35 (analyzing the "formative period" of *Shari'ah* and the transformation from custom, to Prophetic normative instruction, to the basis for Islamic law through the development of the *Hadith*); *see also* NOAH FELDMAN, THE RISE AND FALL OF THE ISLAMIC STATE 23–27 (2008) (characterizing the *Hadith* as one of the "bas[es] for a legal system"). The debate over the role the *Hadith* should play as the secondary basis for *Shari'ah* is in fact the debate between the traditionalists who follow the millennium-old doctrine of the Islamic legal schools versus the progressives, typically in academia. The former account for the "*Shari'ah* authorities"

Shari'ah authorities from the Shi'a Muslim world also accept the *Hadith* as authoritative, they do not accept certain authors' authority—a belief based mostly upon theological grounds.[38] For all *Shari'ah* authorities, however, the *Qur'an* is considered the primary and direct revelation of Allah's will, while the *Sunna* is the indirect expression of that will and secondary.[39] Both sources are generally considered absolutely infallible and authoritative.[40]

In order to divine the detailed laws, norms, and customs for a Muslim in all matters of life, the *Shari'ah* authorities over time developed schools of jurisprudence to guide their interpretations of the *Qur'an* and *Sunna*. While there is broad agreement among the schools about the jurisprudential rules, important distinctions between the schools result in different legal interpretations and rulings, albeit typically differences of degree, not of principle.[41] The rules of interpretation

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and the latter for university professors who wish to distance themselves and Islam from the quite bellicose legal-military doctrines derived from the *Hadith*. The subject is fascinating and rich with drama but not one this article can take up. The interested reader should begin with Coughlin, *supra* note 30, at 83–133, and then turn to one of the founders of the academic study of *Shari'ah* and Islamic jurisprudence, Joseph Schacht. A must-read for anyone interested in the subject is JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW (1982) [hereinafter SCHACHT, ISLAMIC LAW], and JOSEPH SCHACHT, MUHAMMADAN JURISPRUDENCE (1950) [hereinafter SCHACHT, MUHAMMADAN JURISPRUDENCE]. Revisionists abound and two interesting versions are ISLAMIC LEGAL THEORIES, *supra* note 32, and WAEL B. HALLAQ, THE ORIGINS AND EVOLUTION OF ISLAMIC LAW (2005) on the one hand; and M. MUSTAFA AL-AZAMI, ON SCHACHT'S ORIGINS OF MUHAMMADAN JURISPRUDENCE (1996) on the other hand. Useful also would be KAMALI, *supra* note 30.

[38] Shi'a Islam differs from Sunni Islam theologically on whom they consider to be legitimate successors to Mohammad's reign as leader of the Muslim *Umma* or nation; this difference has jurisprudential consequences because Shi'a Muslims, who await the return of the Twelfth Imam or Caliph following Mohammed, consider their Imams who have followed in the Twelfth Imam's footsteps to be his stand-in until his return and as such they share his infallibility. *See* FELDMAN, *supra* note 37, at 128–29; Coughlin, *supra* note 30, at 237–39. Thus, the leading contemporary Shi'a Imams are considered by their followers as inerrant and their legal rulings take on the perfection one would expect from inerrant beings. *See* Coughlin, *supra* note 30, at 27 & n.52.

[39] M. Cherif Bassiouni & Gamal M. Badr, *The Shari'ah: Sources, Interpretation, and Rule-Making*, 1 UCLA J. ISLAMIC & NEAR EASTERN L. 135, 138–39 (2002).

[40] *See id.* at 141 & n.12, 151, 171.

[41] As noted, the *Shari'ah* authorities developed different schools of legal interpretation. These schools are called *maddhahib* (or *maddhab* in the singular form). *See id.* at 161. Early in their development, there were many schisms and new schools, but over time, the main body of legal scholarship and almost all *Shari'ah* authorities have long come to recognize only four extant schools among Sunni Muslims and one dominant school (some cite two) among Shi'a Muslims. *See id.* at 161–62. While there are important jurisprudential and theological differences between the Sunni and Shi'a, see *supra* note 38, and indeed between the schools themselves within the respective Sunni and Shi'a traditions, the specific rulings among all schools on the fundamental issues regarding the purposes of *Shari'ah*, the point of the individual Muslim's life, and the integrity and unity

and their application to finite factual settings in the form of legal rulings are collectively termed *al fiqh* (literally "understanding").[42] *Usul al fiqh*, or the "sources of the law," is what is normally referred to as jurisprudence.[43] Technically, *Shari'ah* is the overarching divine law and *fiqh* is the way *Shari'ah* authorities have interpreted that divine law in finite ways.[44] It is important to note, however, that the word *Shari'ah* appears only once in the *Qur'an* in this context,[45] yet it has gained currency in the Islamic world by virtue of *Shari'ah* authorities, over a period of more than a millennium, creating a *corpus juris* (i.e., *al fiqh*) based upon their interpretative understandings of the *Qur'an* and *Sunna*.[46] As such, this article uses the word *Shari'ah* to mean all of Islamic jurisprudence, doctrine, and legal rulings.

Prior to the twentieth century, there was no discipline termed *Shari'ah*-compliant financing or even a *Shari'ah* sub-code regarding commercial transactions.[47] There are rulings by *Shari'ah* authorities permitting certain contract

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of the Muslim nation as a whole and the methodologies to achieve those ends are remarkably consistent. *See generally* Coughlin, *supra* note 30 (describing similar views among different Muslim schools on *jihad*).

[42] *See* VOGEL & HAYES, *supra* note 17, at 299.

[43] *See* VOGEL & HAYES, *supra* note 17, at 304. *Furu'* is the Arabic word most often associated with positive law or the particular rulings in any given case. *See* VOGEL & HAYES, *supra* note 17, at 299. For a discussion of *furu'* and *usul al-fiqh*, see Wael B. Hallaq, Usul al-Fiqh: *Beyond Tradition*, 3:2 J. ISLAMIC STUD. 172–202 (1992).

[44] *See* VOGEL & HAYES, *supra* note 17 at 23–24; *see also* Bassiouni & Badr, *supra* note 39, at 135.

[45] *See Qur'an* 45:18. *But see Qur'an* 5:48, where a variation of the word appears and has the meaning of the "proper way"; while some might argue that the word appears in yet other variations, the first of these two are the typical verses cited where the word is used in the sense of a legally proper path.

[46] *See generally* Bassiouni & Badr, *supra* note 39, at 135–71 (discussing the process and evolution of Islamic jurisprudence).

[47] The legal verses of the Qur'an are typically broken down into those verses dealing with religious rites and worship (*ibadat*) and those dealing with civil relations including commerce, political life, and the Law of *Jihad* (*mu'amalat*). *See* KAMALI, *supra* note 30, at 26; VOGEL & HAYES, *supra* note 17, at 299, 301. What is confusing to many is that academics writing on the subject of SCF often define *mu'amalat* as civil or commercial relations giving the impression that there is in fact some sub-code of strictly commercial matters devoid of broader implications. *See, e.g.*, Yusuf Talal DeLorenzo & Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis*, *in* ISLAMIC FINANCE, *supra* note 10, at 132, 142 (characterizing *mu'amalat* as "transactions" and stating that *mu'amalat* is "highly articulated . . . precisely" because of the commercial context in which it developed). *But cf.* VOGEL & HAYES, *supra* note 17, at 301 (defining "*mu'amalat*" as "dealings or transactions among human beings; compare '*ibādāt*'"). Thus, while the "glossary" definition is technically correct and properly juxtaposes *mu'amalat* against *ibadat*, the reader who would need such a glossary is not likely to understand that *mu'amalat* is as much the Law of *Jihad* as it is commercial dealings. *See* KAMALI, *supra* note 30, at 26.

forms dating back hundreds of years, but as late as the 1900s, there was still some debate among *Shari'ah* authorities as to whether the prohibition against interest was absolute or just against usurious interest.[48] When contemporary Islamic political thinkers began to confront the collapse of the Ottoman Empire after the First World War and the intrusion of Western modes of social, political, and commercial life into the heart of the Muslim world, *Shari'ah* authorities followed their lead and began to issue legal rulings to confront this new reality.[49] Beginning with the early political-theological writings of men such as Maulana Abul Ala Mawdudi—who argued for an Islamic political resurgence and a unique Islamic political economy—*Shari'ah* authorities followed suit by issuing authoritative legal rulings forbidding interest on deposits and calling for the establishment of "Islamic banks."[50] Over time, these rulings have incorporated prohibitions against transactions considered too uncertain or speculative and also rulings to prevent Muslims from investing in businesses engaged in un-Islamic behavior.[51]

The development of these rules and the formalization of SCF have matured over the past three decades so that today there are entire university departments in the Middle East, Asia, and even in Western universities dedicated to the study of SCF.[52] Most observers connect this recent development to the emphasis of *Shari'ah* in the oil-producing Arab states and their wealth-driven influence throughout the Muslim world and the West.[53]

Effectively, SCF is an attempt to embrace modern interest-based commerce and finance, but developed within a framework of *Shari'ah*-approved structures. For example, while almost all *Shari'ah* authorities forbid any transaction or investment which provides for interest income, SCF rules allow for interest in two ways. One way is to rule that a Muslim can invest in a permitted business that

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[48] *See* Walid S. Hegazy, *Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism*, 7 CHI. J. INT'L L. 581, 581 (2007).

[49] *See generally supra* note 21 (discussing *riba* and the prohibition on interest). For the "socio-economic" impetus for SCF, see Hegazy, *supra* note 48, at 583–88.

[50] *See* LEWIS & ALGAOUD, *supra* note 21, at 119–20.

[51] *See generally* DeLorenzo & McMillen, *supra* note 47, at 132–97 (discussing the implications of modern Islamic commercial jurisprudence).

[52] *See* Muslim-Investor.com, Resources - Education/Curricula in Islamic Finance, Economics and Banking, http://muslim-investor.com/mi/education.phtml (last visited Sept. 13, 2008) (listing university departments); *see also supra* note 6 (discussing Harvard's IFP).

[53] *See generally* WARDE, *supra* note 11, at 72–89 (theorizing of a "First and Second Aggiornamento" to suggest a first movement driven by a centralization of power and influence flowing from Arab oil wealth and a second movement driven by decentralized social, political, and financial constituencies). For a media rendition of the oil wealth-driven industry, see Wayne Arnold, *Islamic Banking Grows with Oil Wealth Infusion: Sharia-based Loans Draw Non-Muslims*, INT'L HERALD TRIB., Nov. 22, 2007, at 12, *available at* http://www.iht.com/articles/2007/11/22/business/islamic.php.

earns or pays interest but only if the amount is below a maximum level.[54] Any profit earned by the Muslim from that interest component, however, must be purified by contributing that portion to a *Shari'ah*-approved charity.[55] A second way to accommodate modern commercial transactions is to structure the forbidden transaction within *Shari'ah*-approved contract forms.[56] These nominate contracts are based upon contract forms found in the classical rulings of the *Shari'ah* authorities prior to the advent of contemporary finance.[57] Thus, a loan might be structured as a "cost-plus sale" where the lender buys the property and immediately sells it back to the borrower for a "profit." This profit is the interest component in the typical loan transaction. The purchase price with the profit component included can be paid over time to resemble an amortized loan repayment schedule. Other forms are available to deal with interest and also with unduly speculative transactions, including sale or lease-back contracts, and partnerships with variations and combinations.[58] For the more complex transactions, these *Shari'ah*-approved nominate contracts are often pieced together and used in combination to arrive at a *Shari'ah*-compliant modern commercial deal.[59]

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[54] The first order of business for determining whether a business is *Shari'ah* compliant is to make certain that it is not involved in a "vice" industry such as interest-based financing, the pork industry, various forms of the entertainment industry, and gambling. The question for *Shari'ah* authorities is how much "involvement" in a prohibited business amounts to a violation of *Shari'ah* such that an investor must not invest in that company. The same question applies to a permitted business that might earn interest on deposits or accounts payable and pay interest on debt: how much interest is too much interest? For a discussion of the *Shari'ah* authority opinions on this matter by one of the leading *Shari'ah* authorities, see generally Yaquby, *supra* note 23.

[55] *See* DeLorenzo, *supra* note 24, at 4–5.

[56] *See, e.g.*, Haider Ala Hamoudi, *Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance*, 40 CORNELL INT'L L.J. 89, 90–91 (2007).

[57] *See* DeLorenzo & McMillen, *supra* note 47, at 144–45.

[58] *See* VOGEL & HAYES, *supra* note 17, at 181–200; *see also* DeLorenzo & McMillen, *supra* note 47, at 143–45 (discussing nominate contracts).

[59] *See* DeLorenzo & McMillen, *supra* note 47, at 143–50. Since the development of SCF, the debate among Islamic, economic, and *Shari'ah* scholars continues over the propriety of this new field of *Shari'ah* scholarship. Some argue that the industry is nothing more than form over substance and an abuse of *Shari'ah*. Others contend that SCF is a convoluted way for *Shari'ah* to effect its purposes in modern Western financial institutions. For the former, the debate is over the perversion of *Shari'ah* and its pre-modern ethic and economic principles. This group of critics would prefer that *Shari'ah* be used to modify the existing political economies to move away from interest-based debt and highly speculative and leveraged derivative transactions. For the latter group of critics, SCF is more than just an attempt to mollify the *Shari'ah* authorities; it is a "Trojan horse" to legitimatize and to institutionalize *Shari'ah*, the purpose of which is the destruction of Western societies as such. For an example of the former group, see generally Hamoudi, *supra* note 56, at 89–

B. Why Is SCF Important?

As a burgeoning industry, SCF is touted as "[o]ne of the fastest growing" sectors in the global financial markets.[60] Total funds committed to SCF investments are estimated to be $800 billion worldwide,[61] with $200 billion of assets under management in *Shari'ah*-compliant banks.[62] Annual growth in this sector is estimated at 15 percent,[63] based presumably upon current trends fueled mainly by profits in the Muslim oil- and gas-producing countries and by a worldwide Muslim population reported to be growing faster than the population of any other of the world's major religions.[64]

Within the SCF market, *Shari'ah*-compliant bonds, known in Arabic as *sukuk*,[65] are the most explosive segment driven by huge petrodollar profits creating enormous sovereign wealth and liquidity.[66] There is reportedly "$1.3 trillion looking for high-quality Islamic assets" with only $37.3 billion in *Shari'ah*-

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133; El-Gamal, *supra* note 21, at 108–11. For the latter group, see generally Alexiev, *supra* note 21, at 13; Timur Kuran, *The Genesis of Islamic Economics; A Chapter in the Politics of Muslim Identity*, SOC. RES., Summer 1997, at 301, *available at* http://findarticles.com/p/articles/mi_m2267/is_n2_v64/ai_19652892/pg_1 (reviewing the recent origins of "Islamic economics").

[60] Drake Bennett, *The Zero Percent Solution: A Renaissance for 'Islamic Finance' -- A Version of Capitalism that Avoids Interest -- Offers Innovative Financial Tools to Muslim and Non-Muslim Alike*, BOSTON GLOBE, Nov. 4, 2007, at C1, *available at* http://www.boston.com/news/education/higher/articles/2007/11/04/the_zero_percent_solution/.

[61] Alexiev, *supra* note 21, at 1.

[62] *See* Inst. of Islamic Banking and Ins., Islamic Banking - Status of Islamic Banking, http://www.islamic-banking.com/ibanking/statusib.php (last visited Sept. 13, 2008).

[63] *See* Mohammed El Qorchi, *Islamic Finance Gears Up*, FIN. & DEV., Dec. 2005, at 46, 46, *available at* http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm. Growth is reported to have reached almost 30% annually. *See* Karina Robinson, *No Subprime Crunch for Islamic Banking*, INT'L HERALD TRIB., Nov. 6, 2007, at 13, *available at* http://www.iht .com/articles/2007/11/05/business/bankcol06.php.

[64] Gayle Young, *Fast Growing Islam Winning Converts in Western World*, CNN INTERACTIVE, Apr. 14, 1997, http://www.cnn.com/WORLD/9704/14/egypt.islam/. The Executive Vice President and General Counsel of the Federal Reserve Bank of New York cited a White House report that Islam is the "fastest growing faith in the United States." Thomas C. Baxter, Jr., Executive Vice President & Gen. Counsel, Fed. Reserve Bank of N.Y., Welcome Speech to the Seminar on Legal Issues in the Islamic Financial Services Industry (March 1, 2005), *available at* http://www.newyorkfed.org/newsevents/speeches/2005/bax050301.html.

[65] *Sukuk* in Arabic is plural for bonds; *sakk* is the singular form. McMillen, *supra* note 12, at 427–28 n.1.

[66] Mark Bendeich, *Islamic Finance: Safe Haven or Irrational Exuberance?* REUTERS, Dec. 10, 2007, http://www.reuters.com/article/bankingfinancial-SP-A/idUSKLR2770822 0071210.

compliant bonds issued in the third quarter—double the amount issued during the same period the previous year.[67] These facts lead one to the conclusion that, despite the increase in the amount of Shari'ah-compliant bonds issued, there is still a much greater demand for them waiting to be quenched

All of this growth, underwritten mostly by the mobile, highly liquid capital flowing out of the GCC states,[68] has generated an industry of financial institutions, law firms, accounting firms, financial advisors, and money managers establishing domestic and international links with the key investment figures in the GCC states in an effort to exploit the opportunity for substantial profits.[69] This enthusiasm has spread to domestic U.S. financial industries, and expresses itself in many forms.[70]

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[67] *Id.* Growth in this industry is best illustrated graphically. For growth data on *Shari'ah* compliant bonds, see *infra* app. A. To put the *Shari'ah* compliant bond issuance in context, the total net issuances of all international bonds and notes for the third quarter of 2007 was $396 billion, which represents a significant downturn in worldwide demand for such debt instruments. *See* Ryan Stever et al., *Highlights of International Banking and Financial Market Activity*, BIS Q. REV. Dec. 2007 at 19, 19–21, *available at* http://www.bis.org/publ/qtrpdf/r_qt0712.pdf. That *Shari'ah* compliant bonds were showing spectacular growth in the same quarter and representing approximately 10 percent of worldwide demand speaks volumes for the popularity and the liquidity of this particular market segment.

[68] *See* Bendeich, *supra* note 66. The principal oil-producing Muslim states are located in and around the Persian Gulf: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, the United Arab Emirates, Iraq, and Iran. These countries, sans Iraq and Iran, formed the Cooperation Council for the Arab States of the Gulf in February 1981. *See* Cooperation Council for the Arab States of the Gulf Charter art. 22, May 25, 1981, *available at* http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=1.

[69] For some of the promotional literature naming several of the "facilitators," see, e.g., John Butcher, *Shariah Funds Inc Introduces the First Islamic Hedge Fund Aided by Scholars*, HEDGE FUNDS REV., http://www.shariahfunds.com/news/images/Hedge_Funds-Rev.pdf (last visited Sept. 13, 2008). For an example of an international law firm offering such services in Qatar, see Patton Boggs LLP, Attorneys at Law, Offices, Doha, http://www.pattonboggs .com/Locations/Office .aspx?office=4 (last visited Sept. 13, 2008). For Patton Boggs promotional material indicating the law firm is also a registered agent for lobbying on behalf of the Saudi Arabian government, see Patton Boggs LLP, Attorneys at Law, Middle East Region, http://www.pattonboggs.com/ middleeast/ (last visited Sept. 13, 2008). The law firm of King and Spaulding also highlights its activities in the area on its Internet site. *See* King & Spaulding, Islamic Finance & Investment: Overview, http://www.kslaw.com/portal/server.pt?space=KSPublicRedirect&control=KSPublicRedirect&PracticeAreaId=141&us_more=0 (last visited Sept. 13, 2008); *see also* Brian O'Connell, *Gulf's Super Rich Return Home*, MIDDLE E. ECON. DIG., Dec. 21, 2007, at 48–50 (discussing the growth of Gulf wealth management services).

[70] For information on GCC sovereign wealth funds purchasing U.S. assets, see generally David Enrich, *Oil-Rich Persian Gulf Countries Show Growing Financial Clout,* DOW JONES NEWSWIRES, Oct. 22, 2007, http://www.zawya.com/story.cfm/sidDN200709 20015851. For the push to establish SCF in the U.S., see generally Wayne Arnold, *Adapting Finance to Islam*, N.Y. TIMES, Nov. 22, 2007, at C1, *available at*

For instance, U.S. companies now seek to invest in *Shari'ah*-compliant bonds domestically and globally;[71] Dow Jones and Company[72] and Standard & Poor's[73] have both established *Shari'ah*-compliant indexes that screen equities based upon software filters meant to eliminate *Shari'ah*-non-compliant businesses; *Shari'ah*-compliant, U.S.-based managed equity funds[74] and off-shore hedge funds[75] managed or advised by entities related to U.S. financial institutions have been established and can now peg their performances against these indexes;[76] and U.S. banks have begun to offer *Shari'ah*-compliant home loans and other credit facilities[77] (with federal banking authorities opining about their legality and at least one state tax authority issuing a ruling on the tax implications of a *Shari'ah*-compliant transaction).[78]

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http://www.nytimes.com/2007/11/22/business/worldbusiness/22islamic.html?ei=5087&em=&en=d6f0821c05a1d02f&ex=1195880400&pagewanted=all.

[71] Karen Lane, *Islamic-Bond Market Becomes Global by Attracting Non-Muslim Borrowers*, WALL ST. J., Nov. 16, 2006, at C1; *see also* Press Release, Dow Jones, Dow Jones Indexes and Citigroup to Launch First Islamic Bond Index (Mar. 6, 2006), *available at* http://www.dj.com/Pressroom/PressReleases/Other/US/2006/0306_US_DowJones Indexes_1095.htm (announcing a new index that measures the performance of *Shari'ah* compliant bonds).

[72] *See* Dow Jones Indexes, Dow Jones Islamic Market Indexes, http://www.djindexes.com/mdsidx/?event=showIslamic (last visited Sept. 13, 2008).

[73] *See* STANDARD & POOR'S, S&P SHARIAH INDICES: INDEX METHODOLOGY (2007), *available at* http://www2.standardandpoors.com/spf/pdf/index/SP_Shariah_Indices_ Methodology_Web.pdf.

[74] *See* The Iman Fund, Comparisons with Market Indexes, http://halastock.com/cgi-bin/client_product.cgi?userid=&password=&member=55&product_id=527 (last visited Sept. 13, 2008) [hereinafter Iman Fund].

[75] *See* Joanna Slater, *Growing Interest: When Hedge Funds Meet Islamic Finance*, WALL ST. J., Aug. 9, 2007, at A1, *available at* http://online.wsj.com/article/SB118661926443492441 .html?mod=todays_us_page_one.

[76] *See* Iman Fund, *supra* note 74.

[77] *See, e.g.*, Devon Bank, Devon Bank Offers Islamic Financing Services Designed to Avoid Conventional Interest Common in Traditional Banking Products, http://www.devonbank.com/Islamic/ (last visited Sept. 13, 2008) (promoting Chicago-based Devon Bank's Islamic finance products).

[78] *See, e.g.*, Shirley Chieu, *Islamic Finance in the United States: A Small but Growing Industry*, CHI. FED LETTER, May 2005, No. 214, *available at* http://www.chicagofed.org/publications/fedletter/cflmay2005_214.pdf (addressing the demand for and availability of financial products catered to Muslim communities); Letter from Jonathan H. Rushdoony, District Counsel, Comptroller of the Currency: Administrator of National Banks, to [Redacted] (June 1, 1999), *available at* http://www.occ.treas.gov/interp/nov99/int867.pdf (opining on whether *Murabaha* financing is part of the business of banking); Letter from Jonathan H. Rushdoony, District Counsel, Comptroller of the Currency: Administrator of National Banks, to Steven T. Thomas, General Manager, United Bank of Kuwait (Oct. 17, 1997), *available at* http://www.occ.treas.gov/interp/dec97/int806.pdf (opining on the compliance of the United Bank of Kuwait's net lease home financing

C. The Need for Heightened Scrutiny

When investing or entering into financial transactions, why should adherence to the normative principles of *Shari'ah* require any special or heightened scrutiny in relation to civil liability or criminal exposure? The most immediate answer is that, according to the proponents and practitioners of SCF, *Shari'ah* is not simply an approach to interest-free, ethical investing. Instead, SCF is invariably described by SCF proponents, practitioners, and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern finance and commerce.[79]

As understood on its own terms or by the many constituencies who interpret it, *Shari'ah* is not predicated upon a personal or subjective understanding of what it means to be a Muslim neither is it simply an objective formal law or behavioral code regulating finance and commercial transactions. *Shari'ah* has been described as "holistic,"[80] as "designating good order, much like nomos,"[81] and definitively by Joseph Schacht, one of the founding fathers of modern scholarship regarding Islamic jurisprudence: "The sacred Law of Islam is an all-embracing body of religious duties . . . ; it comprises on an equal footing ordinances regarding worship and ritual, as well as political and (in the narrow sense) legal rules."[82]

In one of the first academic presentations of this new industry, Professors Frank Vogel and Samuel Hayes explain that *Shari'ah* is not a personalized, subjective, pietistic approach to Islam, but an institutionalized legal-political-normative doctrine and system:

> Islamic legal rules encompass both ethics and law, this world and the next, church and state. The law does not separate rules enforced by

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product for Muslim customers with the United States Code); *see also* Advisory Opinion of the State of N.Y. Comm'r of Taxation and Fin., Petition No. M010821A, at 1–2 (July 26, 2002) , *available at* http://www.tax.state.ny.us/pdf/advisory _opinions/real_estate/a02_ 4r.pdf (opining on the real estate transfer tax consequences on Islamic financing products).

[79] *See generally* VOGEL & HAYES, *supra* note 17, at 4–5 (explaining the shift from the "centuries-old practice of finance in Islamic form" to the "revival of Islamic finance"). SCF is "legal" in the sense that it includes aspects of binding law, especially in Muslim countries where *Shari'ah* is considered both constitutional and statutory, such as Saudi Arabia, Iran, and Sudan; "normative" in the sense that *Shari'ah* is considered an all-encompassing way of life; and "communal" in the sense that communities of Muslims have in fact embraced *Shari'ah* as authoritative at some level. *See id.* at 23–47.

[80] *See* Bassiouni & Badr, *supra* note 39, at 135 (noting that Islam, as a religion, is holistic as a means of describing the workings of Shari'ah).

[81] WARDE, *supra* at note 11, at 33 (citing AZIZ AL-AZMEH, ISLAM AND MODERNITIES 12 (1993)) (quotations omitted). 'Nomos' refers to the overarching internal and external principles which provide order to the world.

[82] SCHACHT, ISLAMIC LAW, *supra* note 37, at 1.

> individual conscience from rules enforced by a judge or by the state. Since scholars alone are capable of knowing the law directly from revelation, laypeople are expected to seek an opinion (fatwa) from a qualified scholar on any point in doubt; if they follow that opinion sincerely, they are blameless even if the opinion is in error.[83]

This classical understanding of *Shari'ah* has been echoed by a leading professor of finance in Australia and a senior official in the Bahrain Ministry of Finance and National Economy:

> Since Islamic law reflects the will of God rather than the will of a human lawmaker, it covers all areas of life and not simply those which are of interest to a secular state or society. It is not limited to questions of belief and religious practice, but also deals with criminal and constitution [sic] matters, as well as many other fields which in other societies would be regarded as the concern of the secular authorities. In an Islamic context there is no such thing as a separate secular authority and secular law, since religion and state are one. Essentially, the Islamic state as conceived by orthodox Muslims is a religious entity established under divine law.[84]

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[83] VOGEL & HAYES, *supra* note 17, at 23.

[84] LEWIS & ALGAOUD, *supra* note 21, at 24. While the authors attempt to "tone down" this absolute statement of *Shari'ah* by suggesting that as a practical matter *Shari'ah* has in fact lived side-by-side with secular law and in some cases even incorporated it into *Shari'ah*, they honestly but almost unnoticeably add the following to their effort to soften *Shari'ah*:

> The continuation of a custom of a particular place or community is allowable under Islamic law, and may in fact be assimilated into the law, as were many of the customs of the Arabs. *To be permissible a custom must not be contrary to revealed injunctions*, and this point remains highly controversial in some areas, for example the treatment of women.

Id. at 25 (emphasis added). What the authors mean by "revealed injunctions" are the legal rulings of *Shari'ah* authorities where there is consensus among the authorities that any particular ruling is based on an explicit verse in the Qur'an or Sunna. *See infra* notes 94, 201 and accompanying text (discussing jurisprudential force of "consensus"). What is intriguing is that of all of the fixed unalterable laws of *Shari'ah*, the authors are concerned about the treatment of women. While many certainly argue that *Shari'ah* demeans and subordinates the Muslim woman, one might have thought that the fixed death penalty for an apostate—a Muslim who wishes to leave Islam—would have captured their concern sufficiently for articulation. Apparently, it is not, in the authors' views, "highly controversial" among the *Shari'ah* faithful.

Shari'ah is therefore not a religious legal code in which offensive[85] areas of law can be isolated and removed from a cauterized *corpus juris*. Instead, *Shari'ah* is understood by authorities and scholars as an indivisible "way of life"[86] that informs a *Shari'ah*-adherent Muslim's entire being and identity as a Muslim,[87] including his relationship to his family, the poor, the stranger, the visitor, national political life, the Muslim *Umma* (or "nation"), religious ritual, business and financial dealings, and the enemy.[88] While *Shari'ah* includes more than a millennium of legal decisions developed through Islamic jurisprudence and informal, code-like compilations developed by the different "schools of jurisprudence,"[89] *Shari'ah* proper is the overarching authoritative architecture for all Islamic jurisprudence and the specific legal decisions that make up the *corpus* of a juristic body of Islamic dictates and norms.[90]

Understood in its proper context, anything deemed *Shari'ah*-compliant by Islamic legal authorities must first and foremost be within the gestalt of *Shari'ah*. It is not enough, according to *Shari'ah*, that a Muslim conducts his own affairs and business according to some narrow definition of Islamic ethical business practices.[91] For a *Shari'ah*-adherent Muslim to conduct his business and financial affairs properly, he must not knowingly promote through his business dealings any forbidden action or violation of a fundamental precept of *Shari'ah* or the legal rulings promulgated thereunder.[92] This is what the scholars mean when they describe *Shari'ah* as "holistic" or a fully integrated religious, moral, and legal code.[93]

It has been the duty of the *Shari'ah* legal scholars over the ages to understand these precepts and to apply them to new and changing circumstances. The degree to which individual Muslims or the political powers ruling over them have adhered to *Shari'ah* as determined by the authoritative Islamic jurists has varied tremendously. It can be said with some historical confidence that *Shari'ah* has

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[85] By "offensive," it is meant contrary to Anglo-American norms and laws. An example of an offensive, yet classical and still authoritative *Shari'ah* ruling might include the imposition of capital punishment for apostasy. *See, e.g.*, Coughlin, *supra* note 30, at 50–51 nn.77–79.

[86] The literal meaning of *Shari'ah* is "the way"—especially to the source of water (i.e., life). *See* Coughlin, *supra* note 30, at 86.

[87] *See, e.g.*, DeLorenzo & McMillen, *supra* note 47, at 136–37.

[88] *See* Coughlin, *supra* note 30, at 85–86 (emphasizing that the principles of Islam encompass the believer's entire life).

[89] Coughlin, *supra* note 30, at 100 n.185. For a detailed discussion of the schools of jurisprudence see *supra* note 41.

[90] *See* Bassiouni & Badr, *supra* note 39, at 135–38.

[91] *See* DeLorenzo, *supra* note 24, at 1–3.

[92] *See* DeLorenzo, *supra* note 24, at 4–6 (explaining the functions of a *Shari'ah* Supervisory Boards).

[93] *See generally* DeLorenzo, *supra* note 26, at 1–13 (demonstrating the holistic approach by the need to have *Shari'ah* Supervisory Boards).

been honored more in the breach than in its observance.[94] But the breaches have not diminished the absolute authority of *Shari'ah* and its jurisprudence, as articulated by Islamic legal scholars and the institutions they have established over the past 1200 years, to define the legal limits of permitted and proscribed behavior among the hundreds of millions of Muslims worldwide who consider *Shari'ah* a way of life, as much religion and moral guide as civil and criminal code.[95]

The implication of this more complete understanding of *Shari'ah* is that one cannot speak of *Shari'ah*-compliant finance, business, or economics in the U.S. without understanding *Shari'ah* as articulated by the *Shari'ah* authorities and its ramifications for the U.S. investor. This is especially true given the legal implications surrounding the duty to disclose for financial institutions contemplating an SCF transaction. Consider, for example, a mutual fund that promotes itself as *Shari'ah*-compliant. Having licensed the use of the Dow Jones Islamic Market Index (DJIMI), which utilizes a software filtering protocol determined to be *Shari'ah*-compliant by the *Shari'ah* advisory board retained by Dow Jones & Company, the mutual fund selects a subset of the indexed, listed equities for its portfolio. A careful reading of the DJIMI's marketing material and of the registration statements filed by DJIMI-utilizing funds indicates that disclosure issues abound.[96]

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[94] There is no shortage of academic literature on the political and religious turmoil that existed in the Muslim empires from soon after the death of Mohammed and the battles between the "traditionalists" who sought a *Shari'ah*-centered political world and those who opposed it for one reason or another. A good, deep history of Islam may be found in the three volume work of HODGSON, *supra* note 34, and, of course, in the required reference to BERNARD LEWIS, THE MIDDLE EAST: A BRIEF HISTORY OF THE LAST 2,000 YEARS (1995). For the narrative of the failures in Islamic history by the political leaders to abide by *Shari'ah* from the "traditionalist" vantage, see SAYYID QUTB, SOCIAL JUSTICE IN ISLAM 169–260 (Hamid Algar trans., rev. ed., 2000). For the classic statement on this "theory" versus "practice" and the dominant role of *Shari'ah* authorities to determine the theory and even the practice when *Shari'ah* is put into practice, see SCHACHT, ISLAMIC LAW, *supra* note 37, at 76–85. For the lament of a "moderate" *Shari'ah* academic scholar who would like to see *Shari'ah* and *usul al-fiqh* modernized so that it might be used to govern modern societies, and suggesting that the failure of *Shari'ah* to keep pace with modernity was precisely because it often was not fully integrated into Islamic society but rather developed as a private affair among *Shari'ah* authorities, see KAMALI, *supra* note 30, at 500–21.

[95] This is evident in SCF itself. The sole authorities for determining *Shari'ah* compliance or even what is "Islamic" regarding finance and commerce are the traditional *Shari'ah* scholars. Whatever qualms some critics might have for the "Islamist" bent of SCF, there is no serious challenge to the absolute authority of the traditionalists in this discipline. *See, e.g.*, VOGEL & HAYES, *supra* note 17, at 9–10, 23 (discussing the practical implementation and role of "the law" in the lives of adherents).

[96] The fundamental standard regarding disclosure of risks and other pertinent information is whether the risks are material and whether any other information would be material to a reasonable investor. For a more thorough discussion of materiality and other disclosure issues, see *infra* Part IV.C.1.

For example, in the registration statement filed with the Securities and Exchange Commission (SEC) for one of the first such funds, the Dow Jones Islamic Market Index Portfolio[97] ("DJIMIP") makes no mention of *Shari'ah* other than a reference to certain "*Shari'ah* screens" or "filters" limiting the universe of acceptable investments. For the investing public, all that is learned about *Shari'ah* in the context of this *Shari'ah*-compliant mutual fund is that equities of companies involved in interest-driven profits, companies dealing with commodities such as alcohol or pork, or companies engaged in the "vice" industries such as entertainment and gambling, are prohibited.[98] In addition, the standard disclosures include references to various financial ratios that work to eliminate companies that might generate too much interest income on its cash reserves or pay too much interest on its debt.[99] In other words, the DJIMI and the mutual funds utilizing such an index appear in many ways like other "socially responsible investing" or customized "values-based" and "faith-based" indexes.

But this is hardly the case. In a "secular" or even "ideologically driven" values-based index, a screen that filters out all tobacco and weapons businesses is just that. Even if the background social or political activism animating the screen is a "smoke-free environment" and "pacifism," the screen is marketed only as a screen that filters out tobacco and weapons industries. It does not purport to be based upon some universal theological-moral-legal system existing independently of the filters.[100]

When the mutual fund, however, markets its product as "Islamic" or "*Shari'ah*-compliant," it is making a claim that goes well beyond the disclosed

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[97] This fund was begun in 1999 and liquidated in 2002. For access to its SEC filings online, see Securities and Exchange Commission, Dow Jones Islamic Market Index Portfolio, http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=000108 8654&owner=include&count=40 (last visited Sept. 13, 2008).

[98] *See* Mahmoud A. El-Gamal, *An Economic Explication of the Prohibition of* Gharar *in Classical Islamic Jurisprudence*, ISLAMIC ECON. STUD., Apr. 2001, at 29, 33 (explaining the prohibition of gambling).

[99] M. H. KHATKHATAY & SHARIQ NISAR, INVESTMENT IN STOCKS: A CRITICAL REVIEW OF DOW JONES *SHARI'AH* SCREENING NORMS 2–4 (2007), *available at* http://www.djindexes.com/mdsidx/downloads/Islamic/articles/DowJonesShariahScreeningNorms.pdf.

[100] Thus, even if it promoted itself as ethical equity-based investing, if it was based upon *Shari'ah*, the disclosure issue would remain. Further, it is different than the so-called Catholic indexes. Even in the case of the "Catholic values" funds, there is no representation that there is an underlying legal code requiring certain investment behavior by adherent Catholics. Instead, the funds follow "Catholic values" as they and their advisors determine them to be based upon the doctrine of the Catholic church (i.e., the magisterium), but there is no representation that there is a specific Catholic doctrine which obligates Catholics to invest only in companies that meet the funds criteria for "Catholic values." It is also noteworthy that the typical Catholic advisory board consists of lay persons. *See, e.g.*, SCHWARTZ INVESTMENT TRUST, AVE MARIA MUTUAL FUNDS PROSPECTUS 29 (2007), *available at* http://www.avemariafund.com/pdf/prospectus.pdf.

screens or filters, even if all that is applied to make it "Islamic" or "*Shari'ah*-compliant" are the filters themselves. A cursory reading of the registration statement filed pursuant to the Investment Act of 1940[101] for the Dow Jones Islamic Portfolio Fund suggests that the lawyers tasked with writing the risk section of the document understood this reality, at least at some rudimentary level,[102] and sought to eliminate the problem with one broad brushstroke. It states:

> The investment objective of the Dow Jones Islamic Market Index Portfolio (the Portfolio) is to seek long-term capital gains by matching the performance of the Dow Jones Islamic Market Index(SM) (the "Index") – a globally diversified compilation of equity securities **considered by Dow Jones' *Shari'ah* Supervisory Board to be in compliance with *Shari'ah* principles.**[103]

Notwithstanding representations throughout the registration statement that various practices of the fund will comply with "*Shari'ah* principles," which are nowhere articulated in a material way, the language in this section intends to sweep *Shari'ah* under the rug by reducing "*Shari'ah* principles" to whatever the Dow Jones *Shari'ah* Supervisory Board says they are. There are, however, a plethora of risk factors specifically associated with anything pegged to *Shari'ah* compliance that such a statement fails to capture. Fundamental disclosure issues for a reasonable investor would be: What is *Shari'ah*? Does applying *Shari'ah* "principles" pose any unique reputational or financial risks for the investment or might it actually pose a risk for the physical safety of the U.S. investor? In other words, if *Shari'ah* is hostile to Western political and financial institutions, would

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[101] Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940).

[102] The lawyers' imputed knowledge is "rudimentary" because very few of the lawyers acting as facilitators in the SCF industry fully understand or acknowledge what *Shari'ah* is beyond thinking of it as just another "value-based screen."

[103] Dow Jones Islamic Market Index Portfolio, Registration Statement, Form N-1A, (Sept. 1, 1999) (emphasis added), *available at* http://www.sec.gov/Archives/edgar/data/1088654/ 0000935489-99-000014.txt (disclosing information pursuant to the Investment Company Act of 1940, Part B, Item 12). In addition, in Part A of the of the registration statement, there are warranty disclaimers relative to the DJIMI, the most important of which is:

> Although Dow Jones uses reasonable efforts to comply with its guidelines regarding the selection of components in the Dow Jones Islamic Market Index, Dow Jones disclaims any warranty of compliance with Shariah law or other Islamic principles . . . .

Id. While this disclaimer might insulate Dow Jones from a claim of breach of warranty, it does not address the failure to disclose material risks relative to the very real problem of competing *Shari'ah* authorities.

that be important for a U.S. investor to know prior to investing in a business that promotes *Shari'ah*-compliant investing?

The point of this example is not to analyze the liability exposure of the registration statement of the now defunct Dow Jones Islamic Portfolio Fund, but rather to illustrate how marketing an investment product as *Shari'ah*-compliant incorporates a set of factual predicates, many of which are material to the investment decision. According to the *Shari'ah* authorities themselves, *Shari'ah*—of which SCF is only a small, integrated component—is more than just a half-dozen filters operating in the background to eliminate interest, speculation, and vice. Rather, it is a motivating force and mark of Muslim identification for hundreds of millions of adherents throughout the world, a *corpus juris* that incorporates a 1200-year-old history of jurisprudence, of institutionalized legal schools with published legal decisions and other scholarly writings, together with more than a millennium of religious and political implications, all of which have generated a body of literature on the import of *Shari'ah* in the ancient and contemporary world.[104]

These realities comprise a dangerous minefield for the naïve or willfully ignorant financial institution seeking to capitalize on the alluring new universe of investment vehicles marketed to *Shari'ah* adherents. This minefield includes questions these financial institutions and their professional facilitators have not even begun to ask, much less answer.[105] This article begins the analysis and the necessary discussion of SCF's implications for the U.S. financial industry, the professionals advising their clients on SCF, and the policy makers in and out of government. Policy makers especially have an obligation to consider the ominous implications for U.S. national and financial security of a fully integrated *Shari'ah*-compliant financial industry.

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[104] *See generally* Bassiouni & Badr, *supra* note 39, at 135–78 (explaining the origins and modes of interpretation of the *Shari'ah*).

[105] The following represent just a few of the queries one might expect to be addressed, all of which force the issue of what does the *Shari'ah* in *Shari'ah* compliant finance really mean: is a company dedicated to atheism or polytheism *Shari'ah* compliant even if it passes the "objective" screens discussed in the text above? What about abortion clinics? Is a company that otherwise passes the publicly-disclosed filters remain *Shari'ah* compliant even if it is owned by or domiciled in the territory of the enemies of the Muslim nation (e.g., an Israeli-owned or domiciled company)? When the DJIMI publicizes that weapons manufacturers are forbidden, does *Shari'ah* in fact forbid weapons manufacturing by Muslims for Muslim nations? Would it be material to a reasonable U.S. investor to know if the answers to any of these questions are "no?" What would happen if the U.S. went to war against a major *Shari'ah*-compliant Muslim nation and, as a result, the GCC states together with most of the authoritative *Shari'ah* scholars in the world declare the war an act of war against the entire Muslim nation? Will this declaration of war affect the DJIMI filters? Would any company owned by non-Muslim U.S. citizens be *Shari'ah*-compliant under those circumstances?

III. TOWARD AN ANALYTICAL TAXONOMY

A. The Lawyer's Role in SCF

As indicated above, *Shari'ah*-compliant financing is nomenclature describing the contemporary Islamic legal, normative, and communal response to the demands of modern-day finance and commerce.[106] *Shari'ah*-adherent Muslims desire to maintain their commitment to the normative demands of *Shari'ah*. At the same time, they wish to participate in the benefits and opportunities afforded by investment in international and Western financial structures that are neither *Shari'ah*-centric nor *Shari'ah*-compliant, at least according to the overwhelming majority of *Shari'ah* authorities.[107]

Transactional lawyers are often required to opine on the transaction's compliance with existing law and the enforceability of the underlying agreements in a court of law or, in some cases, before an arbitrator.[108] These legal opinions assure the parties that there are no hidden issues that might create obstacles to enforcement. In addition, lawyers are required by professional ethics to investigate compliance, disclosure, and due diligence issues in order to understand their clients' legal exposure when an innovative approach to existing financial or commercial transactions is contemplated.[109] Lawyers and accountants themselves have direct exposure to liability for documents submitted by a client to the SEC under several laws, including the Sarbanes-Oxley Act of 2002.[110]

A fundamental predicate of a lawyer's opinion is the knowledge that the basic transactional building blocks of the deal are well-known, predictable, and do not pose any significant risk that a court will refuse to enforce them as intended by the

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[106] *See supra* note 79 and accompanying text.

[107] *See* VOGEL & HAYES, *supra* note 17, at 24–28. Vogel and Hayes note especially the minority view that interest is not prohibited: "But such Muslims, though numerous, appear to be in the minority. A much larger number, *supported by a near-unanimity of traditional scholars*, seem certain that modern bank-interest falls within the revealed prohibitions and entails a major sin, tolerable only in the throes of necessity." VOGEL & HAYES, *supra* note 17, at 25 (emphasis added).

[108] In some complicated cases, both judicial and arbitration venues are chosen depending upon the specific issue litigated or the type of enforcement sought. *See, e.g.*, McMillen, *supra* note 12, at 433 (outlining the likely development of *sukuk* issuance).

[109] MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002); ANNOTATED MODEL RULES OF PROF'L CONDUCT R. 1.2(d) cmt. n.13, 39–40 (5th ed. 2003); *see* David S. Ruder, *Lessons from Enron: Director and Lawyer Monitoring Responsibilities*, Oct. 10, 2002, at 18–19, *available at* http://www.law.northwestern.edu/professionaled/documents/Ruder_Lessons_Enron.pdf (paper presented to the 41st Annual Corporate Counsel Institute, Chi., Ill.).

[110] *See* 15 U.S.C. § 7245 (2006) (explaining that the attorney has a duty to report violations of securities laws).

parties. In simple terms, this means that the deal is structured in a way that has certainty, consistency, predictability, and transparency.[111]

The problems legal counsel faces when attempting to analyze a specific SCF transaction and to opine on compliance and enforceability issues are often related to the *Shari'ah* "black box" phenomenon. Attorneys, accountants, and financial advisors who wish to structure a transaction to be *Shari'ah*-compliant do so by treating *Shari'ah* precisely as *Shari'ah* demands. For the *Shari'ah* faithful, *Shari'ah* is first and foremost the divine and perfect will of the ultimate lawgiver and there are strictures and obligations imposed on its adherents which are not subject to reasoned critique or discourse.[112] As to *Shari'ah* being open to human analysis, it is reserved for *Shari'ah* authorities who can only be challenged by other equally accepted *Shari'ah* authorities.[113] Further, because *Shari'ah* is understood as divine and the *Shari'ah* authorities are considered the trustees of its authority, integrity, and interpretation, the application of *Shari'ah*'s well-established and ancient doctrines to the modern practice of SCF necessarily lacks transparency.

Shari'ah's inability to provide transparency is systemic. Any legal or normative system that is not articulated and enforced within a political structure of codified laws, procedures, courts, binding legal opinions, and effective enforcement mechanisms will, by definition, lack transparency. *Shari'ah* is at its core a divinely ordained law, which can never be subordinated to a secular political, legal, or regulatory system.[114] SCF is an attempt by the participants—financiers, businesspeople, facilitators, and *Shari'ah* authorities—to fit the divine

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[111] While the terms "certainty, consistency, predictability, and transparency" are oft-used in the law in this context, this article borrows these precise terms and their meanings from one of SCF's biggest advocates and one of the most influential of the legal practitioners making a career of SCF. Michael J.T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1207 (2001).

[112] *See* Coughlin, *supra* note 30, at 88–90.

[113] As discussed *supra* at note 18 and in the accompanying text, there is no universal standard of authority or hierarchy for *Shari'ah* authorities. This fact alone and the development of authoritativeness is part of the black box of *Shari'ah*.

[114] *See, e.g.*, McMillen, *supra* note 111, at 1197 (showing the constraints on secular governance in Saudi Arabia by *Shari'ah*). For an interesting example of the notion that *Shari'ah* refuses to subject itself to secular interpretation, see Saudi Basic Indus. Corp. v. Mobil Yanbu Petrochemical Co., 866 A.2d 1, 30–32 (Del. 2005). There, the trial court was asked by the parties to rule on damages in a commercial dispute where the underlying contract applied the law of Saudi Arabia, which the court determined to be *Shari'ah*. *Id.* at 6–7, 30–32. The plaintiff's expert, Professor Vogel of the Harvard Law School Islamic Finance Project (the same Vogel from *supra* note 17) argued that no judge or even secular academic *Shari'ah* "expert" could opine on *Shari'ah*—this role was within the exclusive domain of a qualified *Shari'ah* authority. *Id.* at 32. The court was quite put out by this proposition, especially since it was the plaintiff's expert making this argument after plaintiff had chosen the forum. *Id.*

law within a modern, secularly political, legal, and financial system. But if a secular court or legislature attempts to codify *Shari'ah*'s precepts as they apply to SCF in an effort to establish transparency, it would fail its fundamental purpose because *Shari'ah* cannot be rendered subservient to secular law.[115]

In contrast, domestic finance, commerce in the U.S., and even international financial transactions are based upon Western legal structures that provide transparency.[116] It is transparency that renders a complex transaction manageable and viable. When the parties to a transaction and the professionals facilitating it know that a given transaction format has been used before successfully, the risks of the deal are then limited to the specific business terms and market conditions rather than the formalities of the documents and their enforcement. In these transactions,

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[115] According to *Shari'ah* doctrine rooted directly and firmly in the *Qur'an*, and agreed upon by all legal schools, no secular law can take precedence over Allah's divine law: "[w]hoever does not follow the revealed law and does not judge according to it is counted an unbeliever." *See, e.g.*, AL-AZAMI, *supra* note 37, at 12; *see also supra* notes 84–85 (discussing some of the effects of not believing); Coughlin, *supra* note 30, at 88 ("Known among Islamic jurists to take a more 'liberal' view toward Islamic law, Mohammad Hashim Kamali, in his Principles of Islamic Jurisprudence, nonetheless comes down four-square on the notion of the absolute sovereignty of Allah that necessarily pre-empts all other forms of sovereignty – including the democratic concept of sovereignty of the people.").

The blending of secular law and *Shari'ah* as it has unfolded in many Muslim countries would appear to be *ipso facto* evidence of the failure to tame *Shari'ah* since there are no Muslim dominated countries that one might call "mostly free" with real representative governments except possibly Turkey and Indonesia. Most observers recognize Turkey's success has come at the expense of "religious freedom" since the Kemalists and their use of the army to suppress the public expression of Islam and *Shari'ah* is well documented. *See* Freedom House, Country Reports: 2007 Edition, http://www.freedomhouse.org/template.cfm?page=21&year=2007 (last visited Sept. 13, 2008) [hereinafter Freedom Survey 2007]. Indonesia is changing for the worse due in large part to the growing violence against non-Muslims which in turn is due in large part to the increasing influence of *Shari'ah*. *See id.* For a careful analysis of the extent to which *Shari'ah* is codified as the law of the land in Muslim countries, see generally Tad Stahnke & Robert C. Blitt, *The Religion-State Relationship and the Right to Freedom of Religion or Belief: A Comparative Textual Analysis of the Constitutions of Predominantly Muslim Countries*, 36 GEO. J. INT'L L. 947 (2005). For an examination of "religious freedom" in such Muslim countries as Indonesia, Egypt, Iran, Saudi Arabia, see U.S. COMM. ON INT'L RELIGIOUS FREEDOM, ANNUAL REPORT (2005), *available at* http://www.uscirf.org/countries/publications/currentreport/2005annualrpt .pdf#page=1. For the growing influence of *Shari'ah* in Indonesia, see Tom A. Peter, *At Massive Rally, Hizb Ut-Tahrir Calls for a Global Muslim State*, CHRISTIAN SCI. MONITOR, Aug. 14, 2007, http://www.csmonitor.com/2007/0813/p99s01-duts.html. For a good discussion of "modernist legislation" vis-à-vis *Shari'ah* in Muslim countries, albeit somewhat dated, see SCHACHT, ISLAMIC LAW, *supra* note 37, at 100–11.

[116] *See* McMillen, *supra* note 12, at 432–35 (discussing the role of transparency in financial systems and in *Shari'ah* compliance).

the lawyer can opine with confidence because she knows the rules of the game and knows that she is not subject to fiat or challenge.[117]

This is not the case when a lawyer confronts a high-stakes, complex SCF transaction. In order to render a legal opinion that will satisfy both those involved in the transaction and necessary third parties such as a rating agency for a bond securitization, a number of issues arise that cannot be rationally addressed for at least two reasons: certain transaction restrictions applicable to SCF are considered divine and unalterable; those aspects of a transaction subject to human reason are not subject to *any* human reason, but to the reason of a *Shari'ah* authority.[118] For example, most *Shari'ah* authorities understand interest income as forbidden today.[119] The result has been that SCF utilizes all sorts of *Shari'ah*-compliant transactional structures to convert the exact same income stream from interest to something else such as lease payments.[120] In legal parlance, this is the application of "form over substance."[121]

The use of legal fictions to change the form or the consequence of a transaction without changing its substance is not new to secular law. Liability is often determined by the form rather than the substance of a transaction.[122] The idea is to use a legal fiction to convert a problematical "form" to an acceptable one. In the secular context, the problem itself and the mechanisms to overcome it can be understood, challenged openly, debated, and ultimately modified by lawyers, judges, and legislatures to fit changing circumstances.

The debate within *Shari'ah*, however, is effectively closed. Its principles remain divine and unalterable[123] and the application of these principles to changing

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[117] Certainty, consistency, predictability, and transparency in transactional law are never perfect but operate within a range of comfort for investors. The market tends to step in and price deals inversely to their approximation of these goals. As transparency goes down, price goes up until the deal or product just is no longer in reach of the demand's willingness to pay.

[118] McMillen, *supra* note 111, at 1189–90; *see supra* note 114.

[119] *See* El-Gamal, *supra* note 98, at 30.

[120] *See, e.g.*, McMillen, *supra* note 111, at 1220–25 (describing how transactions are structured in Saudi Arabia).

[121] For a SCF-friendly practitioner's view of these problems, see generally McMillen, *supra* note 111, at 1220–25 (explaining and providing examples of the way financing and transactions are structured so as to not violate the standards of *Shari'ah*).

[122] The existence of the "corporate veil" to protect the individual from liability is a good example of this "form" over "substance." Even though an individual might "maintain the corporate formalities," in substance he is acting as the sole entrepreneur but the law and the policy behind the law shield him from personal liability to promote the risk taking inherent in commercial endeavors. For a discussion of the "legal fiction" of the law's treatment of a corporation as a person, see generally Sanford A. Schane, *The Corporation Is a Person: The Language of a Legal Fiction*, 61 TUL. L. REV. 563 (1987).

[123] Even this claim is not exactly true. According to some scholars, interest was once not divinely prohibited *per se*. *See* KURAN, *supra* note 21, at 39–40; *see also* WARDE, *supra* note 11, at 48 (asserting that the prohibition has been subject to varying

circumstances are subject only to what the *Shari'ah* authorities acting independently of a secular legal and political system determine to be permitted and forbidden. Thus, *Shari'ah* informs the *Shari'ah*-adherent participants in a finance transaction that interest is divinely forbidden. The participants are also told it is forbidden because it is evil and causes the destruction of society.[124] Somehow though, interest—wrapped up in a different form where all of the elements of interest exist except for the name—exits the "black box" of *Shari'ah* as permissible and presumably good for society.[125]

Thus a lawyer involved in a complex SCF transaction confronts challenges at many different levels. In this effort, the diligent lawyer would likely focus on four distinct phases of an SCF transaction: (1) determining if the generic investment or type of transaction is prohibited; (2) developing an alternative (i.e., *Shari'ah*-compliant) transactional structure necessary to achieve the financial or commercial goal of the "secular" or *Shari'ah*-non-compliant investment or transaction; (3) drafting the necessary legal agreements and documents to implement the alternative transaction; and (4) preparing the filing of regulatory documents with government agencies.

At each stage, the lawyer is in effect wrapping the *Shari'ah* component of SCF in what appears to be a secular "black box." By doing so, the lawyer exposes herself and her client to substantial civil and criminal liability. Part III.B. discusses various areas of legal risk, and Part III.C. suggests an analytical taxonomy for evaluating these risks in the SCF context.

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interpretations, including a prohibition only on usurious lending). But the debate about the divinity of this prohibition as it exists today does not appear open to a societal or political discussion and conclusion. Rather, it is confined to the *Shari'ah* black box entrusted to the *Shari'ah* authorities. *See* KURAN, *supra* note 21, at 7–19; El-Gamal, *supra* note 21, at 108–49 (discussing the paradox between the *Shari'ah's* prohibition on interest and the actual functioning of *murabaha* financing which in name is not interest but in result is very similar to traditional interest financing).

[124] *See* Albalagh, Text of the Historic Judgment on Interest Given by the Supreme Court of Pakistan, http://www.albalagh.net/Islamic_economics/riba_judgement.shtml (last visited Sept. 16, 2008).

[125] Islamic scholars in academia have given this issue much attention. *See* Mahmoud A. El-Gamal, *An Economic Explication of the Prohibition of* Ribā *in Classical Islamic Jurisprudence*, May 2, 2001, http://www.ruf.rice.edu/~elgamal/files/riba.pdf; *see also* KURAN, *supra* note 21, at 7–19 (recounting the techniques for lending without charging interest, and commenting that would-be lenders developed "various ruses" for "endow[ing] with legitimacy" various practices that are substantially the same as interest bearing loans); McMillen, *supra* note 111, at 1186–87 n.2 (citing a host of scholars discussing the forms); Kuran, *supra* note 59, at 301–02 (discussing the lack of analysis of the origins of "Islamic Economics," but recognizing the realities of its growth).

B. The Legal Landscape

1. Common Law Tort Action for Deceit or Fraud

The regulation of disclosures by businesses, and by the financial industry in particular, has a long and storied history in U.S. jurisprudence. In most states, the common law incorporated the tort action of deceit, which is commonly referred to as fraud, to allow private rights of action for misrepresentation in the context of what is now referred to as commercial speech.[126] The essential elements of a common law fraud action are: (1) a false representation (2) of a material fact (3) which the defendant knew to be false and (4) with the intent to induce the plaintiff to rely upon it and (5) the plaintiff in fact justifiably relied upon the representation (6) thereby suffering damages as a result.[127]

Most states have relaxed or altered many of the elements of common law fraud. For example, certain relationships under the common law might also give rise to a claim for constructive fraud, which allows recovery for an omission of material fact.[128] The scienter elements have also been relaxed. Thus, the intent elements noted above in (3) and (4), have been "defined to mean everything from knowing falsity with an implication of *mens rea*, through various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault (and would be better treated as creating a distinct species of liability not based on intent)."[129]

2. Federal Securities Laws

In addition to common law actions for fraud or misrepresentation, there are federal and state statutory regimes designed to govern disclosures in myriad business and financial contexts. These include the sale of goods and the provision of loans, investments such as the formation of partnerships, and the sale of intangibles such as the offering of securities. In the world of SCF, the disclosure statutes most obviously implicated in civil and criminal liability issues are the federal and state securities laws.

In the main, the securities laws relating to fraud and misrepresentation were modeled after common law fraud.[130] But it is equally true that Congress intended the securities fraud statutes to have a broader reach than the common law.[131] As a result, securities law sought to include within its enforcement orbit

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[126] *See* Nike, Inc. v. Kasky, 539 U.S. 654, 656–65 (2003) (per curiam) (Stevens, J., concurring) (discussing commercial versus non-commercial speech and suggesting that the case was disposed of summarily on procedural grounds).

[127] LOSS & SELIGMAN, *supra* note 5, at 910.

[128] *Id.* at 910–11.

[129] *Id.* at 911.

[130] *Id.* at 1182–94.

[131] *Id.*

misrepresentations, omissions, schemes, and artifices that would not otherwise be captured by traditional common law fraud.[132] In addition, many of the specific elements of common law fraud were relaxed or in some cases eliminated.[133] While recent federal legislation aimed at curbing abusive class action litigation and subsequent Supreme Court case law have suggested a trimming of the broad reach previously granted federal securities laws, these efforts have been counterbalanced by a concomitant movement at the state level to extend the reach of the state securities laws and to interpret them more liberally than the federal counterparts.[134]

There are principally seven federal statutes that govern securities transactions: the Securities Act of 1933; the Securities Exchange Act of 1934; the Trust Indenture Act of 1939; the Investment Company Act of 1940; the Investment Advisors Act of 1940; the Securities Investor Protection Act of 1970; and the Sarbanes-Oxley Act of 2002.[135] Civil and criminal liability under the federal securities statutes for failure to disclose are regulated by the SEC and its principal weapons are the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").[136] The 1933 and 1934 Acts target different markets in that the 1933 Act regulates initial offerings, whereas the 1934 Act regulates all

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[132] *Id.*

[133] *Id.*

[134] *Id.* at 1187–92.

[135] Securities Act of 1933 (Truth in Securities Act), 15 U.S.C. §§ 77a–77aa (2006) (focusing on initial distribution of securities); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (West 1997 & Supp. 2008) (focusing on ongoing post-distribution trading of trading); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa–77bbbb (West 1997 & Supp. 2008) (supplementing the 1933 Act and focuses on distribution of debt securities); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–64 (West 1997 & Supp. 2008) (governing activity of publicly owned companies that invest in and trade securities); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21 (West 1997 & Supp. 2008) (requiring regulation and registration of those in business of advising others on securities investments); Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa–78lll (West 1997 & Supp. 2008) (creating non-profit membership corporation designed to cover customer losses when broker-dealer firms cannot cover their customer accounts); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2006) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (adding several additional layers of corporate reporting and ethics oversight). The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79–79z-6, which governed public utilities, was repealed by the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2006).

[136] No analysis of the current SCF industry in the U.S. would be complete without an examination of the Investment Company Act of 1940 and the Investment Advisors Act of 1940. This is because much of the SCF investments are being propelled by mutual funds tracking the DJIMI and the S&P's version of the same thing. In addition, with the huge sovereign wealth in the GCC looking for sophisticated investment strategies, *Shari'ah* compliant hedge funds are right around the corner. The analysis which follows will examine these two acts to the extent they implicate these types of SCF investments and require a different analysis of the liability exposure for securities fraud.

subsequent trading. However, the overriding public policy is the same: "full disclosure of every essentially important element attending the issue of a new security" and a "demand that the persons, whether they be directors, experts, or underwriters, who sponsor the investment of other people's money should be held to the high standards of trusteeship."[137]

Although both the 1933 and the 1934 Acts proscribe various types of conduct, including incomplete or inaccurate disclosure of material information, the SEC dictates the specific kinds of minimal (and in some cases maximal) disclosure required by the specific provisions as an administrative matter.[138] Beyond the routine administrative functions granted the SEC, the main weapons against securities fraud are the civil and criminal remedies.[139] Thus, the SEC has access to civil courts to seek injunctive relief, disgorgement, and even civil fines, in addition to ancillary equity-like relief.[140]Also, the Department of Justice, often as a result of an SEC administrative investigation and criminal referral, is authorized to file criminal charges for violations of the federal securities laws when it appears the offending party had the requisite intent.[141]

Finally, private plaintiffs have express and implied rights of action under several provisions. The most used and abused of all such provisions is Rule 10b-5,[142] promulgated under the 1934 Act,[143] which provides for civil litigation[144] and criminal prosecutions.[145] Considering that the class action mechanism, although limited by recent legislation,[146] is available to Rule 10b-5 claimants, the weapons available to prosecute claims for misstatements and omissions of material fact in SEC filings and elsewhere in the public domain are considerable.

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[137] H.R. REP. NO. 73-85, at 3 (1933); *see* 15 U.S.C. § 78b (2006) (stating that one purpose of securities law is "to insure the maintenance of fair and honest markets").

[138] *See* LOSS & SELIGMAN, *supra* note 5, at 1018–31.

[139] *See Id.*

[140] *See Id.*

[141] *See Id.*

[142] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1997); *see* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of this implied remedy is simply beyond peradventure.").

[143] 15 U.S.C. § 78j (2006).

[144] *See generally* LOSS & SELIGMAN, *supra* note 5, at 910, 1273–1301 (discussing the implied right of action under Rule 10b-5).

[145] 15 U.S.C. § 78ff(a) (2006) (criminal penalties); *see* LOSS & SELIGMAN, *supra* note 5, at 1418–25. For a survey of criminal liability under the securities acts, see generally Nic Heuer, Les Reese & Winston Sale, *Securities Fraud*, 44 AM. CRIM. L. REV. 956 (2007).

[146] *See* Jeffrey T. Cook, *Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws*, 55 AM. U.L. REV. 621, 642–46 (2006).

3. State Securities Laws

State securities laws, usually referred to as blue sky laws, essentially track the development of securities disclosure law and securities fraud liability in federal securities law.[147] As noted above, as a result of Congress's efforts to curb private securities fraud litigation and recent Supreme Court rulings regarding the new pleadings requirements, the state securities laws will take on ever greater importance in the securities plaintiff's arsenal of litigation weapons.[148]

4. Federal and State Consumer Protection and Anti-Fraud Laws

Consumer protection statutes, which exist in most states, provide additional weapons to combat fraud. While the Federal Trade Commission Act ("FTC Act")[149] does not apply to securities, it might be implicated where businesses market consumer products and represent that their businesses are run according to *Shari'ah*. Further, modeled in part after the FTC Act, the "little FTC Acts" enacted by most states are often more broadly interpreted than the FTC Act and many have an express or implied private right of action allowing the consumers themselves to battle fraud in the marketplace.[150]

In California, for example, a private plaintiff sued Nike,[151] an Oregon corporation, on behalf of all California residents under the California Unfair Competition Law.[152] The suit was filed after Nike allegedly made false and misleading public statements in the wake of media reports suggesting abuse at its foreign factories.[153] Nike claimed its speech was protected under the First Amendment.[154] The case went to the U.S. Supreme Court after Nike's arguments to get the case dismissed on First Amendment grounds did not persuade the California Supreme Court.[155] But the U.S. Supreme Court sent it back down to the California courts after it determined that certiorari had been improvidently

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[147] *See supra* note 134 and accompanying text.

[148] *See supra* note 134 and accompanying text.

[149] 15 U.S.C. §§ 41–58 (2006).

[150] For a discussion of the broad sweep of state consumer fraud statutes, *see* Victor E. Schwartz & Cary Silverman, *Common-Sense Construction of Consumer Protection Acts*, 54 U. KAN. L. REV. 1, 15–32 (2005).

[151] *See* Kasky v. Nike, Inc., 45 P.3d 243, 247 (Cal. 2002).

[152] *Id.* at 249. The law, referred to by the California Supreme Court in *Kasky* as the Unfair Competition Law ("UCL"), is codified at CAL. BUS. & PROF. CODE §§ 17200–17210 (West 2008). *Kasky*, 45 P.3d at 249. The UCL recently was amended by Proposition 64 to eliminate the right of private plaintiffs to sue as "private attorneys general" without a showing of injury. *See* Schwartz & Silverman, *supra* note 150, at 34–37.

[153] *See Kasky*, 45 P.3d at 247–48.

[154] *Id.* at 248.

[155] *See* Nike, Inc. v. Kasky, 539 U.S. 654 (2003); *Kasky*, 45 P.3d at 262.

granted[156] and Nike settled the case.[157] The implications of this type of state action for the SCF industry will be addressed below. Another potential source of liability exists in at least three states that allow their respective consumer protection statutes to be used for securities fraud, which would bring the entire SCF industry under consumer fraud scrutiny.[158]

Additional laws implicated are the federal Lanham Act,[159] which regulates, *inter alia*, fraud in the description of goods, services, or commercial activities,[160] and laws governing consumer finance. Consumer finance in the U.S. falls within the ambit of the federal Truth-in-Lending Act (TILA)[161] and the myriad regulations promulgated thereunder referred to collectively as Regulation Z.[162] Banks and other lenders advertising "zero-interest loans" or "*riba*-free loans" might in fact run afoul of the TILA disclosure requirements and the restrictions on deceptive advertising. The Home Ownership and Equity Protection Act (HOEPA) and the state versions of HOEPA,[163] which are part of TILA, might also apply to what amounts to predatory lending to *Shari'ah*-adherent Muslims to the extent that the fees and costs are almost always higher than conventional loans.

5. Due Diligence and Compliance Statutes

The federal securities laws in several instances incorporate due diligence as defenses to the anti-fraud provisions and as such are an integral part of any legal analysis for civil or criminal exposure.[164] In addition, due diligence is incorporated

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[156] *See Nike, Inc.*, 539 U.S. at 655.

[157] Mark B. Baker, *Promises and Platitudes: Toward a New 21st Century Paradigm for Corporate Codes of Conduct?*, 23 CONN. J. INT'L L. 123, 146–47 (2007).

[158] The three states are Arizona, see State *ex rel.* Corbin v. Pickrell, 667 P.2d 1304, 1307 (Ariz. 1983) (stating that an amendment to the Arizona Consumer Fraud Act "provide[s] an additional avenue of relief" to those aggrieved by securities act violations); Illinois, see Onesti v. Thomson McKinnon Sec., Inc., 619 F. Supp. 1262, 1267 (N.D. Ill. 1985) (construing Illinois's Consumer Fraud and Deceptive Practices Act as covering securities); and Pennsylvania, see Denison v. Kelly, 759 F. Supp. 199, 202–05 (M.D. Pa. 1991) (construing Pennsylvania's Consumer Protection Act to apply to securities transactions).

[159] Pub. L. No. 79-489, 60 Stat. 427 (1946) (codified as amended at 15 U.S.C. §§ 1051–1141n (2006)).

[160] *See* 15 U.S.C § 1125 (2006).

[161] Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601–1693r (2006)).

[162] Truth in Lending Rule (Regulation Z), 12 C.F.R. § 226 (2007).

[163] Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2190 (1994) (codified as amended in scattered sections of 15 U.S.C.).

[164] LOSS & SELIGMAN, *supra* note 5, at 1205 (discussing the defense of "reasonable care" under Section 12(a)(2) of the 1933 Act); LOSS & SELIGMAN, *supra* note 5, at 1227–39 (reviewing reasonable care and "expertizing" defenses under Section 11 of the 1933 Act).

into several compliance regimes such as the Bank Secrecy Act[165] and anti-money laundering statutes,[166] many of which were modified by the Patriot Act.[167] Insofar as SCF incorporates the *Shari'ah* obligation to tithe and also requires the "purification" of profits earned in violation of, *Shari'ah*, the question for the legal practitioner is who decides what happens to the monies gifted to charities and which charities are selected. Given the historical connection between some of the largest and well-known Muslim charities and the funding of terrorist groups,[168] these questions take on added focus in the context of material support of terrorism. Finally, the structure of the *Shari'ah* authority boards and their professional membership organizations raise antitrust issues.

C. A Suggested Analytical Taxonomy

The challenges described above for the SCF transactional lawyer and other professionals advising clients on the intricacies of legal compliance are not inconsequential. In agreements and in law, words are given context by the intent of the parties. The inherent problem of SCF is that the intent of the parties is to comply with *Shari'ah*, but the intent of *Shari'ah* generally and in any particular transaction is typically lost on the secular professionals who help structure SCF within the bounds of secular regulation.[169] These professionals, especially the lawyers, are very good at solving problems by re-structuring a transaction through wordsmithing, thereby arriving at the same result in different form. But their approach is to deal only with the trees hindering the client's path to the goal within the landscape of the transaction itself.

For the typical secular financial transaction, this is sufficient because there is no dark forest in which to get lost. An obstacle in the path can be safely circumvented because the problem is transparent and thus its ramifications for disclosure and compliance are understood. When the trees, however, grow out of the forest known as *Shari'ah*, it is not at all clear to these professionals why they are where they are, what dangers might lurk there, or where the forest might lead. This is because *Shari'ah* is not accessible to the secular professionals. As a

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[165] *See* 31 U.S.C.A. § 5318(i) (2006). The Bank Secrecy Act was enacted as Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 31 U.S.C.A. §§ 5311–5332 (West 2003 & Supp. 2007)).

[166] *See infra* Part V.C.1.a.

[167] Pub. L. No. 107-56, 115 Stat. 272 (2001) (codified as amended at scattered titles of U.S.C.).

[168] *See infra* Part V.C.1.b.

[169] It is not enough to refute this proposition by stating that the intent of *Shari'ah* is known to include the avoidance of interest, speculation, and vice. If the refutation were both true and meaningful, it would suggest that the speaker knows what *Shari'ah means* by interest, speculation, and vice. And, if that were true, the speaker could devise his own legal structures without reference to or assistance from *Shari'ah* scholars and authorities. But this is not the case.

consequence, the forest is packaged as a black box and ignored. It is no surprise then that the professional literature has paid little attention to the liability and criminal exposure issues unique to a financial investment or business transaction fitted to *Shari'ah*.[170] This article seeks to facilitate academic and professional scrutiny of SCF by suggesting an analytical taxonomy separating SCF-related legal exposure into two elements: those arising of out endogenous elements and those arising out of exogenous elements.[171]

1. Exposure Arising out of Endogenous Elements

To understand the risks and exposure for a financial institution contemplating SCF, a lawyer must first understand what *Shari'ah* itself says it is—that is, what the *Shari'ah* authorities understand it to be, without reference to how SCF attempts

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[170] A good example is to look at the published works of the legal practitioners who provide expert legal services to the SCF industry. The articles by McMillen cited herein generally are examples, but notably see McMillen, *supra* note 12, at 439–40 n.18 and accompanying text. McMillen considers the utilization of *Shari'ah* in Saudi Arabia and various other Muslim countries, yet does not raise even a word of caution regarding abuses under *Shari'ah* legal systems. This is not unique to legal academics and professionals studying SCF. *See generally* FELDMAN, *supra* note 37 (theorizing that *Shari'ah* in the hands of the classic Islamic Empire's *Shari'ah* authorities acted as a constitutional balance of power and brake on run-away executive authority; opining that this condition is the necessary ingredient to restore sensible political order to the Islamic world; but failing to address the *telos* of Shari'ah, the purpose of the *Shari'ah* political order per Shari'ah, or the methodology of subjugation and violent Jihad used to achieve that end).

[171] These terms are borrowed from 1 THE SAGE ENCYCLOPEDIA OF SOCIAL SCIENCE RESEARCH METHODS 308–09, 347 (Michael S. Lewis-Beck, Alan Bryman, & Tim Futing Liao eds., 2004), *available at* http://www-personal.umd.umich.edu/~delittle/Encyclopedia%20entries/endogeneous%20variable.pdf&wwwpersonal.umd.umich.edu/~delittle/Encyclopedia %20entries/exogenous%20variable.pdf. The endogenous/exogenous taxonomy for analyzing disclosure has an ancient pedigree. In standard common law fraud, commentators such as Judge Story distinguished between the heightened duty to disclose for intrinsic elements of a deal versus the extrinsic:

> Intrinsic circumstances are properly those which belong to the nature, character, condition, title, safety, use, or enjoyment, &c., of the subject-matter of the contract, such as natural or artificial defects in the subject-matter. Extrinsic circumstances are properly those which are accidentally connected with it, or rather bear upon it at the time of the contract, and may enhance or diminish its value or price, or operate as a motive to make or decline the contract; such as facts respecting the occurrence of peace or war, the rise or fall of markets, the character of the neighborhood, the increase or diminution of duties, or the like circumstances.

1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 301–02 (W. H. Lyon, Jr. ed., 14th ed. 1918).

to navigate the demands of modern finance. This inquiry can be termed an analysis of the endogenous elements or aspects of *Shari'ah*, and it will be relevant to many fundamental issues of SCF. Moreover, to the extent that *Shari'ah* compliance is determined by *Shari'ah* authorities, presumably there is something in the institution of *Shari'ah* itself that will inform a lawyer who qualifies as an authority and how the qualification process operates. Finally, to the extent that *Shari'ah* is in fact what its proponents say it is—a way of life combining authoritative Islamic legal, moral, theological, and normative social constructs—an attorney has a responsibility to ensure that her client has conducted the necessary due diligence to be certain that these structures do not violate U.S. law. These endogenous elements are explored in Part IV below in further detail.

2. Exposure Arising out of Exogenous Elements

As discussed above, SCF is a term of art used to describe the contemporary Islamic response to the demands of modern finance and commerce. As such, the rules and norms of *Shari'ah* are being forced to attend to the demands of a Muslim demographic that desires to exploit the opportunities available in Western financial and legal structures yet at the same time to remain faithful to a system that rejects as unlawful and evil many of the financial premises of Western political economies and structures. To achieve this seemingly impossible goal, *Shari'ah* authorities have developed a range of transactional structures and legal-definitional parameters to guide them in their determination of whether a given transaction or investment is permitted or prohibited.

In this part of the analysis, a lawyer should address the exogenous features of SCF that might raise liability exposure issues that are not inherent in *Shari'ah* principles but are adaptations of *Shari'ah* principles to fit Western financial structures and institutions. An example of a transactional structure designed to deal with this collision between *Shari'ah* and a Western world built on the time-value of money is the sale-lease back agreement.[172] While sale-lease back agreements are not unique to SCF and are in fact a popular vehicle in contemporary finance, in the two contexts, they are not identical in structure and are worlds apart in their purposes.[173] An example of the legal-definitional parameters set out by *Shari'ah*

[172] One such *Shari'ah*-based nominate lease contract is called *Ijara*. VOGEL & HAYES, *supra* note 17, at 143–45.

[173] Typically, a sale-lease back financing transaction is a way for a company to gain liquidity and to move a capital asset off the balance sheet to avoid the burdens to the company's debt ratios if standard capital asset financing is used. For a short discussion of the accounting aspects, see generally Ronald T. Max & Richard J. Strotman, *Sale/Leaseback: Financing Tool for the '90s*, CPA J., Apr. 2001, at 48, *available at* http://www.nysscpa.org/cpajournal/old/10691657.htm (explaining sale/leaseback financing). The motivation for a *Shari'ah* sale-lease back, however, is to avoid interest and to accommodate *Shari'ah* fixed rules relative to the actual transfer of ownership of the property, who is responsible for repairs (lessor), who can cancel the contract under changed

authorities to deal with the doctrinal conflicts between the two systems is the ruling that, while interest income is absolutely forbidden in *Shari'ah*, it is not forbidden to invest in a company that earns less than X%[174] from interest income that is not a core business of the company (i.e., interest earned on liquid assets or accounts receivables).[175] Further discussion of the exogenous elements of SCF is provided in Part V below.

IV. THE ENDOGENOUS ELEMENTS: DISCLOSURE OF *SHARI'AH* IN SCF

A. The Preliminary Analysis

The first order of business for an attorney providing advice in the context of disclosure laws to a U.S. financial institution interested in SCF should be answering the following question: how intimate is the connection between SCF and *Shari'ah* itself? In legal terms, how material is *Shari'ah* to SCF? If *Shari'ah* is a material part of SCF, the attorney must confront the likelihood that it is a material fact of SCF in the context of disclosure laws. While the answer to the question might appear self-evident—that is, *Shari'ah* has everything to do with SCF—extant literature by legal scholars and practitioners suggests that, even if *Shari'ah* is a material component of SCF, it is not material to any of the disclosure laws because *Shari'ah* is treated as a "black box" that merely turns out rules requiring specific kinds of contractual arrangements.[176]

But secular lawyers' treatment of *Shari'ah* as a "black box" that does not concern them—except in the specific rulings relative to a given investment or transaction—is simply a willful avoidance of material facts. Those facts are the endogenous elements of *Shari'ah* that result in the "rules and principles" of

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circumstances (lessee), and how the parties will treat future sale and option terms. In other words, the purposes of a secular sale-lease back are purely for accounting purposes or "form"; for the *Shari'ah* contract, however, the purpose is to effect the actual "substance" required by *Shari'ah* in an approved "form."

[174] *See, e.g.*,Yaquby, *supra* note 23, at 21–24 (addressing various "guidelines" of "permissibility," such as prohibiting investment in companies that earn more than 5–15% of total earnings from interest income). The DJIMI achieves this prohibitory goal by screening out companies with a debt to market capitalization ratio equal to or greater than 33%. For this and other ratios intended to screen for interest income, see M. H. KHATKHATAY & SHARIQ NISAR, INTERNATIONAL CONFERENCE ON ISLAMIC CAPITAL MARKETS, INVESTMENT IN STOCKS: A CRITICAL REVIEW OF DOW JONES *SHARI'AH* SCREENING NORMS 11–12 (2007), http://www.djindexes.com/mdsidx/downloads/Islamic/articles/DowJonesShariahScreeningNorms.pdf.

[175] Yaquby, *supra* note 23, at 21–24.

[176] *See, e.g.*, McMillen, *supra* note 12 (discussing contractual enforceability issues); McMillen, *supra* note 111 (discussing the structuring of financial arrangements).

SCF.[177] Indeed, according to the proponents and practitioners of SCF, *Shari'ah* is not just an approach to interest-free, ethical Islamic business practices or investing.[178] Invariably, SCF is described by its proponents, practitioners, and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern-day finance and commerce.[179] What makes the response "Islamic," or one pursued almost exclusively by Muslims,[180] is the fact that this legal, normative, and communal response to modern finance is framed and regulated by *Shari'ah* authorities ruling on what *Shari'ah* permits and prohibits.[181] Thus, whether called *Shari'ah*-compliant finance, Islamic economics and finance, or even "ethical" investing, the one unifying characteristic of SCF is the appearance of authoritative Muslim *Shari'ah* scholars who, individually and collectively through various manifestations of consensus,[182] define the "rules and principles" of SCF and set out how a *Shari'ah*-adherent Muslim may "lawfully" engage in commerce, investing, and finance.[183]

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[177] "*Shari'ah* rules and principles" is a term of art among *Shari'ah* authorities. Various standards publications are available to the public through the Islamic Financial Services Board ("IFSB"), one of the premier standards institutes of SCF. *See* Islamic Financial Services Board, Defining New Standards in Islamic Finance, http://www.ifsb.org/index.php?ch=4&pg=140 (last visited Aug. 3, 2008) [hereinafter IFSB Standards].

[178] *See generally* WARDE, *supra* note 11, at 1–4 (highlighting the challenge of reconciling Homo Islamicus and Homo Economicus); *see also* DeLorenzo & McMillen, *supra* note 47, at 132-197 (analyzing examples of "Islamic economy" from both *Shari'ah* and secular sources).

[179] *See* WARDE, *supra* note 11, at 74–75 (discussing the challenge of building a financial system that could feasibly "be at once consistent with religious precepts and viable in a modern economy").

[180] Excepting of course the non-Muslim facilitators and financial institutions who desire to exploit it for purely pecuniary gain.

[181] VOGEL & HAYES, *supra* note 17, at 9–10.

[182] *See* DeLorenzo & McMillen, *supra* note 47, at 139–51 (explaining how Islamic economics has evolved to a point where "modern Islamists have settled for majority-based decisions" so that "scholars have been engaging in . . . ijtihad [*Shari'ah*-based reasoning]"); WARDE, *supra* note 11, at 40–41. As the literature makes clear, consensus among *Shari'ah* authorities is an important part of the tradition and integrity of *Shari'ah*. *See infra* notes 201–202 and accompanying text. In some Muslim countries, however, there is actual government oversight and regulation. *See, e.g.*, POLITICS, *supra* note 11, at 155–285 ("offer[ing] case studies of Islamic banking experiences" in various countries). *See generally* ISLAMIC FIN. SERVS. BD., GUIDANCE ON KEY ELEMENTS OF THE SUPERVISORY REVIEW PROCESS OF INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (TAKĀFUL) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS), Dec. 2007, http://www.ifsb.org/view.php?ch=4&pg=257&ac=36&fname=file&dbIndex=0&ex=12015 33270&md=%C1h%D5%BB%AA%B9zc%C3%9E%7CV%29%0A%BA%3C (giving "guidance on key elements in the supervisory review process for authorities supervising institutions offering only Islamic financial services") [hereinafter IFSB STANDARD].

[183] *See* IFSB STANDARD, *supra* note 182, at 11–12; *infra* note 411.

Further, the *Shari'ah* authorities are clear: SCF is not a discreet or segregable component of *Shari'ah*.[184] It is a fully integrated discipline within the *corpus juris* of *Shari'ah*, which in turn is a holistic, all-encompassing way of life.[185] *Shari'ah* is not divisible. For example, one cannot extract from *Shari'ah* the SCF "commercial legal code" from *Shari'ah* and end up with a body of laws articulating a secular code of business conduct. This is demonstrated by the prohibitions against businesses that trade in pork products (seemingly strictly an issue of dietary code) or the leasing of a building to a church (quite obviously a theological consideration informing a business law issue).[186] Even in Islamic legal rulings relating to whether a Muslim bank or individual may receive interest from deposit accounts, the decision turns in large part on whether the deposits reside in a jurisdiction called the "abode of war," where non-Muslims predominate, or the "abode of peace," where Muslims predominate.[187]

The inclusiveness, universality, and indivisibility of *Shari'ah* are not just evidenced by the published work of *Shari'ah* authorities on the one hand and secular academic scholars on the other. Especially important for a lawyer

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[184] *See infra* notes 186–187 and accompanying text; *see, e.g.*, VOGEL & HAYES, *supra* note 17, at 53–55 (attempting to describe SCF by examining the "religious wellsprings of the law and the moral logic of particular outcomes").

[185] DeLorenzo & McMillen, *supra* note 47, at 136–37; *see also* WARDE, *supra* note 11, at 44–48 (suggesting the difference between Homo Islamicus and Homo Economicus "is the assumption of altruism . . . . Islam is preoccupied with the welfare of a community where every individual behaves altruistically and according to religious norms").

[186] *See* 2 A COMPENDIUM OF LEGAL OPINIONS ON THE OPERATIONS OF ISLAMIC BANKS 13–29 (Yusuf Talal DeLorenzo ed. & trans., 2000). A typical ruling reads: "If the lease of real estate is for purely prohibited purposes, like a bar, or a church, or a nightclub, then the lease contract is prohibited and legally void because the benefit, or subject of the contract, is prohibited." *Id.* at 16.

[187] *See, e.g.*, *id.* at 214–45. In a detailed legal ruling relating to interest earned in a bank in non-Muslim lands, a leading *Shari'ah* authority explains that the strictures of *Shari'ah* on certain business transactions such as deposits in a non-Muslim bank are relaxed when a Muslim enters the Abode of War (*dar al-harb*), which is the land of non-Muslims. The point of citing this ruling is to give a concrete example of how even the Law of *Jihad* in the context of the doctrines relative to the Abode of War versus the Abode of Islam is integral to the law of commerce. Thus, in the legal ruling, the *Shari'ah* authority began his analysis as follows:

> In the terminology of Islamic Law, "people of the abode of war" are not only those who are actually at war with Muslims, but all those who are not formally allied with Muslims by a covenant of protection, such that war could conceivably be declared between them and Muslims at any time.

Id. at 224 (emphasis added). For a ruling on whether a Muslim can lease a building in the Abode of Islam to a coeducational foreign school for foreign, non-Muslim students, see *id.* at 27–28.

attempting to determine what the "*Shari'ah*" of SCF is in the context of disclosure laws, and what if anything of this "*Shari'ah*" is material and subject to the duty to disclose, is what *Shari'ah* actually is in practice. An attorney in search of the actual presentation of *Shari'ah* as an extant and authoritative basis for law in modern times has the opportunity to examine several Muslim regimes which have implemented *Shari'ah* as the law of the land to a substantial degree. The best examples of such implementation are Iran, Saudi Arabia, and Sudan.[188] The Taliban of Afghanistan had also imposed a fully authoritative *Shari'ah*, and many other Muslim regimes have utilized aspects of *Shari'ah* to complement a non-*Shari'ah* secular code.[189] The more a country's laws are based upon *Shari'ah*, the better the evidence of what *Shari'ah* actually is in practice—devoid of all the academic theorizing and parsing.[190]

It is beyond this article's scope to determine what *Shari'ah* is in fact or what it means to the contemporary *Shari'ah* authorities sitting as the final arbiters of SCF. However, examining the literature of *Shari'ah* over the course of its history; determining what *Shari'ah* is in Muslim countries that apply traditional *Shari'ah* rules and principles; and, importantly, studying the published rulings by contemporary *Shari'ah* authorities on what *Shari'ah* is,[191] what its purposes are, and what *Shari'ah* considers the appropriate means to achieve those ends, are all part of any inquiry into the material endogenous elements of *Shari'ah* subject to disclosure.

B. The Hypothetical: Not so Hypothetical

Notwithstanding a reluctance based on practical considerations to engage in a full analysis of the material endogenous elements of *Shari'ah*, it is helpful to assume a few facts about *Shari'ah* in order to provide a factual predicate for the analysis of the disclosure (and other) laws that follow. The first assumption is that consensus exists among *Shari'ah* authorities on the fundamental purpose of *Shari'ah*: submission to the will of Allah as expressed in Allah's law. Second, the *Shari'ah* seeks to establish that Allah is the divine lawgiver and that no other law may supersede Allah's law. Third, *Shari'ah* seeks to achieve this goal through

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[188] *See, e.g.*, Stahnke & Blitt, *supra* note 115, at 954–62 (examining the connections between Islam and government in predominantly Muslim countries). Recently, northern Nigeria has been added to this list. *See* Lydia Polgreen, *Nigeria Turns from Harsher Side of Islamic Law*, N.Y. TIMES, Dec. 1, 2007, at A1, *available at* http://www.nytimes.com/2007/12/01/world/africa/01shariah.html?_r=1&oref=login.

[189] U.S. Dep't of State, Afghanistan: International Religious Freedom Report Released by the Bureau of Democracy, Human Rights, and Labor (Oct. 26, 2001), http://www.state.gov/g/drl/rls/irf/2001/5533.htm.

[190] Except perhaps as noted in *supra* note 182. For a country-by-country analysis by Freedom House, see Freedom Survey 2007, *supra* note 115.

[191] An integral part of this inquiry is a study of the extant rulings of the classical *Shari'ah* authorities considered to be authoritative by contemporary *Shari'ah* authorities.

persuasion and other non-violent means. Finally, when necessary and under certain prescribed circumstances, the use of force—and even full-scale war to achieve the dominance of *Shari'ah* worldwide—is not only permissible but obligatory.

While this article poses these conclusions as a hypothetical, they are not entirely conjectural. In fact, as set forth in an important study on the subject, they reflect the rulings of the classical *Shari'ah* authorities dating back almost a millennium and include the most contemporary of *Shari'ah* authorities issuing authoritative legal rulings today.[192] This study, conducted by Major Stephen Collins Coughlin, examines *Shari'ah* as a law defined and interpreted by *Shari'ah* authorities themselves.[193] Further, it surveys the binding rulings of *Shari'ah* authorities covering the classical periods dating back to the early days after Mohammed's death, the so-called Golden Era of Islamic enlightenment, and the chaotic period around the fall of the Ottoman Empire through to the present day.[194] The contemporary survey also includes reference to a best-selling 7th grade textbook used in Islamic day schools throughout the U.S. to validate the study's choice of authorities and to confirm that their legal rulings are used pedagogically as the foundation for understanding traditional, *Shari'ah*-centered Islam.[195] Further, Coughlin carefully authenticates the authorities so that one is not misled into accepting either a weak authority or an "extremist" view point.[196] The work is the best of any such scholarship because it treats doctrinal *Shari'ah* as *Shari'ah* expects to be treated and as evidenced by the published rulings of the *Shari'ah* authorities: as a sectarian legal-political-military normative social construct sourced in divine and immutable law.[197]

Coughlin's study demonstrates that *Shari'ah* and the doctrines of war articulated as the Law of *Jihad* are as valid today as they were one thousand years ago.[198] *Jihad,* in this context meaning violent struggle and war,[199] should be implemented as circumstances permit, and the contemporary authoritative *Shari'ah* scholars continue to teach, preach, and issue legal rulings to this effect.[200] Coughlin's investigation further explicates that once the *Shari'ah* authorities reach a consensus on a legal ruling based on the *Qur'an* and *Hadith*, the ruling is

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[192] *See generally* Coughlin, *supra* note 30 (studying *Shari'ah* and its foundational role as controlling doctrine for *Shari'ah*-adherent terrorists in their war against the infidel).

[193] *Id.* at 87–96.

[194] *Id.* at 43–70.

[195] *Id.* at 69, 86, 144, 284; *see also* YAHIYA EMERICK, WHAT ISLAM IS ALL ABOUT: STUDENT TEXTBOOK (3d. prtg. 2000).

[196] *See* Coughlin, *supra* note 30, at 43–70.

[197] The classic scholarly work on the subject is SCHACHT, ISLAMIC LAW, *supra* note 37; *c.f.* ISLAMIC LEGAL THEORIES, *supra* note 32, at 162–206 (exploring the theories of Abu Ishaq al-Shatibi as a theory that "provide[s] for flexibility and adaptability in positive law" but that has as its primary goal "restoring . . . the true law of Islam").

[198] *See* Coughlin, *supra* note 30, at 219–20.

[199] *See id.* at 134–68.

[200] *See infra* note 208 and accompanying text.

considered immutable and irrevocable.[201] This adds further concretization to the rulings on *Jihad* because the purpose of Islam and the methodologies to achieve those ends per *Shari'ah* are universally accepted by the *Shari'ah* authorities with relatively minor exceptions as to specifics.[202]

Based upon a consensus of legal authorities, Coughlin's study places the Law of *Jihad* in a milieu permeated by the consequences of the jurisprudential rule of consensus and establishes three fundamental points:

(1) The goal of *Jihad* to convert or conquer the entire world and the methodology to achieve this end by persuasion, by force and subjugation, or by murder is extant doctrine and valid law by virtue of a universal consensus among the authoritative *Shari'ah* scholars throughout Islamic history.[203]

(2) The doctrine of *Jihad* is foundational because it is based upon explicit verses in the *Qur'an* and the most authentic of canonical *Sunna*. It is considered a cornerstone of justice and until the infidels and polytheists are converted, subjugated, or murdered, their mischief and domination will continue to harm the Muslim nation.[204]

(3) *Jihad* is conducted primarily through kinetic warfare, but it includes other modalities such as propaganda and psychological warfare.[205]

Coughlin's thesis is supported by the rulings of several very prominent contemporary *Shari'ah* authorities. In a book of collected writings by one such authority, Mufti M. Taqi Usmani—a member of numerous *Shari'ah* advisory boards and one of the most respected *Shari'ah* authorities in the world[206]—advocates violent and aggressive *Jihad* even against peaceful non-Muslims residing in the West if they don't heed the call to Islam[207] or if they in any way obstruct *Shari'ah*'s mandate for Islam to dominate legally and socially all other

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[201] Coughlin, *supra* note 30, at 97–107, 134–68.

[202] One poignant example is Coughlin's use of Averroes (Abu al-Walid Muhammad ibn Ahmad ibn Rushd), one of the leading *Shari'ah* authorities of the so-called Golden Era in Islamic history often touted as an age of Muslim enlightenment, pluralism, and peace. Coughlin points out, based upon available English translations of Averroes' major work on *Jihad*, that even in their best light *Shari'ah* authorities consistently maintain that infidels and polytheists must be fought. *See, e.g.*, Coughlin, *supra* note 30, at 68, 108–09, 184–86. For the entire work on *Jihad* translated, see PETERS, *supra* note 8, at 27–42.

[203] *See* Coughlin, *supra* note 30, at 134–68.

[204] *Id.* at 134–68.

[205] *Id.* at 168–206, 220–21. *See also*, Brief for Center for Security Policy as Amicus Curiae Supporting Plaintiffs, Boim v. Holy Land Foundation for Relief and Development, Nos. 05-1815, 05-1816, 05-1821, 05-1822 (consol.) (7th Cir. Aug. 22, 2008) (en banc) (detailing the connection between violent Jihad and "other modalities" such as Da'wa or civil, political, and economic outreach).

[206] Shariah, Law, and 'Financial Jihad': How Should America Respond?: Analysis and Findings of a Workshop Co-sponsored by: The McCormack Foundation and The Center for Security Policy 25-32 (2008) (detailing Usmani's work on behalf of Dow Jones, HSBC, Guidance Financial Group, and many others).

[207] Coughlin, *supra* note 30, at 168–206, 220–21.

religions.[208] He bases his ruling explicitly on legal verses in the *Qur'an*, the actions of Mohammed and the successor Caliphates, and a consensus among *Shari'ah* authorities.[209] If Coughlin is correct, then Usmani is but one example of a *Shari'ah* authority who both embraces the Law of *Jihad* as an extant doctrine for action by *Shari'ah*-adherent Muslims and bases his rulings on the classical *Shari'ah* authorities who fully embraced the consensus on the Law of *Jihad*.

C. Applying the Endogenous Elements of Shari'ah to the Specific Duty to Disclose

As noted previously, the SCF industry in the U.S. includes a panoply of businesses regulated by the securities laws.[210] Examples include mutual funds tracking one of the Islamic indexes, publicly traded bond issuances and the trading of securitized bond issuances on a secondary market, and even U.S. public companies who conduct their business affairs in accordance with the principles of *Shari'ah*.[211] Do the facts of *Shari'ah*—representing the overriding purposes of *Shari'ah* and the methods authorized to achieve those purposes—require disclosure under the securities laws?

Failure to disclose a material fact (or the material misrepresentation of an asserted fact) is the basis for administrative, civil, and criminal actions under all of the securities laws requiring disclosure.[212] The breach of this duty might arise in a registration, prospectus or other required filing with the SEC, or "in connection with" a purchase or sale of securities.[213] For example, the 1933 Act imposes a number of requirements upon issuers, underwriters, and dealers to make full and fair disclosures in securities offerings.[214] Section 11 of the 1933 Act ("Section 11") provides that purchasers of securities may sue for material misrepresentations or omissions in registration statements as long as they did not know of the misrepresentation or omission at the time of purchase.[215] The dragnet under Section 11 for potential defendants is fairly wide and includes: (1) any person who signed the registration statement;[216] (2) any person who was a director or partner of the issuer at the time of the filing of the registration statement;[217] (3) any person

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[208] MUFTI MUHAMMAD TAQI USMANI, ISLAM AND MODERNISM 123–39 (1999) (representing a part of Usmani's writings and rulings over a 27-year period).

[209] *See id.*

[210] *See supra* notes 70–77 and accompanying text.

[211] *See supra* notes 70–77 and accompanying text.

[212] *See supra* notes 136–141 and accompanying text.

[213] Rule 10b-5 uses the language "in connection with." *See* discussion *infra* notes 223–227 and accompanying text.

[214] *See, e.g.*, 15 U.S.C. § 77g (2006) (requiring disclosures in registration statements); *id.* § 77j (requiring disclosures in prospectuses); *id.* § 77aa (requiring schedules of information in registration statements).

[215] *Id.* § 77k.

[216] *Id.* § 77k(a)(1); *see also id.* § 77(f).

[217] *Id.* § 77k(a)(2).

listed in the registration statement as a soon-to-be director or partner;[218] (4) every accountant, engineer, appraiser, or other expert named in the statement after having consented, but only as to any liability arising from the portion of the statement attributed to the specific expert;[219] or (5) any underwriter of the securities.[220] In addition, Section 12 of the 1933 Act ("Section 12") authorizes a purchaser of securities to sue the offeror or seller for any material misrepresentation or omission in a prospectus and adds "oral communication[s]" to the landscape.[221] The depth of the exposure from both of these provisions is demonstrated by the fact that a private plaintiff generally need not allege or show actual reliance on the misrepresentation or show that the absence of the material omission was in fact a contributing element.[222]

The preeminent statutory authority regarding disclosure in securities transactions is Section 10(b) of the 1934 Act[223] and its regulatory offspring, Rule 10b-5.[224] It has been the source for much litigation due to its breadth and the fact that it includes an implied private right of action, thereby adding private plaintiff and class action claims to the enforcement suits by the SEC and Department of Justice criminal prosecutions.[225] The essential elements of a Rule 10b-5 action are: (1) a misstatement or omission; (2) of material fact; (3) with scienter; (4) in connection with the purchase or the sale of a security; (5) upon which the plaintiff reasonably relied; and (6) that the plaintiff's reliance was the proximate cause of his or her injury.[226]

Once these elements of the Rule 10b-5 cause of action are established, a criminal penalty can be imposed under Section 32(a) if the government satisfactorily proves a willful violation of the 1934 Act.[227]

This article examines two elements unique to most fraud claims based upon allegations that the defendant omitted material information about *Shari'ah* in public filings and representations: materiality and scienter. Because the discussion regarding materiality in a federal securities fraud action also applies to fraud claims under the common law, state blue sky laws, or other anti-fraud federal and state statutes, the discussion of materiality will not treat these other claims separately. These two elements of the fraud action are carved out for special attention because a failure to consider them properly will contribute to the

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[218] *Id.* § 77k(3).

[219] *Id.* § 77k(4).

[220] *Id.* § 77k(a)(5).

[221] *Id.* § 771.

[222] *See* LOSS & SELIGMAN, *supra* note 5, at 1200–01, 1227–29.

[223] 15 U.S.C. § 78j(b).

[224] 17 C.F.R. § 240.10b-5 (2007).

[225] *Supra* notes 142–145 and accompanying text.

[226] *See* 17 C.F.R. § 240.10b-5; LOSS & SELIGMAN, *supra* note 5, at 1273–1301; *see also* Heuer, Reese & Sale, *supra* note 145 (reviewing the legal bases of securities fraud).

[227] 15 U.S.C. §.78ff(a); *see also* Heuer, Reese & Sale, *supra* note 145, at 965–66 nn.53–54, 1014–19.

conclusion that the *Shari'ah* "black box" poses no great risk to U.S. companies involved in SCF. This conclusion, if reached without due consideration of the matters raised herein, would be faulty and very costly.

1. Materiality

(a) The Supreme Court's Standards

Materiality is a fundamental element for an action alleging a failure to disclose under the securities laws. For instance, a hypothetical complaint might allege the following:

(1) Plaintiff bought shares in a closed-end mutual fund, which represented itself to be *Shari'ah*-compliant.

(2) An important part of these representations was the high-repute of the *Shari'ah* advisory-board members who were to watch over the fund's *Shari'ah* compliance.

(3) Various representations by the defendant financial institution, its agents, and representatives spoke of the ethical and socially responsible nature of *Shari'ah*.

(4) It was subsequently discovered and made public that the *Shari'ah* advisory board members all treated the rulings and pronouncements of Ibn Taymiyyah, a fourteenth-century Hanbali *Shari'ah* authority and scholar "with strikingly modern-sounding views" on commerce and finance,[228] as authoritative. It was also discovered and made public that Ibn Taymiyyah was a key *Shari'ah* authority for most of the terrorists associated with al Qaeda.[229] He was also a leading advocate of a *Shari'ah*-centered political organization for Muslims that would declare war against infidels and Muslims who rejected *Shari'ah*.[230] In fact, all sorts of "Islamists" who have declared war on the U.S. and seek the establishment of a worldwide Caliphate are students and followers of the *Shari'ah* "rules and principles" espoused by Ibn Taymiyyah insofar as he advocates Muslims to war against infidels.[231]

(5) There is a consensus among *Shari'ah* authorities from all schools of *Shari'ah* jurisprudence that forced subjugation or *Jihad* against non-Muslims is obligatory when efforts to peacefully convert the non-Muslims fail, and war is a viable option.[232]

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[228] VOGEL & HAYES, *supra* note 17, at 38.

[229] *See* MARY R. HABECK, KNOWING THE ENEMY: JIHADIST IDEOLOGY AND THE WAR ON TERROR 19 (2006).

[230] *Id.* at 19–22.

[231] *See* Coughlin, *supra* note 30, at 47, 147–50.

[232] *See* USMANI, *supra* note 208, at 123–39 (exploring the difference between defensive and offensive jihad, and concluding that "Aggressive Jehad [sic] . . . . is obligatory against non-hostile, non-Muslim states if Muslims have enough power to carry it out); Coughlin, *supra* note 30, (reviewing the doctrinal basis of *Jihad*); *see also* PETERS,

In addition to these allegations, which would support an SEC enforcement action or a private right of action for rescission, a plaintiff might opt to pursue damages. In such a case, one might anticipate the following hypothetical consequences: Were the information alleged above to become public knowledge, the fund might suffer irreparable reputational damage, and many of the U.S. investors would sell their shares in the mutual fund, causing the value of the traded shares to plummet. The complaint might also allege that the plaintiff purchased shares in the mutual fund without knowing anything about *Shari'ah* other than what the defendants represented to the public. Since the defendants promoted their *Shari'ah* authority board members as highly respected scholars and authorities in their field, and since these authorities ruled that *Shari'ah* forbade interest and excessive speculation in investments, and also prohibited investing in various "vice" industries, the plaintiff reasonably relied on these representations in the belief that *Shari'ah* was a "socially responsible" business practice and worth utilizing as an investment "screen."[233] The plaintiff would also have to show that had she known the facts about *Shari'ah* as they had now come to light, the plaintiff would never have invested in a *Shari'ah*-compliant mutual fund. In addition to damages, the plaintiff would likely apply to certify a class of similarly situated investors.[234]

The first issue confronting the plaintiffs under Rule 10b-5 would be whether the omissions of fact relating to *Shari'ah* doctrine and its treatment of apostates (both non-Muslims and Muslims) were material. The leading decision in this area is *TSC Industries, Inc. v. Northway, Inc.*,[235] where the Supreme Court addressed whether a failure to disclose in the context of a proxy solicitation was material.[236] The Court began by rejecting what it considered to be too low a threshold for materiality as adopted by the lower court.[237] The Court considered the lower court's standard of "all facts which a reasonable shareholder *might* consider important"[238] to be "too suggestive of mere possibility, however unlikely."[239]

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supra note 8, at 1–8 (noting that "Classical Muslim Koran interpretation . . . did not go [in the] direction" of interpreting *Jihad* "only as a defense against aggression").

[233] In what might be termed a typical 10b-5 private action for damages, the plaintiff would have to show reliance although when there is a duty to disclose and a public representation, reliance may be presumed (albeit a rebuttable presumption). *See* LOSS & SELIGMAN, *supra* note 5, at 1273–84. *But see* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 774 (2008) (refusing to extend 10b-5 liability to aiders and abettors involved in the deceptive acts of another company).

[234] *See generally* LOSS & SELIGMAN, *supra* note 5, at 1376–92 ("Claims under the federal securities laws are particularly susceptible to class action treatment." (quoting Hudson v. Capital Mgmt. Int'l, Inc., 565 F.Supp. 615, 628 (N.D. Cal. 1983)).

[235] 426 U.S. 438 (1976).

[236] *Id.* at 440.

[237] *Id.* at 445–47.

[238] *Id.* at 445.

The Court went on to explain in detail the objective standard it chose for materiality:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[240]

Arguably, the question whether the *Shari'ah* in SCF is a material fact that ought to be disclosed will rest on one of two analytical approaches, or possibly both. The first approach seeks to determine the materiality of *Shari'ah* in principle. It asks: Would a reasonable post-9/11 investor consider the connection between *Shari'ah* and SCF important to his or her decision to invest? In other words, would a reasonable investor, looking to invest in something promoted as "*Shari'ah*-compliant," want to know what *Shari'ah* and its "rules and principles" say about constitutional government, treatment of infidels, the Law of *Jihad*, the use of suicide-homicide bombers, and other acts of terrorism? Would the reasonable investor want to know about the published statements by international terrorist leaders citing *Shari'ah* authorities as justification for their war against the U.S. and other Western nations? These and similarly phrased questions all attempt to get at the associational link between *Shari'ah* in principle as an authoritative set of rules and principles advocating violence and SCF. If in fact such an association exists, would it be material information to a reasonable investor?[241]

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[239] *Id.* at 449 (quoting Gerstle v. Gamble-Skogmo, Inc., 478 F. 2d 1281, 1302 (2d Cir. 1973)).

[240] *Id.* at 49 (citation omitted).

[241] A related question would be who decides and how does one decide what *Shari'ah* is? This is not specific to the query of materiality. As noted previously, if a financial institution relies upon specific *Shari'ah* authorities, the question might be as simple as determining what these specific *Shari'ah* authorities consider to be authentic and authoritative *Shari'ah* rulings on *Jihad*, terrorism, and violence against non-Muslims and non-*Shari'ah*-compliant Muslims. *See supra* notes 228–231 and accompanying text. Aside from a careful examination of the rulings on these subjects issued by the relevant *Shari'ah* authorities, a problem arises if they have not published rulings in these areas, so one would be well-advised to look to the classical *Shari'ah* authorities upon which contemporary *Shari'ah* authorities rely as authoritative in their SCF rulings. Such reliance might not be dispositive (i.e., a *Shari'ah* authority might rely on Ibn Taymiyyah for purposes of determining what kind of nominate contract *Shari'ah* allows for any given transaction, but in fact reject Ibn Taymiyyah's rulings on *Jihad* and war against the infidels). At the very least, it raises an important question of fact for the reasonable investor that might very well rise to the level of materiality: do the *Shari'ah* authorities of the particular financial institution consider Ibn Taymiyyah's *Shari'ah*-based rulings on war against non-Muslims and non-*Shari'ah* compliant Muslims authoritative? If not Ibn Taymiyyah's, whose?

The second analysis relevant to materiality goes beyond the association in principle of SCF with *Shari'ah* and its call to violence and asks whether there is enough evidence of association in fact. This analysis asks: Is the nexus between *Shari'ah* and violence so contingent or speculative that it would render any theoretical association between *Shari'ah* and violence immaterial? This is another way of analyzing the argument often made against any association between *Shari'ah* or Islam and violence. The argument is made that *Shari'ah* can be interpreted in peaceful or violent ways; the argument is supported by claiming that those authorities who interpret *Shari'ah* violently and in ways that would shock the conscience of a reasonable U.S. investor are extremists and represent such a small percentage of the recognized *Shari'ah* authorities that it would render any theoretical link between *Shari'ah* and violence against non-Muslims and *Shari'ah*-non-compliant Muslims so tenuous as to be immaterial to a reasonable investor. In short, this is an argument that accepts that violence might in fact be associated in principle with *Shari'ah*,[242] but argues that the association is less than material because it is not representative of *Shari'ah* as espoused by the vast majority of contemporary *Shari'ah* authorities.

While Coughlin's investigation and documentation may demonstrate this argument to be lacking in credibility,[243] the analysis in a courtroom would instead turn on an examination of the facts and the law. As the Court opined in *TSC Industries*, "[t]he issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts."[244] Such a question of fact might be addressed by a simple factual showing that Islamic terrorists base their *raison d'être* for violence on the dictates of *Shari'ah* as expressed by the classical *Shari'ah* authorities and some contemporary ones, or by introducing evidence establishing what the contemporary *Shari'ah* authorities consider to be the purposes and authorized methods of *Shari'ah*. This question might be presented to a jury by introducing evidence (1) of the rulings of the contemporary *Shari'ah* authorities,[245] (2) of the rulings of classical *Shari'ah* authorities upon which the contemporary authorities have relied, and (3) of *Shari'ah in actu*, which would include a brief on Muslim-dominated regimes generally recognized as following *Shari'ah*. The latter would include their *Shari'ah*-based criminal codes and punishments and their track record for violations of the basic norms of the Law of Nations and human decency.[246]

The legal question presented by this second analysis will not be different in kind from the first analytical approach, which examines the association in principle

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[242] This is procedurally akin to a defendant's position on a motion to dismiss or for summary judgment. Assuming all the allegations are true, as a matter of law, there is no actual evidence that *Shari'ah* is the doctrinal impetus for violence rather than its excuse.

[243] See the discussion of Coughlin's work *supra* notes 198–205.

[244] 426 U.S. at 450.

[245] *See, e.g.*, *supra* note 208.

[246] *See, e.g.*, *supra* note 115; *infra* notes 408–409 and accompanying text.

between *Shari'ah*, its call to violence, and SCF. In both, one must determine if the law requires disclosure of qualitatively material facts as opposed to quantitatively material facts.[247] Quantitative materiality requires companies only to disclose hard, empirical facts such as financial data and any criminal convictions of management personnel.[248] Qualitative materiality requires a fuller disclosure of behavior that might be considered unethical or even illegal but which has not yet resulted in an actual conviction.[249]

While qualitative materiality is frowned upon by the courts and commentators because it renders the duty to disclose open to wholesale uncertainty about what must be disclosed in the first instance,[250] the problem of disclosure for the *Shari'ah*-compliant financial institution is not circumscribed by this concern. Disclosure remains a significant legal issue for the company looking to promote its SCF business (or simply to disclose publicly the involvement in SCF) because of the difference between whether a duty to disclose exists in the first instance and what must be disclosed to make a partial disclosure not misleading to the reasonable investor.[251] Thus, to the extent an SCF business actively promotes its business or includes SCF within the risk factors in its SEC filings, this disclosure opens the door to a full and accurate disclosure of all facts that a reasonable investor would find material. It hardly seems in doubt that a post-9/11 investor, when contemplating an investment in something represented as *Shari'ah*-compliant, would consider material any factual link between *Shari'ah* and the call for violence against non-Muslims and *Shari'ah*-non-compliant Muslims, or more specifically against the U.S. or U.S. interests abroad. Indeed, it would be improbable that a post-9/11 investor would not want to know what *Shari'ah* says about the Law of *Jihad* and the use of *Shari'ah* by Islamic terrorists, even if the reporting company made no disclosure or representation about being *Shari'ah*-compliant. *Shari'ah* compliance itself would likely be a sufficiently material fact for the duty of disclosure to exist independently of any partial representation.[252]

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[247] LOSS & SELIGMAN, *supra* note 5, at 171–74.

[248] *Id.*

[249] *Id.* For a thorough discussion of the quantitative-qualitative distinction in disclosure, see John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard,* 48 CATH. U. L. REV. 41, 44–47 (1998).

[250] Fedders, *supra* note 249, at 42, 87–88.

[251] Common law fraud did not originally impose a duty to disclose; rather, once a statement represented something as fact, it had to be truthful. Materiality gets at "truthfulness" in that "half-truths" can be as misleading as false statements. The development of the law on the disclosure of omitted facts has always lagged behind the duty to disclose the whole of a truth partially told. For a discussion of this development relative to securities fraud cases, see LOSS & SELIGMAN, *supra* note 5, at 910–18.

[252] This would be the case whether a company made no disclosure at all or represented itself as focused on "socially responsible" or "ethical" investing without any mention of *Shari'ah*. If the business model was in fact based upon *Shari'ah*, this would remain a material fact.

The confusion at a procedural level for the legal advisor attempting to weigh the materiality issue within the overall analysis of liability exposure might be the existence of counterfactual claims suggesting that *Shari'ah* has a peaceful face in addition to its connection to Islamic terror. But these "counter-facts" would simply create a question of fact. This analysis suggests that a well-pleaded complaint, alleging a sufficient nexus between SCF, *Shari'ah*, terror, and violence would survive a motion for summary judgment. This surmise seems especially likely, given the effectiveness of *Shari'ah*-inspired terrorists to convert calls for violence based upon *Shari'ah* into actual violence.

(b) Global Security Risk: A Material Fact?

The close nexus in the hypothetical factual predicate for this discussion between *Shari'ah* and global terrorism is, as explained above, more than just theoretical. Efforts by corporate legal counsel to dismiss these concerns will invariably run up against the wall of common understanding linking in material ways the violent and oppressive world of *Shari'ah* one hears about in the public media,[253] terrorism committed in the name of *Shari'ah*,[254] *Shari'ah* itself,[255] and something calling itself SCF. This common understanding has already begun to articulate itself in the debate over materiality in the context of what is a material or relevant disclosure with respect to shareholder proxy statements.

In at least two instances, the New York City Comptroller, as the custodian and trustee of several major New York City employee pension funds, which had acquired substantial stock in Halliburton Company and General Electric, demanded that these two U.S. multi-national corporations doing business in Iran approve a shareholder proposal at their respective annual meetings to examine the "potential financial and reputational risks" associated with doing business in terror-

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[253] Recent media stories about the *Shari'ah* criminal law include a Muslim convert to Christianity sentenced to death and a rape victim sentenced to lashes. *See, e.g.*, Josh Gerstein, *Widespread Outrage at Afghan Facing Death for Abandoning Islam*, N.Y. SUN, Mar. 21, 2006, http://www2.nysun.com/article/29500; Dave Goldiner, *Saudi Juliet Told She Can't Stay Wed to Romeo*, N.Y. DAILY NEWS, Jan. 21, 2008, at 12. For a scholarly look at the *Shari'ah* criminal law from the time of the Ottoman Empire until today, see generally RUDOLPH PETERS, CRIME AND PUNISHMENT IN ISLAMIC LAW: THEORY AND PRACTICE FROM THE SIXTEENTH TO THE TWENTY-FIRST CENTURY (2005).

[254] *See* HABECK, *supra* note 229, at 101–33.

[255] For *Shari'ah* as expressed by *Shari'ah* authorities over the past millennium, see DAVID COOK, UNDERSTANDING JIHAD, 5–162 (2005) (defining *Jihad* and the role of Islam in contemporary times); PETERS, *supra* note 8 (outlining a broad survey of *Jihad*); see also Coughlin, *supra* note 30, at 83–106 (reviewing scholarly consensus); ANDREW G. BOSTOM, THE LEGACY OF JIHAD 141–250 (Andrew G. Bostom, M.D., ed., 2005) (compiling a collection of writings from influential Muslim theologians and jurists).

sponsoring countries.[256] The first effort was directed against Halliburton and began in late 2002, culminating in a final negative response to Halliburton's request for an SEC no-action letter in March 2003.[257] The denial of a no-action letter was perhaps influenced by the Comptroller's statement that "[t]he link between Iran and Halliburton is of special interest to the public, including institutional, professional and non-professional investors, who are paying a great deal more attention to the relationship between their investments and terrorism."[258]

Almost two years later, the SEC took the same hands-off policy when GE came knocking at the door also seeking a no-action letter to support its contention that it need not include a proxy proposal by the Comptroller at its annual shareholders' meeting.[259] In its correspondence in opposition to GE's request, the Comptroller quoted at length from the Congressional Conference Report on the 2004 Budget, which requested that the SEC establish an Office of Global Security Risk to evaluate the risks caused by the conduct of business operations in terrorist states.[260] The SEC denied GE's no-action letter and ultimately established an Office of Global Security Risk, the purpose of which is to "monitor whether the documents public companies file with the SEC include disclosure of material information regarding global security risk-related issues."[261]

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[256] Halliburton Co., SEC No-Action Letter, 2003 SEC No-Act LEXIS 433, at *18–19 (Jan. 16, 2003) [hereinafter Halliburton No-Action File]. For General Electric, see General Electric Co., SEC No-Action Letter 2005 SEC No-Act LEXIS 137, at *1 (Jan. 12, 2005) [hereinafter GE No-Action File]. For a broader article discussing these cases in some detail in the context of compliance by foreign subsidiaries of U.S. corporations, see Terence J. Lau, *Triggering Parent Company Liability Under United States Sanctions Regimes: The Troubling Implications of Prohibiting Approval and Facilitation*, 41 AM. BUS. L.J. 413, 414–20, 445–46 (2004).

[257] *See* Halliburton No-Action File, *supra* note 256, at *1–2, *26–28.

[258] Letter from Janice Silberstein, Assoc. Gen. Counsel, City of N.Y., Office of the Comptroller, to SEC, Div. of Corporate Fin., Office of the Chief Counsel (Feb. 7, 2003), *in* Halliburton No-Action File, *supra* note 256.

[259] *See* GE No-Action File, *supra* note 256.

[260] Letter from Richard S. Simon, Deputy Gen. Counsel, City of N.Y., Office of the Comptroller, to SEC, Div. of Corporate Fin., Office of the Chief Counsel (Dec. 10, 2004), *in* GE No-Action File, *supra* note 256.

[261] U.S. Securities and Exchange Commission, Office of Global Security Risk, http://www.sec.gov/divisions/corpfin/globalsecrisk.htm (last visited Aug. 4, 2008). In this context, the SEC proposed the following:

> II. Disclosure of Business Activities in or With Countries Designated as State Sponsors of Terrorism
>
> The federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism. However, the federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's

It is clear that U.S. companies can no longer consider their associations with countries or entities tainted by terror a private, non-material, or irrelevant matter. While the courts have not yet entered the fray, the executive and legislative branches have laid down some markers. This trend suggests that the closer a company gets to a "state sponsor of terror," the more it has to disclose. Prudent counsel suggests that the closer a company gets to *any* association with terror, the more it has to disclose. The obvious question raised by the two proxy examples above would be: If a shareholder submits a proxy proposal to a publicly reporting financial institution involved in SCF, requiring a full study of the risks associated

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> statements, in the light of the circumstances under which they are made, not misleading.[6] [Note 6 citation appears here in the text. See below.] The term "material" is not defined in the federal securities laws. Rather, the Supreme Court has determined information to be material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision or if the information would significantly alter the total mix of available information.[7] [Note 7 citation appears here in the text. See below.]
>
> The materiality standard applicable to a company's activities in or with State Sponsors of Terrorism is the same materiality standard applicable to all other corporate activities. Any such material information not covered by a specific rule or regulation must be disclosed if necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. The materiality standard's extensive regulatory and judicial history helps companies and their counsel to interpret and apply it consistently, and we remain committed to employing this standard to company disclosure regarding business activities in or with State Sponsors of Terrorism.
>
> Although the Commission is well positioned to review disclosure relating to business activities regardless of the country in which they are conducted, we do not have the expertise or information necessary to identify the particular countries whose governments have funded, sponsored, provided a safe haven for, or otherwise supported terrorism. Nor is it the Commission's role to determine the degree to which a public company's business activities may support terrorism or may be inconsistent with U.S. foreign policy or U.S. national interests.
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> . . . .
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> [6] Rule 408 of Regulation C, [17 CFR 230.408] and Rule 12b-20 under the Securities Exchange Act of 1934 [17 CFR 240.12b-20].
>
> [7] *TSC Industries v. Northway, Inc.*, 426 U.S. 438 (1976). It has also held that materiality of contingent or speculative events or information depends on balancing the probability that the event will occur and the expected magnitude of the event. *Basic v. Levinson*, 485 U.S. 224, 238 (1988).

Concept Release on Mechanisms to Access Disclosures Relating to Business Activities in or with Countries Designated as State Sponsors of Terrorism, 72 Fed. Reg. 65862, 65863 (proposed Nov. 23, 2007) (to be codified at 17 C.F.R. pts. 228, 229, 230, 239, 240 & 249).

with *Shari'ah*, will the company have legitimate grounds to argue that the risks of *Shari'ah* and its connection to terror are not relevant? Outside of the proxy arena, if a company engages in SCF and represents to the public that *Shari'ah* is a standard set by *Shari'ah* authorities relied upon by the company, has the company disclosed enough about *Shari'ah* to tell the whole story? Given the hypothetical this analysis has been working with, the answer appears to be "no."

2. Scienter

Unlike materiality, which is an element in any type of fraud action, scienter, or intent, is a critical element of the common law and of most statutory provisions imposing liability on a wrongdoer.[262] As understood by the common law, a plaintiff's claim for deceit could only survive a motion to dismiss if the pleadings alleged that the defendant knew the falsity of the representation and that the false representation was made in an effort to induce reliance by the plaintiff.[263] Over time, this standard has been relaxed to include not merely false representations but also half-truths.[264] This change means that having opened the door to a representation, the putative defendant must be certain to have told the whole truth or at least the whole material truth.[265]

But the question remains: Having omitted some important part of the story, and assuming that the omitted part was material, did the defendant withhold the omitted part (1) knowingly and (2) with intent to deceive? Successful civil and criminal fraud litigation is as much about properly alleging scienter as it is proving it.[266] Judges will decide the former; jurors are most likely to decide the latter.[267]

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[262] *See generally* LOSS & SELIGMAN, *supra* note 5, at 910–11, 1018–31 (surveying varying conceptions of the scienter requirement, and the application of scienter to securities claims).

[263] *See* LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 910 (5th ed. Supp. 2008).

[264] *Id.*

[265] *See supra* note 251.

[266] This is especially true after the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which ratcheted up the scienter pleadings requirements and froze discovery during a defendant's motion to dismiss to eliminate frivolous suits and to eliminate the "leverage" plaintiffs use by propounding reams of discovery requests early on to tie-up company management and extort a settlement. For a good discussion of the pleadings requirements post-PSLRA, see Ray J. Grzebielski & Brian O. O'Mara, *Whether Alleging "Motive and Opportunity" Can Satisfy the Heightened Pleading Standards of the Private Securities Litigation Reform Act of 1995: Much Ado About Nothing*, 1 DEPAUL BUS. & COM. L.J. 313, 317–27 (2003).

[267] Certainly this division is true in the Second Circuit Court of Appeals, given the ruling in Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999) ("Whether or not a given intent existed is, of course, a question of fact." (quoting SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996))); *see also id.* ("Whether a given intent existed is generally a question of fact." (quoting *In re* Time Warner, 9 F.3d 259, 270–71

Today, fraud claims alleging a failure to disclose might be based upon violations of federal securities laws, state blue sky laws, state consumer protection laws, or other federal and state anti-fraud statutes. While the common law has generally moved away from requiring a specific intent to defraud and toward a standard of recklessness—and in those jurisdictions that have adopted Section 552 of the Restatement (Second) of Torts,[268] the move has included even negligent misrepresentation—specific claims under federal or state anti-fraud statutes will vary depending upon the statute, the specific jurisdiction, and whether the action is administrative, civil, or criminal.

For example, under federal securities laws, there are statutes and rules permitting SEC administrative and civil enforcement actions and private causes of action that do not impose a requirement to plead or prove scienter. Under the 1933 Act, which arguably has become far more important for those seeking to pursue class action claims,[269] Sections 17(a)(2) and (a)(3) are free of any scienter requirement for SEC civil actions and, to the extent that a private right of action exists, the no-scienter rule is likely to extend to private plaintiffs.[270] Also, Section 11, which relates to misrepresentations in a registration statement, imposes absolute liability on the issuer without any reference to scienter, but does provide for reasonable-care defenses as a kind of substitute for scienter for other defendants.[271] Section 12(2) imposes liability without reference to scienter in public offerings[272] but provides an out for a defendant who can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."[273]

Another serious avenue for enforcement that avoids the scienter issue arises under the Investment Advisors Act of 1940 (Investment Advisors Act). Fund

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(2d Cir. 1993))). For an argument in favor of the Second Circuit's approach to scienter, see Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung Too Far in Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL'Y & ETHICS J. 943, 958–60 (2006).

[268] RESTATEMENT (SECOND) OF TORTS § 552(1) (1977).

[269] *See supra* notes 266–267; *see also* Cook, *supra* note 146 (providing an overall examination of the jurisdictional issues raised by the recent federal legislation affecting class actions alleging securities fraud).

[270] *See generally* LOSS & SELIGMAN, *supra* note 5, at 1019, 1029 (discussing scienter and its pleading).

[271] LOSS & SELIGMAN, *supra* note 5, at 1230–33. *But see* LOSS & SELIGMAN, *supra* note 5, at 1232–33 (discussing the limited effectiveness of "expertizing" part of a statement as a defense to misrepresentations).

[272] Per its terms, section 12(2) creates civil liability for misrepresentations when someone "offers or sells a security" and does so "by means of a prospectus or oral communication." 15 U.S.C. § 77l(a)(2) (2006); *see also* Gustafson v. Alloyd Co., 513 U.S. 561, 569 (1995) (stating that a "prospectus" is a specific kind of document under the 1933 act and misrepresentations of the written kind must be in the prospectus to be the basis for an action under Section 12(2)).

[273] 15 U.S.C. § 77l(a)(2).

managers who embrace SCF while ignoring *Shari'ah* as a material part of the disclosure will likely face serious scrutiny as the SEC and large institutional investors come to understand the intimacy between the terms "*Shari'ah*-compliant," "Islamic finance," "socially responsible Islamic investing," and the *Shari'ah* witnessed in Iran, Saudi Arabia, and Sudan. Indeed, an SCF investment or business which attempts to disguise the "*Shari'ah*" and utilize a less emotionally charged term has added to its exposure, since that would be circumstantial evidence that the putative defendants knew of the dangers of *Shari'ah* and sought to minimize them by using a more acceptable, public relations-sensitive nomenclature.

Specifically, investment advisors, including those who might otherwise fall within a registration exemption, come within the Act's anti-fraud provisions. Thus, under Rule 206(4)-1:

> a. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act . . . for any investment adviser registered or required to be registered under section 203 of the Act . . ., directly or indirectly, to publish, circulate, or distribute any advertisement:
>
> . . . .
>
> 5. Which contains any untrue statement of a material fact, or which is otherwise false or misleading.[274]

In addition, Rule 206(4)-8, captures the pooled investment fund advisors:

> (a) *Prohibition.* It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act . . . for any investment adviser to a pooled investment vehicle to:
>
> (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
>
> (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.[275]

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[274] 17 C.F.R. § 275.206(4)-1 (2007) (citations omitted).

[275] For the SEC Final Rule, see Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,761 (Aug. 9, 2007) (codified at 17 C.F.R. pt. 275).

As the Supreme Court made clear in *SEC v. Capital Gains Research Bureau*,[276] the Investment Advisors Act was meant to safeguard the fiduciary relationship between the advisor and the investor.[277] The nature of the SEC proceeding, the heightened duty of such fiduciaries, and the purposes of the act eliminate the need to show intent to injure as in common law fraud.[278] The exposure of investment advisors to the claim that they have a duty to disclose all of the material facts about *Shari'ah* prior to any investment in an SCF fund, securitization, or company seems quite substantial, which is further highlighted by the complete lack of attention given the duty and its breach by the SCF industry.

While scienter's common law and statutory roles appear greatly diminished in the contexts discussed above, the same cannot be said for implied rights of action under Rule 10b-5. Congress and the Supreme Court have gone a long way to gut both the 1934 Act and the blue sky laws of their private class action fear factor—in part by requiring strict pleading of all necessary elements, including scienter.[279] The attorney representing the financial institution must keep in mind, however, that the SEC and institutional plaintiffs with significant investments at stake will continue to employ Rule 10b-5 and state securities anti-fraud provisions. As an economic matter, institutional investors with large investment portfolios are very likely less inclined to turn to class actions when they can bring far more manageable private civil claims that carry enough investment clout to make a difference to the defendant.

Moreover, even after the Supreme Court's decision in the oft-cited *Ernst & Ernst v. Hochfelder* case,[280] while a Rule 10b-5 allegation requires more than negligence, a reckless disregard for the truth likely suffices.[281] This is as much about artful pleading as it is about nailing down the legal standard, especially after a financial institution opens the door to a partial but misleading truth—experience

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[276] 375 U.S. 180 (1963).

[277] *Id.* at 195.

[278] *Id.* For a discussion of whether there is a private right of action to void contracts under section 215 of the Investment Advisors Act, see Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 18–19 (1979); see also LOSS & SELIGMAN, *supra* note 5, at 1241–47.

[279] *See supra* note 266; *see also* Jeffrey W. Stempel, *Class Actions and Limited Vision: Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. U. L. Q. 1127, 1189–93 (2005) (discussing the Class Action Fairness Act of 2005 (CAFA)).

[280] 425 U.S. 185, 201 (1976) (holding that negligent actions cannot give rise to Rule 10b-5 liability).

[281] *See* Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (stating the "recklessness" standard as follows: "[H]ighly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it") (quoting Franke v. Midwestern Oklahoma Dev. Auth., 428 F.Supp. 719, 726 (W.D. Okla. 1976)).

dictates that the rule announced in *Rubin* on half-truths being viewed, "in the light of the circumstances under which they were made," is an invitation for good plaintiffs' counsel to plead well the circumstances so as to avoid a motion to dismiss.[282] Thus, a financial institution that recognizes the threshold duty to disclose something about *Shari'ah* and the *Shari'ah* authorities who set the standards for the particular SCF investment or business must be extremely careful to capture all of the material facts about *Shari'ah*, its purposes, and its methods. Failure to recognize an extant connection between *Shari'ah* and violence after representing *Shari'ah* as divine Islamic law based on the *Qur'an*, the *Sunna*, and legal rulings of the competent *Shari'ah* authorities will likely suffice to satisfy the scienter requirement—at least at the pleadings stage.

Recklessness, especially in a case where a representation was made but without all the requisite material facts, is a notoriously fact-based standard that allows a showing of proof through circumstantial evidence.[283] The case law suggests a "totality of the circumstances" test where a variety of factors come into play to establish recklessness.[284] The specific factors typically cited include how material the omission was; how available the omitted facts were to the defendant; whether there was an extant standard of care in the industry giving rise to a duty to disclose

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[282] *See supra* note 251; *see also* City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 686–89 (6th Cir. 2005) (discussing recklessness as to the truth of corporate representations). In the *Bridgestone* case, the court quoted Rubin v. Schottenstein, 143 F.3d 263, 267 (6th Cir. 1998) (en banc), as follows:

> The question thus is not whether a [defendant's] silence can give rise to liability, but whether liability may flow from his decision to speak . . . concerning material details . . ., without revealing certain additional known facts necessary to make his statements not misleading. This question is answered by the text of [SEC] Rule 10b-5(b) itself: it is unlawful for any person to "omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . ."

Bridgestone, 399 F.3d at 670 (alterations in original).

[283] *See Bridgestone*, 399 F.3d at 669 (quoting Helwig v. Vencor, Inc., 251 F.3d 540, 555 (6th Cir. 2001) (explaining that "[a]s for materiality, whether or not a statement is material turns on 'a fact-intensive test.'")). The court also stated that "[m]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Id.* at 669 (quoting *Helwig*, 251 F.3d at 555 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988))). Finally, the court summarized the inquiry as: "would the information, had it been presented accurately, have '"significantly altered the ['']total mix['] of information made available?"'" *Id.* at 669 (quoting *Helwig*, 251 F.3d at 563 (quoting *Basic*, 485 U.S. at 231–32)).

[284] *See Id.* at 683 (quoting PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 683 (6th Cir. 2004)).

the omitted facts; how egregious the breach was; and what the likely consequences were of not disclosing the material facts.[285]

Rule 10b-5 is important because it operates as a "catch-all" anti-fraud statute with an implied private right of action. But beyond Rule 10b-5, there are many state securities laws which require no scienter and are broader in their reach than Rule 10b-5. Arizona's blue sky anti-fraud provisions have been given an expansive reach to get at all kinds of securities fraud without the burden of scienter[286] and also permit punitive damages.[287] In addition, at least three states provide for a securities fraud claim under their respective consumer anti-fraud statutes,[288] of which, two have a private right of action allowing for punitive damages.[289] Even a

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[285] While the Supreme Court has not ruled definitively on the question of recklessness, the lower courts have taken the general approach of examining a whole host of factors that might imply scienter:

> (1) insider trading at a suspicious time or in an unusual amount;
> (2) divergence between internal reports and external statements on the same subject;
> (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information;
> (4) evidence of bribery by a top company official;
> (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit;
> (6) disregard of the most current factual information before making statements;
> (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication;
> (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and
> (9) the self-interested motivation of defendants in the form of saving their salaries or jobs.

Helwig, 251 F.3d at 552 (citing Greebel v. FTP Software, Inc., 194 F.3d 185, 196 (1st Cir. 1999)).

[286] *See* ARIZ. REV. STAT. ANN. § 44-1991 (2003); *see also* Richard G. Himelrick, *Arizona Securities Fraud Liability: Charting a Non-Federal Path*, 32 ARIZ. ST. L.J. 203, 216–18 (2000) (reviewing Arizona's law and the differences between it and Federal law).

[287] *See* Himelrick, *supra* note 286, at 230 & n.186.

[288] *See supra* note 158.

[289] For case law regarding Illinois' private right of action, see *In re* CLDC Management Corp., 18 B.R. 797, 799–800 (Bankr. N.D. Ill. 1982) (allowing an implied private right of action); Martin v. Heinold Commodities, 634 N.E.2d 734, 756–57 (Ill. 1994) (allowing punitive damages). For case law regarding Arizona's private right of action, see Holeman v. Neils, 803 F. Supp. 237, 242–43 (D. Ariz. 1992) (allowing an implied private right of action); Dunlap v. Jimmy GMC of Tucson, Inc., 666 P.2d 83, 87–88 (Ariz. Ct. App. 1983) (allowing punitive damages).

state like California, which does not recognize securities fraud as a cause of action under its consumer fraud statute, will allow a consumer fraud claim relating to a holder of securities where the allegation is of fraud, but not in connection with the sale or purchase of a security.[290] These state consumer fraud actions are potentially effective weapons in the hands of sophisticated plaintiffs against financial institutions treading down the seemingly golden path of SCF.

D. Sedition: Shari'ah as the Advocacy of the Violent Overthrow of the U.S. Government

The Smith Act of 1940 makes it criminal to "knowingly or willfully advocate[e], abet[], advis[e], or teach[] the duty, necessity, desirability, or propriety of overthrowing or destroying the government of the United States."[291] The Supreme Court has taken four occasions to review cases prosecuted under the Smith Act. In the first case, *Dennis v. United States*, the Court heard appeals from Communist Party leaders who had been convicted of violating the Smith Act and whose conviction had been affirmed by the lower court.[292] The Court examined the First Amendment and other constitutional challenges, upheld the statute as constitutional, and affirmed the convictions.[293]

The Court again examined the Smith Act six years later in the case of *Yates v. United States*.[294] By this time, however, the Court was now under the spell of Chief Justice Earl Warren and the other liberal Justices of the time. They had already tested their mettle in *Brown v. Board of Education*[295] some three years earlier, and one could reasonably have wondered whether the Court would sustain a First Amendment challenge and effectively overrule *Dennis*.

Because the charges in *Yates* were brought under the "advocat[ing]" and "teach[ing]" prohibitions of the Smith Act, the defendants argued that the Act was an unconstitutional restriction on their freedom of speech.[296] Rather than overturning the Smith Act, the Court carefully sidestepped the issue by narrowly construing the words "advocates" and "teaches" to bring them within the Court-created boundaries for permissible speech restrictions.[297] Specifically, the Court limited the Smith Act to cases where the advocacy for the overthrow of the

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[290] Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 U.S. Dist. LEXIS 9625, at *30 (N.D. Cal. March 7, 2005).

[291] 18 U.S.C. § 2385 (2006).

[292] *See* Dennis v. United States, 341 U.S. 494, 495 (1951).

[293] *See id.* at 516–17.

[294] 354 U.S. 298 (1957).

[295] Brown v. Bd. of Educ., 347 U.S. 483 (1954).

[296] *Yates*, 354 U.S. 298, 312–18.

[297] *Id.* at 319 ("We need not, however, decide the issue before us in terms of constitutional compulsion, for our first duty is to construe this statute. In doing so, we should not assume that Congress chose to disregard a constitutional danger zone so clearly marked . . . .").

government was more than merely theoretical.[298] The Court limited the Act by holding that criminal advocacy under the Smith Act requires a nexus between the advocacy itself and some action that was being urged to achieve the treasonous goal.[299]

In *Scales v. United States*, the Court again examined the Smith Act.[300] In this case, the defendant sought to have his conviction for being a member of the Communist Party set aside on "statutory, constitutional, and evidentiary grounds."[301] While the procedural aspects are not relevant to this discussion, the statutory and constitutional parts of the case are. The first argument raised by the defendant-petitioner was based on the claim that another federal statute had been enacted providing that mere membership in the Communist Party would not constitute a *per se* violation of any federal statute.[302] From this, the petitioner formulated the argument that the Smith Act's membership clause had been repealed *pro tanto*.[303] The Court rejected this argument on several grounds, but most importantly because the Court found that the petitioner's Smith Act conviction was for being a member of an organization which called for the violent overthrow of the U.S.[304] There was nothing unique about the Communist Party except its doctrine for violent overthrow; the Smith Act applied to any organization, not just to the Communist Party.[305]

The petitioner also challenged his Smith Act conviction on *per se* constitutional grounds.[306] The petitioner argued that the membership clause of the Smith Act violated his First and Fifth Amendment rights.[307] The Fifth Amendment claim essentially boiled down to this: although the trial court instructed the jury that the defendant had to be an "active member" of the criminal group, in accord with the earlier decision in *Yates*, which required a nexus between advocacy and action, the trial court did not require that the defendant actually participate in the criminal activity.[308] It was enough that the defendant knew of the criminal designs

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[298] *Id.*

[299] *See id.* at 324–25.

[300] *See* Scales v. United States, 367 U.S. 203, 205 (1961).

[301] *Id.* at 206.

[302] *Id.* at 206–07. The intervening statute purportedly overruling the Smith Act membership clause, the Internal Security Act of 1950, 64 Stat. 987 (codified at 50 U.S.C. § 781), was repealed by The FRIENDSHIP Act, Pub. L. No. 103-199, § 803(1), 107 Stat. 2317, 2329 (1993) (codified at 50 U.S.C. § 783).

[303] *Scales*, 367 U.S. at 206–07.

[304] *Id.* at 207–08.

[305] *Id.* ("[T]he membership clause of the Smith Act . . . only [proscribes membership] in organizations engaging in advocacy of violent overthrow . . . .").

[306] *See id.* at 219–20. The petitioner also raised "as applied" claims but these boiled down to an evidentiary analysis. *See id.* at 220. ("The balance of [the 'as applied' claims,] essentially concerns the sufficiency of the evidence . . . .").

[307] *See id.* at 224, 228.

[308] *See id.* at 220.

of the group at large and that the defendant was an active member, even if such activity was wholly legal.[309] As such, the petitioner argued that the absence of this nexus violated his Fifth Amendment rights to due process because it convicts a person for mere association and not overt criminal activity.[310] The First Amendment claim was similarly an argument that the defendant's right to freedom of association was unconstitutionally infringed by virtue of the threat of criminal prosecution for mere non-criminal membership.[311]

The Court rejected the argument, asserting that:

> Any thought that due process puts beyond the reach of the criminal law all individual associational relationships, unless accompanied by the commission of specific acts of criminality, is dispelled by familiar concepts of the law of conspiracy and complicity. . . . In this instance it is an organization which engages in criminal activity, and we can perceive no reason why one who actively and knowingly works in the ranks of that organization, intending to contribute to the success of those specifically illegal activities, should be any more immune from prosecution than he to whom the organization has assigned the task of carrying out the substantive criminal act.[312]

Thus, the Court concluded that a Smith Act membership conviction will stand when (1) the defendant knows (2) that the group to which the membership attaches intends criminal purposes and (3) that the defendant's membership evidences a specific intent to promote the criminal goals of the organization (4) even if the defendant's membership and involvement is not itself criminal activity.[313]

In *Noto v. United States*, the fourth of the Smith Act cases to come before the Court and a companion case to *Scales*, the Court overturned the conviction because it found the nexus between the theory of violence and the actual call to violence too remote.[314] Quoting from its opinion in *Yates*, the Court explained that the advocacy must be "not of . . . mere abstract doctrine of forcible overthrow, but of action to that end, by the use of language reasonably and ordinarily calculated to incite persons to . . . action" immediately or in the future.[315]

Given this judicial treatment of the Smith Act, a lawyer representing a U.S. company which retains *Shari'ah* authorities must be critically aware of several threatening circumstances. One, if the *Shari'ah* authorities advocate the Law of *Jihad* against the U.S., this advocacy probably falls within the Smith Act as refined

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[309] *See id.* at 220–21.

[310] *Id.* at 220.

[311] *Id.*

[312] *Id.* at 225–27.

[313] *See id.* at 226–28.

[314] Noto v. United States, 367 U.S. 290, 297–98 (1961).

[315] *Id.* at 297 (quoting Yates v. U.S., 354 U.S. 298, 316 (1957)) (alterations in original).

by the Supreme Court. The argument here rests on two prongs. First, the *Shari'ah* authorities are not mere advocates of theory or theology but authorized religious leaders who have been retained by the company precisely because their legal rulings and pronouncements are authoritative. Moreover, the call to violence at some point in the future when *Shari'ah*-adherent Muslims have the logistical opportunity to conduct *Jihad* is captured by the Smith Act as the Court explained when it stated that advocacy is an actual call to violence whether it advocates violence "immediately or in the future."[316]

Second, the *Shari'ah* authorities are not speaking as advocates to an empty auditorium, but as jurists who issue normative and instructional commands to the members of their group—*Shari'ah*-adherent Muslims. Further, these *Shari'ah* authorities are chosen because the *Shari'ah* faithful listen and act upon their legal rulings. Thus, the call to violence is likely to result in violence. Evidence of this direct nexus can be observed in numerous terrorist and violent events that occur immediately after *Shari'ah* authorities issue legal rulings calling for violence. One relatively recent event was the violence over the publication of cartoons in a Danish paper which satirized Mohammed. The cartoons had been public for several months and it was not until certain leading *Shari'ah* authorities called for a "day of anger" and "for Muslims worldwide to protest" that protests, violence, and murder erupted en masse.[317]

Additionally, to the extent that *Shari'ah* authorities are employed by a U.S. corporation to issue legal rulings on *Shari'ah* and, while serving in that capacity, issue rulings which include a call to *Jihad* against the United States, the

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[316] *Id.* In Brandenburg v. Ohio, 395 U.S. 444, 447 (1969) (per curiam), the Court held, in striking down a state law criminalizing speech advocating criminal acts including violence and terrorism—this genre of law often referred to as a criminal syndicalism statute—that such speech is constitutionally protected unless it is intended and likely to cause imminent illegal conduct. While the *Brandenburg* Court understood its decision as concordant with the Smith Act cases cited, many First Amendment commentators have understood the "imminence" requirement as, in effect, overruling *Dennis* and its progeny. *See id.*; GEOFFREY R. STONE, PERILOUS TIMES: FREE SPEECH IN WARTIME 522–23 (2004). For an analysis of the "imminence" requirement and what it might mean or should mean, see Marc Rohr, *Grand Illusion? The* Brandenburg *Test and Speech That Encourages or Facilitates Criminal Acts*, 38 WILLAMETTE L. REV. 1 (2002); see also, Eugene Volokh, *Crime-Facilitating Speech*, 57 STAN. L. REV. 1095 (2005) for an interesting if not overly pedantic analysis of First Amendment issues, including Brandenburg's imminence test, in the context of crime incitement versus crime facilitating speech. While the Supreme Court has not applied "imminence" to a real sedition case, the point to be made here is that sedition is more like crime-facilitation or conspiracy than it is to incitement where imminence has some temporal context. The application of "imminence" will no doubt plague future cases and remain a fact-based inquiry and will likely involve not simply the timing of the threat of violence, but also its seriousness and its likelihood.

[317] Olivier Guitta, *The Cartoon Jihad: The Muslim Brotherhood's Project for Dominating the West*, WKLY STANDARD, Feb. 20, 2006, at 10, *available at* http://www.weeklystandard.com/Content/Public/Articles/000/000/006/704xewyj.asp.

corporations should not ignore the threat of criminal exposure. The important case on this point is the Supreme Court's decision in *New York Central & Hudson River Railroad v. United States*.[318] In *New York Central*, prosecutors indicted a railroad company based on the conduct of an assistant traffic manager, who paid illegal rebates.[319] While corporations could be liable for breach of civil law duties, "earlier writers on the common law held the law to be that a corporation could not commit a crime" in part because, as artifices of the law, they could not have the requisite mens rea.[320] The Court, however, took this opportunity to transport the concept of *respondeat superior* from tort law and import it into the criminal law:

> Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.
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> . . . [W]e see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them. If it were not so, many offenses might go unpunished and acts be committed in violation of law where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices, forbidden in the interest of public policy.[321]

In the matter under discussion, legal counsel will be somewhat misguided to argue in defense of their corporate clients that the *Shari'ah* authorities were employed strictly to issue legal rulings on financial matters and all other rulings fall outside the scope of their employment. Typically, *respondeat superior* would apply for intentional transgressions in the criminal context where the agent (1) committed a crime; (2) within the scope of employment; and (3) with intent to benefit the company.[322] Arguably, a crime was committed by advocating violent *Jihad* against the U.S. The problem with legal counsel's defense on the "scope of

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[318] 212 U.S. 481 (1909).

[319] *Id.* at 489. According to the Court, the Elkins Act made it illegal to "give or receive a rebate whereby goods are transported in interstate commerce at less than the published rate." *Id.* at 498; *see* Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 61 n.42 (2007).

[320] *New York Cent.*, 212 U.S. at 492.

[321] *Id.* at 494–95 (citations omitted).

[322] *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 499–508 (5th ed. 1984). For a general discussion on corporate liability, see Note, *Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247–51 (1979).

employment" element is the fact that *Shari'ah* authorities have stated time and again that there is no separation between a ruling on commercial matters and one on *Jihad*. As illustrated by the very software "filters" employed in SCF, the legal rulings on prohibited vice industries are part and parcel of the undivided whole of *Shari'ah*. This explains the SCF legal ruling by many *Shari'ah* authorities that Muslims, including U.S. Muslims, should not invest in U.S. defense industries. Yet, these same *Shari'ah* authorities praise and obligate Muslim investment in weapons for Muslim nations as part of preparation for *Jihad*.[323] In other words, the ruling on weapons in the context of SCF is part and parcel of the Law of *Jihad*.[324] Finally, by definition, every legal ruling by a *Shari'ah* authority is for the achievement of Allah's divine law and for the attainment of truth, and therefore, of benefits to all Muslims, including the companies in which they invest.

While it is not necessarily the case that an aberrant ruling by an "extremist" *Shari'ah* authority will always be imputed to his employer, it is not a stretch to conclude that a company employs a *Shari'ah* authority precisely because his legal rulings are authoritative and because *Shari'ah* is a holistic and integrated legal and normative unit.[325] Thus, a ruling on *Jihad* by a *Shari'ah* authority is no less a part of his role as an internationally renowned *Shari'ah* authority—and his employment as such—than his other rulings on SCF.[326]

V. THE EXOGENOUS ELEMENTS OF SCF: DISCLOSURE, DUE DILIGENCE, AND OTHER COMPLIANCE ISSUES

Beyond the duty of disclosure of endogenous elements of *Shari'ah*—facts that would be material to a reasonable investor who has been told of an investment or business transaction represented to be *Shari'ah*-compliant—several other legal issues arise in the context of how SCF is actually structured. In addition to the question of what must be disclosed about *Shari'ah* itself, the "rules and principles" of *Shari'ah* have been fitted to modern finance and business to achieve a product

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[323] *See* USMANI, *supra* note 208, at 36–38.

[324] In his essay on the proper role of a *Shari'ah* authority for a mutual fund, DeLorenzo argues that beyond the "quantitative" rules, there are "socially responsible" screens that must be applied over the purely objective ones. DeLorenzo, *supra* note 26, at 6.

[325] *See infra* notes 397–409 and accompanying text.

[326] This point can be illustrated by the connection among Usmani, *Jihad*, Dow Jones and HSBC. *See supra* notes 207–208. By retaining *Shari'ah* authorities who call for *Jihad* against the West, U.S. financial institutions raise the profile and importance of the *Shari'ah* legal rulings of these authorities, thereby contributing to the likelihood that their call for *Jihad* will be heeded. At what point does Dow Jones' or HSBC's failure to conduct even minimal due diligence arise to the level of willful blindness or recklessness, which begins to touch upon criminal scienter? *See generally* Robin Charlow, *Wilful Ignorance and Criminal Culpability*, 70 TEX. L. REV. 1351 (1992) (providing an overview of the criminal law related to willful ignorance).

that is represented as *Shari'ah*-compliant. These contemporary structures are exogenous to *Shari'ah* but very much a part of how *Shari'ah* has been manipulated to accommodate modern finance and commerce. These exogenous elements reflect on how *Shari'ah* has been transformed, modeled, and presented in various SCF contexts.

It is important to keep in mind a fundamental principle of SCF: *Shari'ah* compliance must be judged by one or more *Shari'ah* authorities.[327] It is clear from the literature that a non-Muslim cannot determine what is *Shari'ah*-compliant and further that a Muslim who is not recognized by his peers as a *Shari'ah* authority cannot assume the role of one.[328] The corollary of this principle is that the *Shari'ah* authorities are themselves bound by the community of *Shari'ah* authorities within which they operate.[329] The exact nature of this community or "consensus," both in terms of its theoretical elasticity and its geographic boundaries, is only vaguely articulated in the SCF literature, but the implications of its contours both when adhered to and when breached are significant.[330]

A. Disclosure

Our analysis begins with an examination of several questions about what it means to represent to the public that a financial institution or business has embraced SCF. Is there a duty to represent to the public what a *Shari'ah* authority is and how any given authority has obtained that status? Is it material to the investment? Is the failure to articulate the risks associated with conflicting SCF rulings from a more authoritative *Shari'ah* authority a disregard of minimal standards of disclosure?[331]

Moreover, is there a duty to disclose to the public whether the *Shari'ah* authorities chosen by a U.S. financial institution have issued authoritative rulings on matters that would implicate discrimination or violence against non-Muslims and *Shari'ah*-non-compliant Muslims? Is it important that a financial institution's *Shari'ah* authority relies on the *Shari'ah* rulings of authorities who have called for a worldwide Islamic Caliphate ruled by *Shari'ah*? Further, when the *Shari'ah* authorities rule that investments in a military or weapons industry are forbidden by *Shari'ah*, is it important for the U.S. financial institution to disclose to the reasonable post-9/11 investor whether there is such a *Shari'ah* ban on investments

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[327] *See* DeLorenzo, *supra* note 24, at 1–3.

[328] *See* Ian D. Edge, *Shari'a and Commerce in Contemporary Egypt*, *in* ISLAMIC LAW AND FINANCE, *supra* note 21, at 33.

[329] *See* VOGEL & HAYES, *supra* note 17, at 9–10.

[330] *See Id.* at 9–10.

[331] It seems *Shari'ah* authorities themselves understand the reputational and even financial risks of not imposing some broad standards for entry into the elite group of *Shari'ah* authorities and for not standardizing what is *Shari'ah*-compliant and what is not. *See, e.g.*, IFSB Standards, *supra* note 177 (providing a wide range of standards covering areas such as disclosure, corporate governance, and exposure).

by Muslims in Muslim military industries for weapons to be sold to Muslim regimes?

In this context, the *Nike* case takes on a new dimension. Recall that Nike, an Oregon corporation, was sued in California under its Unfair Competition Law on the grounds that Nike's public statements in defense of its labor practices abroad were actionable.[332] The California Supreme Court was not inclined to restrict the statute's reach and rejected Nike's argument that non-commercial speech rights were violated, remanding for reconsideration.[333] Nike argued that the extension of such business fraud statutes to generic discussions by companies that have more to do with social commentary on issues of public importance than promoting the sale of specific goods and services effectively denies First Amendment protections to U.S. businesses.[334] In effect, after being attacked in the media and having chosen to speak in its own defense, Nike had invited the lawsuit under California's Draconian consumer fraud statute.[335] The company could have continued to litigate the case for years, attempting to prove that it had spoken truthfully about its offshore labor practices, but it understood that every new twist and turn in the litigation would amount to millions of dollars in bad publicity for a company that spent millions trying to build and maintain its brand.[336]

Nike's experience raises the following question for proponents of SCF: When U.S. companies tout SCF as "ethical" and "socially responsible investing" or as simply innocuous "interest-free" and "vice-free" investing, does this claim amount to consumer fraud? In California at least, the groundwork for an affirmative finding has been prepared.

Another exogenous factor has been addressed by the academic and professional SCF literature. A significant focus of SCF publications is the dearth of competent *Shari'ah* authorities worldwide.[337] This is because while *Shari'ah* authorities are available in sufficient numbers to answer the needs of the *Shari'ah*-adherent communities worldwide,[338] there is a severe shortage of these authorities who are sufficiently versed in English and modern finance to handle the international documentation invariably drafted with an eye towards institutions

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[332] Nike, Inc. v. Kasky, 539 U.S. 654, 656 (2003) (per curiam) (Stevens, J., concurring); *see supra* notes 152–156 and accompanying text.

[333] *Nike*, 539 U.S. at 657 (Stevens, J., concurring).

[334] *See id.* at 656–57.

[335] *See id.* at 656.

[336] See *id.* at 668 (Breyer, J., dissenting).

[337] *See generally* Islamic Banking and Finance, Issue #3 Summary, http://islamicbankingandfinance.com/summary3.html (last visited Aug. 4, 2008) (summarizing an issue of the London-based journal *Islamic Banking and Finance*, which discusses this "bottleneck").

[338] This is assisted by the burgeoning use of Internet sites, which provide legal rulings (*fatawa*) to the *Shari'ah* faithful anywhere in the world. *See, e.g.*, IslamOnLine.net, http://www.islamonline.net/english/index.shtml (last visited Aug. 3, 2008) (providing a "Fatwa Bank" with questions and answers on *Shari'ah*).

working out of London or New York.[339] There are only approximately 20–25 sufficiently trained *Shari'ah* authorities, and each of these exclusive club members sits on dozens of *Shari'ah* supervisory boards around the world.[340] The result is a small clique that advises the lion's share of competing financial institutions on how to develop new SCF products and transaction structures.[341]

The legal advisor must evaluate the disclosure issues, a complicated task given the fact that a *Shari'ah* authority's rulings and artful craftsmanship in finding new transactional structures to avoid *Shari'ah* prohibitions might very well differ from one institutional client to another. For instance, are there issues that ought to be disclosed to a reasonable investor relating to confidentiality and the systems put in place to protect confidentiality? What duty of care do the *Shari'ah* authorities owe the financial institutions? Are they considered experts for purposes of the 1933 Act?[342] Do they participate in writing the portions of the registration statement or prospectus that deal with *Shari'ah*?

In all of these areas, the materiality and scienter issues will play into the calculus for the legal advisor as the examination of these and other exogenous elements unfold.[343] An additional facet of the disclosure complex, especially as it relates to the scienter standard of recklessness, is the implication for the financial institutions and their professional advisors of a duty to conduct due diligence to make certain that what they have said about SCF is the whole of the material truth.[344]

B. Due Diligence

The articulation of a breach of duty to disclose is closely related to the duty to exercise reasonable due diligence as either an element of scienter or a defense where scienter is not at issue. For example, under the 1933 Act, Sections 11 and 12(a)(2) provide for a due diligence defense for certain defendants who have failed to disclose all relevant material facts.[345] The case law and literature on these defenses is extensive, and legal counsel for any financial institution will have to seriously consider the implications of ignoring the exogenous structures set up for a *Shari'ah*-compliant investment or business.[346] At the very least, each of the

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[339] *See id.*

[340] *See* Michelle Wallin, *Among Islamic Banks, A Shortage of Scholars*, N.Y. TIMES, Feb. 8, 2005, at C8, *available at* http://www.nytimes.com/2005/02/08/business/world business/08bahrain .html?_r=1&pagewanted=print&position=&oref=slogin.

[341] Alexiev, *supra* note 21, at 16 n.43. There are probably more *Shari'ah* authorities if Pakistan, Malaysia and the GCC states are counted. *See* VOGEL & HAYES, *supra* note 17, at 10–12.

[342] *See supra* note 219 and accompanying text.

[343] *See* discussion *supra* Parts IV.C.1, IV.C.2.

[344] *See supra* notes 283–285 and accompanying text.

[345] *See supra* notes 271–273 and accompanying text.

[346] *See* LOSS & SELIGMAN, *supra* note 5, at 1230–32.

exogenous disclosure issues should be the subject of a carefully prepared legal opinion. Failure to rely on an expert legal opinion will likely expose the financial institution and its management to greater liability insofar as failure to do so rises to the level of reckless breach of the duty of care. The duty to rely on a formal legal opinion intimates the lawyer's exposure to liability for failure to conduct a reasonably competent investigation.

C. Other Compliance Issues

1. Global Security Risks Revisited

The due diligence requirements implied in the scienter element of many fraud actions and provided expressly as defenses under securities laws are only one component of the due diligence analysis pertinent to SCF. In the main, the effort to combat the global security risks associated with Islamic terror networks and the regimes that support those networks has incorporated many strategies, only some of which are appropriately suited to the task at hand. One approach is through trade sanctions and embargoes. These foreign policy initiatives are authorized by such laws as the Trading with the Enemy Act (TWEA)[347] and the International Emergency Economic Powers Act (IEEPA),[348] which authorize the Office of Foreign Assets Control (OFAC) of the Treasury Department to establish sanction regimes on states identified by the President as falling within the jurisdictional reach of either of the two laws.[349]

The Halliburton affair described above began as a seemingly innocuous inquiry by the New York City Comptroller on behalf of some shareholders into disclosure requirements of an annual proxy statement but soon spiraled out of control.[350] After Halliburton was forced to report to its shareholders on the financial and reputational risks of doing business in a terror-sponsoring state, the Comptroller was still unsatisfied and considered the company's disclosures inadequate.[351] Soon thereafter, OFAC got involved and referred the matter to the Department of Justice, which initiated a grand jury investigation.[352] Other

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[347] 50 U.S.C. app. § 1 (2006).

[348] 50 U.S.C.A. §§ 1701–1706 (West 2003 & Supp. 2008).

[349] *See, e.g.*, Continuation of the National Emergency with Respect to Iran, 72 Fed. Reg. 10,883 (Mar. 12, 2007) (renewing the national emergency, with respect to Iran, pursuant to 50 U.S.C. §§ 1701–1706).

[350] *See supra* note 256 and accompanying text.

[351] *See supra* notes 257–258 and accompanying text.

[352] *See* Halliburton, Annual Report (Form 10-K), at 58 (Dec. 31, 2006), *available at* http://www.sec.gov/Archives/edgar/data/45012/000004501207000072/ed10k2006_final.htm. The report provides a relatively concise summary of the complicated events:

companies doing business in terror-sponsoring states have also run into trouble.[353] While the implications for financial institutions relying on *Shari'ah* authorities associated with or sympathetic to terrorists do not touch upon TWEA or IEEPA compliance per se, the duty of disclosure of material facts under the compliance regimes remains.[354]

(a) Reverse Money Laundering Revisited

Another approach to the global security risk of Islamic terrorism has been the strengthening of anti-money laundering laws and regulations. The "heavy lifting" of this effort of late has been accomplished by the Patriot Act and its amendments

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Operations in Iran

We received and responded to an inquiry in mid-2001 from the Office of Foreign Assets Control (OFAC) of the United States Treasury Department with respect to operations in Iran by a Halliburton subsidiary incorporated in the Cayman Islands. The OFAC inquiry requested information with respect to compliance with the Iranian Transaction Regulations. These regulations prohibit United States citizens, including United States corporations and other United States business organizations, from engaging in commercial, financial, or trade transactions with Iran, unless authorized by OFAC or exempted by statute. Our 2001 written response to OFAC stated that we believed that we were in compliance with applicable sanction regulations. In the first quarter of 2004, we responded to a follow-up letter from OFAC requesting additional information. We understand this matter has now been referred by OFAC to the Department of Justice. In July 2004, we received a grand jury subpoena from an Assistant United States District Attorney requesting the production of documents. We are cooperating with the government's investigation and responded to the subpoena by producing documents in September 2004.

Separate from the OFAC inquiry, we completed a study in 2003 of our activities in Iran during 2002 and 2003 and concluded that these activities were in compliance with applicable sanction regulations. These sanction regulations require isolation of entities that conduct activities in Iran from contact with United States citizens or managers of United States companies. Notwithstanding our conclusions that our activities in Iran were not in violation of United States laws and regulations, we announced that, after fulfilling our current contractual obligations within Iran, we intend to cease operations within that country and withdraw from further activities there.

Id.

[353] *See* Lau, *supra* note 256, at 418–19.

[354] *See id.* at 420 (noting that the Office of Global Security Risk identifies "companies whose activities raise concern about global security risks that are material to investors," with the SEC then looking "at whether a company has operations in a country where 'political, economic or other risks exist that are material'").

to the Bank Secrecy Act (BSA)[355] and the anti-money laundering statutes.[356] But with all of the fanfare and political disputation surrounding this legislation by civil libertarians, civil rights activists, and various Muslim organizations,[357] the legislation still fails to grapple effectively with the problem of money laundering in support of terrorism.[358] Almost all of the BSA, and the regulations promulgated thereunder, and the anti-money laundering statutes approach the problem of terrorist financing in the traditional way, notwithstanding a dangerous new *modus operandi*.[359] The BSA and anti-money laundering statutes are intensely focused on spotting and reporting suspicious money transfers, especially cash transfers that have criminal sources.[360]

This approach to battling the funding of terrorism fits the traditional approach to anti-money laundering efforts, which looks for money from illegal activities such as drugs and gambling, typically in the form of cash, and its laundering into clean money invested in legitimate businesses.[361] As long as the effort is "following the money" in the form of cash from its entry into the regulated and reporting financial system (what the professionals call "placement"),[362] and winds its way to its ultimate destination, the system works at least moderately well—though, most experts will admit that it both misses large sums and suffers from over-reporting of perfectly legitimate cash transactions.[363] A larger difficulty is "reverse money laundering," where clean money is used to support criminal ends.[364]

Reverse money laundering stands the classic model on its head—perfectly legitimate funds, some of which may come from charities, are wired or transferred

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[355] 31 U.S.C.A. §§ 5318, 5318A, 5319, 5321(a), 5322, 5324, 5326, 5328 5330(d)(1)(A), 5332, 5341(b) (West 2003 & Supp. 2007).

[356] *See generally* Eric J. Gouvin, *Bringing out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism*, 55 BAYLOR L. REV. 955 (2003) (reviewing money laundering legislation and discussing some of the USA Patriot Act's inadequacies in this area).

[357] *See, e.g.*, Council on American-Islamic Relations-Chi. Office, Action Alert: CAIR Launches Patriot Act Blog (Dec. 1, 2005), http://www.cairchicago.org/actionalerts.php?file =aa_blog12012005 (announcing a special Internet "blog" pushing for the incorporation of additional civil liberties protections in a renewed Patriot Act, published by the Council on American-Islamic Relations (CAIR)).

[358] *See* Gouvin, *supra* note 356, at 973–81.

[359] *Id.* at 962.

[360] *Id.*

[361] *Id.*

[362] FED. FIN. INSTS. EXAMINATION COUNCIL, BANK SECRECY ACT/ANTI-MONEY LAUNDERING EXAMINATION MANUAL 8 (2006), *available at* http://www.ffiec.gov/pdf/ bsa_aml _examination_manual2006.pdf.

[363] *See* Gouvin, *supra* note 356, at 967–69.

[364] *See* Stefan D. Cassella, *Reverse Money Laundering*, 7 J. MONEY LAUNDERING CONTROL 92, 92 (2003).

to terrorists.[365] These transactions are difficult to spot unless government regulators already have the specific charities and organizations in question under surveillance.[366] Such proactive or prophylactic surveillance runs into privacy and constitutional thickets.[367] Assuming the federal government does not have sufficient evidence for probable cause or a Foreign Intelligence Surveillance Act warrant,[368] targeting Muslim charities would be roundly protested as racial profiling irrespective of the actual legal or constitutional infirmities of the practice.[369] As a result, while administrative "blocking orders" promulgated under the authority of the IEEPA have been an effective tool in disrupting and shutting down some of the largest and most dangerous Muslim charities funding terrorism,[370] prosecutions of terror-financing through charities have had mixed results.[371]

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[365] *Id.*

[366] Gouvin, *supra* note 356, at 976–77.

[367] *See generally* Richard Henry Seamon & William Dylan Gardner, *The Patriot Act and the Wall Between Foreign Intelligence and Law Enforcement*, 28 HARV. J.L. & PUB. POL'Y 319 (2005) (discussing Fourth Amendment "criminal" warrant standards and detailing FISA's reduced requirements for a warrant directed at foreign threats, even if they are on domestic soil).

[368] "FISA" is the Foreign Intelligence Surveillance Act of 1978, Pub. L. No. 95-511, 92 Stat. 1783 (1978) (codified as amended at 50 U.S.C. §§ 1801–1871), which was amended materially by the Patriot Act. *See* USA PATRIOT ACT, Pub. L. No. 107-56 § 218, 115 Stat. 272, 291 (2001) (amending 50 U.S.C. §§ 1804(a)(7)(B), 1823(a)(7)(B)).

[369] *See* David Hardin, Note, *The Fuss over Two Small Words: The Unconstitutionality of the USA PATRIOT Act Amendments to FISA Under the Fourth Amendment*, 71 GEO. WASH. L. REV. 291, 342 & n.395 (2003).

[370] *See* Montgomery E. Engel, Note, *Donating "Blood Money": Fundraising for International Terrorism by United States Charities and the Government's Efforts to Constrict the Flow*, 12 CARDOZO J. INT'L & COMP. L. 251, 282–85 (2004). Specifically, Engel writes that:

> The authority of the President to issue both Executive Orders 12,947 and 13,224 originates in the International Emergency Economic Powers Act ("IEEPA"). Upon declaration of a national emergency in response to an "unusual and extraordinary threat," IEEPA grants the President broad authority to govern the disposition and block the assets of "any person, or with respect to any property, subject to the jurisdiction of the United States." The Supreme Court has upheld IEEPA's broad grant of authority to the President in its form as amended in 1977. The Court refused to limit the President's authority to continued blocking or freezing but ensured that it extended to the permanent disposition of assets suggested by IEEPA's congressional grant of the power to "transfer," "compel," and even "nullify" assets. Underlying this deferential grant, the Court recognized a legitimate and discretionary exercise of the President's power to govern foreign policy by using frozen assets as a "bargaining chip" in dealing with a hostile country.

This problem raises its ugly head with SCF in two ways. One way, although it does not yet appear to be the norm in the U.S., is through a charitable contribution made by an SCF financial institution or business. This contribution would occur because faithful Muslims must gift a certain percentage of their income to charity.[372] Some SCF companies, banks, and investment funds actually calculate the amount that individual Muslim investors owe from profits and distribute those funds automatically to *Shari'ah*-approved Islamic charities, and only then distribute the net, after-*Shari'ah*-charitable-tax profits to the individual investor.[373] Most SCF institutions, however, leave such tithing to the individual investor to calculate and distribute.[374]

Several questions arise for those SCF businesses and investments which net the returns to the investor after this charitable payment: Which charities are *Shari'ah*-compliant? Who makes this determination? Do the businesses or financial institutions direct these contributions, or are these decisions made by the

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Id. at 258–59 (citations omitted). The role of Muslim charities in financing terror has been discussed in Congressional testimony as well. *See Role of Charities and NGOs in the Financing of Terrorist Activities: Hearing Before the Subcomm. on International Trade and Finance of the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Matthew Levitt, Senior Fellow, Washington Institute for Near East Policy), *available at* http://banking.senate.gov/02_08hrg/080102/levitt.htm. Military strategists have also looked at this modality for furthering the terrorist war aims. *See* MAJ. WESLEY J. L. ANDERSON, DISRUPTING THREAT FINANCES: UTILIZATION OF FINANCIAL INFORMATION TO DISRUPT TERRORIST ORGANIZATIONS IN THE TWENTY-FIRST CENTURY 8–11 (Nov. 4, 2007), *available at* http://stinet.dtic.mil/cgi-bin/GetTRDoc?AD=A470454&Location=U2&doc=GetTRDoc.pdf.

[371] *See* Danielle Stampley, Comment, *Blocking Access to Assets*, 57 AM. U. L. REV. 683, 709 & n.152 (2008) (highlighting the fact that prosecutions for the "material support of terrorism" are difficult cases to try before a jury because they often require specific evidence against the defendants, like financial data evidence, as opposed to hearsay evidence and circumstantial evidence of associational links, which will lead the defendant to raise the defense that they had no specific knowledge that the money they contributed was going to support illegal activities). For an Internet site dedicated to tracking the results of terrorism-related prosecutions, *see* TRAC Reports: Criminal Terrorism Enforcement in the United States During the Five Years Since the 9/11/01 Attacks, maintained by the Transactional Records Access Clearinghouse (TRAC) associated with Syracuse University, http://trac.syr.edu/tracreports/terrorism/169/ (last visited Sept. 2, 2008).

[372] *See* Munir Morad, *Current Thought on Islamic Taxation: A Critical Synthesis*, *in* ISLAMIC LAW AND FINANCE, *supra* note 21, at 122–23.

[373] *See* DeLorenzo, *supra* note 24, at 11.

[374] *Id.* at 11. One of the leading *Shari'ah* authorities recommends that *Shari'ah*-compliant mutual funds leave the donation to the individual investor; though, it may be best for *Shari'ah* Supervisory Boards to prepare guidelines for the calculation of the religious tax called *zakat* "on profits earned through investments in funds." DeLorenzo, *supra* note 24, at 11. The assumption for this article has been that if a reporting mutual fund does not disclose that it has the authority to gift *zakat* contributions on behalf of the individual investors, then the mutual fund has left that for the individual investors.

Shari'ah authorities? Is there any vetting of the recipients of these charities to determine what they do with these funds? Why is this process not transparent?

A second form of this problem arises when some of the gross income of a business is from *Shari'ah*-prohibited sources. This typically occurs in two ways. The first is via the exceptional event when a *Shari'ah* "filter" misses a tainted source of income altogether. This might happen when a *Shari'ah*-compliant company in a *Shari'ah*-compliant mutual fund acquires a forbidden company, the main business of which is in a forbidden industry such as finance or hog farming.[375] Assuming the acquired company's forbidden assets are not *de minimis*, the acquisition renders the parent company in the mutual fund's portfolio *Shari'ah*-prohibited and the equity position in that company must be sold.[376] Where the proceeds of that sale will include a certain amount of profits attributed to the forbidden assets, that amount must be calculated and "purified."[377]

The second occasion for purification is more typical. For example, a mutual fund is permitted to invest routinely in companies which earn up to a fixed percentage of their income from interest on the forbidden business activities.[378] Notwithstanding this leniency, any profits to the mutual fund attributed to this forbidden income must be "purified" at some point.[379]

Because the calculation of this purification can be complex, most *Shari'ah* authorities either insist or prefer that the purification take place by the SCF institution so the *Shari'ah* authorities will have the opportunity to assess the amount needed to be purified and supervise the logistics.[380] As in the charitable contribution discussion, the purification process typically is not fully disclosed in public filings of U.S. SCF financial institutions.[381] The questions raised above about disclosure for the general charitable tax apply here *mutatis mutandis*. However, since most *Shari'ah* authorities have ruled that it is more appropriate to

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[375] *See* Yaquby, *supra* note 23, at 21 (detailing the total prohibition on investment in "unlawful activities, such as conventional banks, insurance companies, alcoholic beverages companies and gambling, pork, brothels, pornography-related companies and other similar companies").

[376] *See* LEWIS & ALGAOUD, *supra* note 21, at 222–23.

[377] *See* DeLorenzo, *supra* note 24, at 4–5; *see also* ISLAMIC FIN. SERVS. BD., EXPOSURE DRAFT: GUIDING PRINCIPLES ON GOVERNANCE FOR ISLAMIC COLLECTIVE INVESTMENT SCHEMES 14–17 (Dec. 2007), *available at* http://www.ifsb.org/docs/ed_islamic_collective_investment.pdf (outlining standards for governance); s*ee generally* Yaquby, *supra* note 23 (discussing different views on impurity and appropriate responses).

[378] *See* Yaquby, *supra* note 23, at 23–24.

[379] *See* DeLorenzo, *supra* note 24, at 4–5.

[380] *Id.* at 4–5.

[381] *See* Dow Jones Islamic Market Index Portfolio, Registration Statement (Form N-1A) (Sept. 1, 1999), *available at* http://www.sec.gov/Archives/edgar/data/1088654/0000935489-99-000014.txt.

have the purification process carried out by the SCF company rather than by the individual investor, one might reasonably assume that this is the general rule.[382]

In both instances, the legal advisor to the SCF financial institution or business must be careful about how these charitable contributions are made and who the beneficiaries of these funds are. Given the prosecutions of Islamic charities for funneling contributions to terrorist organizations directly and indirectly through other charitable organizations in a laundering process,[383] the anti-money laundering laws must be analyzed carefully by the attorney to be certain that the financial institution is not facilitating a criminal violation and that there is strict compliance with all reporting requirements.

The principal anti-money laundering statutes are 18 U.S.C. §§ 1956–1957. The focus of these statutes is on criminalizing the movement of funds from unlawful activity.[384] As such, they have a limited application to the issue of charitable contributions directed by *Shari'ah* authorities related to a given SCF financial institution. The legal advisor, however, must take the following into consideration before proffering advice because Section 1956(a)(2) criminalizes the following:

> (2) Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States—(A) with the intent to promote the carrying on of specified unlawful activity; . . . .[385]

Two issues stand out. First, a purely domestic transfer of legal funds with the requisite criminal intent is not a per se violation under this provision. Arguably, if a domestic transfer took place but with the understanding that the funds would find their way overseas as part of the criminal intent, such a transfer would be prohibited. Thus, a U.S. financial institution might run afoul of this provision when it "purifies" its forbidden assets by transferring funds to a terrorist-supporting charity overseas or possibly even to a domestic charity as a conduit to problematic overseas groups.

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[382] While it does not appear that the DJIMI calculates the "purification" requirement for its index of funds with a concomitant reduction in the stated values and returns for its universe of stocks, one index actually promotes this feature: "Incorporates Dividend Purification. In addition, the application of a dividend adjustment factor in the creation of the MSCI Islamic Index Series results in more relevant benchmarks, as they reflect the total return to an Islamic portfolio net of dividend purification." MSCI Barra, MSCI Global Islamic Indices, http://www.mscibarra.com/products/indices/islamic/ (last visited Sept. 3, 2008).

[383] *See supra* note 370 and accompanying text.

[384] *See supra* notes 362–363 and accompanying text.

[385] 18 U.S.C. § 1956(a)(2)(A) (2006).

The second issue is intent. The statute requires that the defendant have the intent to move the funds to promote one of the illegal activities enumerated.[386] Terrorism is one of those criminal activities set out in Section 1956(c)(7).[387] A lawyer representing a financial institution contemplating "purification" must consider the possibility that the charitable gift might be going to a charity with intimate connections to terrorists.[388] In this context, prudent legal counsel must determine who directs the funds to the charitable contribution, whether the charities or universe of acceptable charities are chosen by the *Shari'ah* authorities, and whether this decision is binding on the financial institution. The issue here is obvious. If the financial institution places this decision-making authority into the hands of the *Shari'ah* authorities it has retained, it is possible that any criminal "intent" or "purposes" connecting the *Shari'ah* authorities to these charities will be attributed to the financial institution. The criminal culpability in this case is similar to that described above in the discussion of the Smith Act.[389]

While many financial institutions involved in SCF attempt to distance themselves from the *Shari'ah* authorities, a lawyer analyzing these issues must determine who made the decision about which charities would be considered *Shari'ah*-complaint and thus recipients for the "purification" of funds. Moreover, if it turns out that these charities have ties to terrorists or are implicated in the material support of terrorism, the lawyer must determine whether this fact was known to any agent of the company.[390]

Obviously, the criminal exposure arising from the "purification" process might lead responsible legal counsel to ask the following questions about any list

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[386] *Id.*

[387] *Id.* § 1956(c)(7)(D) (referring to other sections relating to various types of terrorist acts).

[388] As one commentator began an analysis into the problem of Muslim charities being used to funnel funds to Islamic terrorists:

> On December 4, 2001, nearly three months after the terrorist attacks of September 11th and barely three days after a pair of terrorist suicide bombings killed 25 and injured 200 in Israel, President Bush declared the Holy Land Foundation for Relief and Development ("HLF") of Richardson, Texas, a terrorist organization, its assets frozen, and announced that its offices had been raided by the FBI. Purportedly the largest Muslim charity in the United States, HLF had been under investigation by the FBI for its alleged financing of the Islamic Resistance movement, or Hamas, for nine years. Ten days later, the Bush Administration acted again, freezing the assets and raiding the offices of two more Muslim charities, the Benevolence International Foundation ("BIF") and the Global Relief Foundation ("GRF"), both located in the Chicago, Illinois area.

Engel, *supra* note 370, at 251 (citations omitted).

[389] *See supra* Part VI.D.

[390] Or, as set out *supra* at note 280, was this fact willfully or recklessly avoided?

of potential charities: Are these well-known non-Muslim charities? If they are Muslim charities, have they been vetted and by whom? The three largest Muslim charities in the U.S. have all been implicated in financing terror and were subject to administrative blocking orders wherein their assets were frozen and they were effectively shut down.[391]

The practice of Muslim charities funneling money to terrorists is so widespread and the problem so insidious that the federal government keeps an updated list on dozens of such organizations worldwide.[392] But it will not suffice for the legal advisor to simply determine that the charities are "well-known" Muslim charities and not currently listed as designated supporters of terrorism. At a minimum, the following queries would need to be undertaken: Who are the ultimate beneficiaries of the contributions?[393] Do these charities have overseas branches? Is the financial institution wiring the funds domestically or internationally? Who or what organization founded the organizations and who controls them today? Once these questions are answered, the legal advisor will need to be careful that, whatever policies are put in place to avoid criminal exposure under Sections 1956 and 1957, the client continues to monitor these "charitable contributions" carefully.[394]

(b) Material Support of Terrorism and Related Civil Exposure

Material support of terrorism is a federal crime under 18 U.S.C. §§ 2339A–2339B. The Intelligence Reform and Terrorism Prevention Act of 2004[395] amended the definition of "material support" to read as follows:

> (1) the term "material support or resources" means any property, tangible or intangible, or service, including currency or monetary instruments or financial securities, financial services, lodging, training, expert advice or assistance, safehouses, false documentation or identification, communications equipment, facilities, weapons, lethal substances, explosives, personnel (1 or more individuals who may be or include oneself), and transportation, except medicine or religious materials.[396]

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[391] *See supra* note 388.

[392] *See* U.S. Department of the Treasury, Terrorism and Financial Intelligence, Key Issues: Protecting Charitable Organizations, http://www.ustreas.gov/offices/enforcement/key-issues /protecting/charities_execorder_13224-a.shtml (last visited Aug. 3, 2008).

[393] In other words, who or what is the ultimate recipient of the charities' "good deeds"?

[394] Typically, good legal counsel, when developing a due diligence plan, will construct it such that it accounts for the threshold *prima facie* requirements of an indictment or other criminal charging process rather than an acquittal at trial.

[395] Pub. L. No. 108-458, 118 Stat. 3638 (2004).

[396] 18 U.S.C.A. § 2339A(b)(1) (West Supp. 2008).

A *Shari'ah* authority issuing, promoting, or advocating a legal ruling for *Jihad* to anyone for the purpose of conducting terrorism would clearly fall within the definition of "'expert advice or assistance' . . . derived from . . . specialized knowledge."[397] In addition, a New York federal district court found that an attorney who passed along a legal ruling calling for *Jihad* had provided "material support" in the form of "personnel" as part of a terror-laden conspiracy.[398] In *U.S. v. Satter*, the court upheld attorney Lynne Stewart's conviction for violating Section 2339A.[399] There, Stewart merely passed along a *fatwa* or legal ruling regarding *Jihad* issued by her client, Sheikh Omar Abdel Rahman, indirectly to terrorists in Egypt, some of whom apparently respected his authority in matters of *Shari'ah*.[400] The court concluded that passing along a legal ruling could be equivalent to providing "personnel" to the co-conspirators and amounted to material support.[401]

A U.S. company that promotes the legal rulings of a *Shari'ah* authority who is known for issuing such rulings on the Law of *Jihad* could risk extraordinary criminal exposure. While it is not likely that the company would promote the actual rulings relative to *Jihad* or do so with the intent to cause violence, this will not be the standard. Instead, the question will be what role does the *Shari'ah* authority occupy within the company or what relationship does he have to the company if he is an "outside advisor?" To the extent that criminal *respondeat superior* implicates the corporate entity in the *Shari'ah* authority's scienter, a defense built upon lack of knowledge by the board of directors will not be effective. Also, the fact that such legal rulings are published in broad daylight and available from English open sources will render the corporation's plea of lack of intent all the more unavailing to the extent it rises to the level of "willful blindness" or "recklessness."[402]

Additional areas of criminal and civil liability exposure relate to the anti-money laundering statutes. To the extent that any "purification" funds move from the financial institution to a charity and are found to support terrorist activities, there would likely be additional criminal exposure under Sections 2339A and 2339B because both of these statutes forbid the provision of material support for terrorism.[403] The distinction between the two statutes is important. Section 2339A requires a showing that the defendant provided support knowing its intended purposes.[404] Under Section 2339B, the defendant need only know of the status of the target organization as a designated terrorist organization and need not know or

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[397] *See id.* § 2339A(b)(3).

[398] United States v. Sattar, 395 F. Supp. 2d 79, 93, 95, 99, 103 (S.D.N.Y. 2005).

[399] *Id.* at 82, 103.

[400] *See id.* at 87–88.

[401] *Id.* at 99.

[402] *See, e.g.*, USMANI *supra* note 208, at 123–39 (discussing the topic of *Jihad*).

[403] 18 U.S.C.A. §§ 2339A, 2339B (West 2000 & Supp. 2008).

[404] *Id.* § 2339A(a) (West Supp. 2008).

intend that the material support is going to support terrorism.[405] This also applies to the discussion regarding corporate criminal exposure for the intent of the company's agents and must be considered by legal counsel.

In addition to criminal exposure, to the extent that a U.S. financial institution can be criminally linked to terrorist organizations as a result of the "purification" funds or via other "material support" relationships between the *Shari'ah* authorities and the terrorists, additional statutes provide civil remedies to victims of such violence, even if the violence occurs outside the jurisdiction of the U.S. The most important of these statutes is 18 U.S.C. § 2333, which provides for civil remedies and treble damages for any U.S. national injured by terrorists.[406] Several federal circuits have allowed private rights of action under this statute against defendants who have "aided and abetted" the offending terrorists by violating Sections 2339A and 2339B.[407]

Beyond the civil exposure in Section 2333, the Alien Tort Statute (ATS)[408] probably exposes companies linked criminally to terrorism to enormous civil liability. It is severe enough to be sued by U.S. nationals for damages caused by terrorism, but the potential for mass litigation by foreigners for such damages is greater still. Once the criminal connection is made through the anti-money laundering or the material support of terrorism statutes, the plaintiffs' bar will likely then allege that terrorism is a violation of some norm of the law of nations that is "specific, universal, and obligatory" and that there is a proximate cause between the "material support of terrorism" alleged and the injuries suffered.[409]

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[405] *See id.* § 2339B(a)(1); United States v. Sattar, 314 F. Supp. 2d 279, 301–02 (S.D.N.Y. 2004) (discussing this point in an earlier appeal arising out of the same trial).

[406] 18 U.S.C. § 2333(a) (2006).

[407] *See, e.g.*, Boim v. Quranic Literacy Inst., 291 F.3d 1000, 1023–24 (7th Cir. 2002) (allowing suit under section 2333 for U.S. "citizen murdered in Israel by Hamas terrorists").

[408] 28 U.S.C. § 1350.

[409] *See id.*; *see, e.g.*, Sosa v. Alvarez-Machain, 542 U.S. 692, 738 (2004) (demonstrating the utility of ATS as a jurisdictional statute). In particular, ATS gives an alien plaintiff access to federal courts if there is an allegation that the alien suffered some harm that is in "violation of the law of nations or a treaty of the United States." 28 U.S.C. § 1350. In the Court's opinion, it was "persuaded that federal courts should not recognize private claims under federal common law for violations of any international law norm with less definite content and acceptance among civilized nations than the historical paradigms familiar when § 1350 was enacted," and the Court implicitly endorsed the "specific, universal, and obligatory" standard. *Sosa*, 542 U.S. at 732 (citing *In re* Estate of Ferdinand Marcos, 25 F.3d 1467, 1475 (9th Cir. 1994)). To the extent that U.S. laws against torture encompass terrorism and the "material support of terrorism," they are in accord with the Law of Nations and, at the very least, would likely satisfy the "specific, universal, and obligatory" standard. *See* Torture Victim Protection Act of 1991, Pub. L. No. 102-256, § 2(b), 106 Stat 73, 73 (1992) (codified at 28 U.S.C. § 1350 notes); Filartiga v. Pena-Irala, 630 F.2d 876, 885 (2d Cir. 1980) (stating that torture is a violation of the Law of Nations).

2. Antitrust

Another area of civil liability exposure related to the exogenous structure imposed by the need for *Shari'ah* authority boards arises under antitrust law. As noted above, at present there are a limited number of *Shari'ah* authorities filling the positions available on the *Shari'ah* authority boards of the major *Shari'ah*-compliant financial institutions worldwide.[410] There has been a concerted effort among these *Shari'ah* authorities to impose universal standards to prevent materially divergent opinions. Such efforts have been launched by the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") and the Islamic Financial Services Board ("IFSB"). The AAOIFI seeks to establish accounting standards for the various transactional structures, whereas the IFSB sets the standards by which *Shari'ah* authorities self-regulate and interact with the financial institutions that employ them.[411]

According to the IFSB and the independent writings of many *Shari'ah* authorities, there are designs to establish industry-wide minimal credentials that a newcomer would be required to obtain to enter this apparently lucrative market.[412] The initial antitrust issue raised by such efforts is the problem of "group boycotts" or the implications of "self-regulation" for a small, discreet, and insular group of authorities who have almost total market share deciding how one gains entry into the market.[413] Applying the standard "rule of reason," courts will look to the motivations and anti-competitive effects of such "industry standards."[414]

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[410] *See supra* note 337 and accompanying text.

[411] *See supra* note 18 and accompanying text; *see also* Accounting and Auditing Organization for Islamic Financial Institutions, http://www.aaoifi.com/index.shtml (last visited Aug. 5, 2008) (describing itself as "responsible for developing accounting, auditing, ethics, governance, and Shari'a standards for the international Islamic banking and finance industry"); Islamic Financial Services Board, http://www.ifsb.org/index.php (last visited Aug. 5, 2008) (explaining that the organization "is an international standard-setting organisation [sic] that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors").

[412] *See* ISLAMIC FIN. SERVS. INDUS. DEV., TEN-YEAR FRAMEWORK AND STRATEGIES 10, 23, 47, 50, 52, 58, 61 (2007) (joint initiative of the Islamic Research & Training Institute Islamic Development Bank, Islamic Financial Services Board, and the Islamic Research and Training Institute), *available at* www.ifsb.org/docs/10_yr_framework.pdf (describing the industry and laying out goals for the next ten years).

[413] *See* Nw. Wholesale Stationers, Inc. v. Pac. Stationery & Printing Co., 472 U.S. 284, 290, 293–95 (1985).

[414] *See* Robert Pitofsky, Chairman, Fed. Trade Comm'n, Self Regulation and Antitrust (Feb. 18, 1998), http://www.ftc.gov/speeches/pitofsky/self4.shtm; Debra A. Valentine, Gen. Counsel, Fed. Trade Comm'n, Industry Self-Regulation and Antitrust Enforcement: An Evolving Relationship (May 24, 1998), http://www.ftc.gov/speeches/other/dvisrael speech.shtm.

This is especially problematic in SCF should a non-recognized *Shari'ah* authority attempt to market his services to the financial institutions seeking *Shari'ah* guidance. In such cases, *Shari'ah* authorities would not be satisfied with the newcomer's credentials and would likely render the market closed to that newcomer. This issue exists because financial institutions that market SCF products to the *Shari'ah*-adherent consumer are extraordinarily sensitive to the problem that public disputes among the *Shari'ah* authorities over what is permitted or prohibited could devastate both the demand for SCF products generally and render any given SCF product suspect.[415]

The problem of "self-regulation" would become an issue for the financial institutions if they play a material part in this effort to control entry into the market by newcomers in a *de jure* or *de facto* collusion with the dominant group.[416] Another potential problem is "rules collusion,"[417] Here, the effort of the financial institutions and their agents—the *Shari'ah* authorities—to agree upon what transaction structures and investments should be considered "*Shari'ah*-compliant" will limit the development of new competitive products by market players. This collusion, in turn, will make it more difficult for the consumer to distinguish between SCF products, while raising the cost of searching for newer, innovative SCF products—thereby shaping and softening competition among cartel members in order to increase the profits of the parties to the agreement.[418] The fact that such

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[415] *See* McMillen, *supra* note 12, at 431–33; *Booming Islamic Bond Market Embroiled in Debate over Religious Compliance*, INT'L HERALD TRIB., Jan. 11, 2008, http://www.iht.com/articles/ap/2008/01/11/news/Mideast-Islamic-Bonds.php. *See generally* McMillen, *supra* note 12, at 458–67 (attempting to cure the lack of transparency, certainty, consistency, and predictability of SCF by arguing for the IFSB to propose Model Acts like the Model Acts propounded by the National Conference of Commissioners on Uniform State Laws).

[416] *See* Am. Soc'y of Mech. Eng'rs v. Hydrolevel Corp., 456 U.S. 556, 570, 576–78 (1982). In fact, the SCF financial institutions participate at various levels in setting the standards for the industry. *See* Accounting and Auditing Organization for Islamic Financial Institutions, Members, http://www.aaoifi.com/members.html (last visited Sept. 5, 2008). *But see* Islamic Financial Services Board, Members, http://www.ifsb.org/index.php?ch =3&pg=7&ac=10 (last visited Aug. 5, 2008) (showing that private banks do not appear to play as significant a role in setting standards for the IFSB).

[417] For an interesting discussion of "rules collusion" as "Type III," see Robert H. Lande & Howard P. Marvel, *The Three Types of Collusion: Fixing Prices, Rivals, and Rules*, 2000 WIS. L. REV. 941, 949–84 (2000).

[418] *Id.* at 942–43. The anti-competitive effects of the rule-making monopoly currently enjoyed by the *Shari'ah* authorities go in some measure to the endogenous aspects of what *Shari'ah* itself says about who is qualified to be part of the *Ulema* or scholarly elite with any real authority. *See supra* Part IV.A. Historically and institutionally, because the *Shari'ah* authorities have used "consensus" and the limitation of new interpretations via the doctrine of the "closing of the gate of *ijtihad*" as a self-regulator, they have been extraordinarily successful in keeping the group over time true to the early doctrines

a financial market is predicated upon a consensus of the market's private rules advisors suggests that SCF within the financial industry presents substantial exposure to antitrust liability.

3. Racketeering

As described above, the leading two dozen *Shari'ah* authorities effectively establish all of SCF's rules and regulations. If these men have as their ultimate and collective goal the implementation of a *Shari'ah*-based Caliphate in the U.S. and their methodologies include the Law of *Jihad*—meaning violence when necessary or possible and otherwise fraud and misrepresentations about the true purpose of *Shari'ah*—a prima facie case for a lawsuit under RICO is almost unavoidable.[419] This is especially true now that the Patriot Act has added the federal terror-related crimes to the RICO predicate offenses and beefed up the predicate offenses relating to money laundering.[420]

A cursory examination of the elements of a viable RICO prosecution reveals the enormous exposure. RICO is violated when a defendant, or in this case a cadre of defendants acting as *Shari'ah* authorities, engage in a "pattern of racketeering activity" and through these activities or the proceeds, have invested in an enterprise, acquired an enterprise, conducted or participated in an enterprise, or conspired to do any of the preceding.[421] The "pattern of racketeering activity" simply means two or more of the predicate offenses within a ten-year period.[422] Predicate offenses include mail and wire fraud, bank fraud, material support of terrorism, and money laundering.[423] The "enterprise," which is an entity, person, or group of entities or persons associated in some *de jure* way (e.g., partnership) or as a *de facto* association, exists separately from the defendants.[424] In this scheme, the enterprise is the financial institution involved in SCF. As discussed above, to the

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developed after the formal schools had articulated them. *See* Bassiouni & Badr, *supra* note 39, at 135, 137–38, 146–47, 153–55, 163–64 (2002).

[419] *See* PETERS, *supra* note 8, at 2–5 (pointing to some verses in the *Qur'an* which "order Muslims to fight the unbelievers unconditionally").

[420] CHARLES DOYLE, CRIMINAL MONEY LAUNDERING LEGISLATION IN THE 109TH CONGRESS 2–3 (2006), *available at* http://www.house.gov/gallegly/issues/crime/crime docs/RS22400.pdf.

[421] 18 U.S.C. § 1962(a)–(d) (2006).

[422] *Id.* § 1961(5) (2006); *cf.* H.J. Inc. v. Nw. Bell Tel. Co., 492 U.S. 229, 238–39 (1989) (stating that it must be shown that the predicate acts are related to one another and that they "amount to, or . . . constitute a threat of, *continuing* racketeering activity").

[423] 18 U.S.C.A. § 1961(1)(B), (G) (West Supp. 2008) (adding material support of terrorism via section 1961(1)(G) by reference to section 2332b(g)(5)(B)). Insofar as the material support of terrorism is a predicate offense under the anti-money laundering statutes, violation of the latter might occur by virtue of a *Shari'ah* authority issuing a fatwa in support of *Jihad*. *See supra* notes 395–401 and accompanying text.

[424] 18 U.S.C. § 1961(4) (2006).

extent that a U.S. financial institution has criminal culpability for the predicate offenses, that particular institution would join the list of defendants and operate as part of the enterprise.[425] The evidence of the RICO crime then would include the fraud and ulterior motives of the *Shari'ah* authorities and how they have manipulated the enterprise to achieve their criminal ends. If such an indictment were handed down, it could lead to a pretrial asset freeze[426] and a post-conviction forfeiture of the criminal enterprise's assets.[427]

4. Banks and Consumer Loans

Regulated commercial banks and private lenders have recognized the SCF market and have made significant inroads establishing this new industry. At least one U.S. commercial bank has attempted to design a *Shari'ah*-compliant depository account.[428] The unique feature of this kind of account is that it must be "at risk" as an equity investment and not viewed as a guaranteed deposit with interest income.[429] A U.K. bank has developed a regulatory work-around,[430] but although U.S. regulators do not appear to have officially permitted such accounts yet, one community bank advertises a *Shari'ah*-compliant profit-sharing deposit account, which purportedly does not earn interest but rather a share of the bank's profits.[431] This bank apparently received an exemption from a *Shari'ah* authority because the bank guarantees the principal of the deposit, as required by U.S. banking laws, and such "no risk" guarantees are typically considered forbidden under *Shari'ah*.[432]

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[425] *See* Schofield v. First Commodity Corp., 793 F.2d 28, 30, 32 (1st Cir. 1986) (discussing criminal *respondeat superior* under RICO and noting that although a corporation cannot be both the enterprise and a person at the same time, "a corporation may be a 'person' under [18 U.S.C. § 1961(4)]" and section 1962(a) "must be read to allow corporations to serve both as the RICO person and the RICO enterprise").

[426] 18 U.S.C. § 1963(d) (2006); *see also* 18 U.S.C.A. § 1956(b)(3)–(4) (West Supp. 2008) (providing pre-trial asset freezes for money laundering).

[427] 18 U.S.C. § 1963(a)–(c).

[428] *See* William L. Rutledge, Executive Vice President, Fed. Reserve Bank of N.Y., Regulation and Supervision of Islamic Banking in the United States, Address at the 2005 Arab Bankers Ass'n of N. Am. Conference on Islamic Fin.: Players, Products & Innovations in New York City (Apr. 19, 2005), http://www.nubank.com/islamic/regulation.pdf.

[429] *See* El-Gamal, *supra* note 98, at 32–34.

[430] *See* Rutledge, *supra* note 428; *see also* Callum McCarthy, Chairman, Fin. Servs. Auth., Speech at Muslim Council of Britain Islamic Fin. and Trade Conference (June 13, 2006), http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml.

[431] *See* Shaheen Pasha, *Niche Banks Find Growth in Muslim Market*, CNNMONEY.COM, Jan. 17, 2006, http://money.cnn.com/2006/01/17/news/companies/banks_muslims/index.htm.

[432] *See* El-Gamal, *supra* note 98, at 32–34; Rutledge, *supra* note 428.

Another impediment for commercial banks entering this market appears to have been overcome. In a typical SCF home mortgage transaction, the lender purchases the property and either resells it immediately to the borrower at a stepped-up price to be paid out over time (i.e., a cost-plus sale) or leases it back to the borrower through a sale-lease back arrangement.[433] The problem for commercial banks in these transactions is that U.S. law does not allow banks to own real estate except in limited circumstances, such as the bank's own offices or property acquired through foreclosures on bad loans.[434] Two banks have received approval from the Office of the Comptroller of Currency (OCC) for such SCF transactions.[435] The rationale for the approvals was a substance-over-form analysis. Since these mortgage products were in fact disguised loans with interest and the real estate was only owned for a limited purpose, the Comptroller did not see these *Shari'ah*-compliant mortgages as a violation of the prohibition against owning real estate.[436] The OCC also granted one of the banks approval to use the cost-plus sale transaction structure to accommodate construction loans and other consumer loans.[437]

While the Comptroller was focused on the real estate-banking regulations, one area that the attorney for any lender must pay special care to address is compliance with all of the various consumer anti-fraud statutes. The statutes implicated in traditional bank lending are found in TILA, the Lanham Act, and many of the anti-fraud statutes referenced above.

Commercial banks and other lenders must comply with TILA[438] and its complex Regulation Z.[439] TILA prohibits specific types of misrepresentations or misleading omissions in advertising.[440] It requires "lenders to make standardized disclosures whenever other price terms are advertised."[441] For example, any advertisement that states an interest rate must state the annual percentage rate (APR).[442] An oral response to consumer inquiries about closed-end loans, however,

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[433] *See* EL-GAMAL, *supra* note 15, at 15–17.

[434] 12 U.S.C. § 29 (2006). For a senior officer at the Federal Reserve Bank of New York remarking favorably on Islamic banking in the United States, see Michael Silva, *Islamic Banking Remarks*, 12 AM. LAW & BUS. REV. 201, 203–05 & n.4 (2006).

[435] *See supra* note 78 and accompanying text.

[436] *See* Office of the Comptroller of the Currency, Interpretive Letter No. 806, *supra* note 78, at 8.

[437] *See* Office of the Comptroller of the Currency, Interpretive Letter No. 867, *supra* note 78, at 4–8.

[438] *Supra* note 161.

[439] *Supra* note 162.

[440] *See generally* Patricia A. McCoy, *The Middle-Class Crunch: Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007) (discussing the strengths and weaknesses of TILA in regulating misleading advertising).

[441] *Id.* at 128.

[442] 15 U.S.C. § 1664(c) (2006); Truth in Lending (Regulation Z), 12 C.F.R. § 226.24(b) (2005).

may only state the APR.[443] Advertisements quoting a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number of payments, or the period of repayment must also state the APR, the terms of repayment, and the amount or percentage of any down payment.[444]

The problem lenders have is that they are marketing the SCF products as interest-free and therefore *Shari'ah*-compliant.[445] In fact, and as scrutinized by the OCC and likely by the IRS and state tax authorities,[446] these various interest-free transactions are merely disguised loans. The banks are treating these products and representing them to the government authorities as conventional loans with interest

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[443] 15 U.S.C. § 1665a.

[444] *Id.* § 1664(d); Supp. I to Part 226–Official Staff Interpretations, 12 C.F.R. pt. 226 at 476–77 (construing section 226.24(c)).

[445] *See, e.g.*, University Islamic Financial Corp., Home Finance, http://www.universityislamicfinancial.com/homefinance.html (last visited Aug. 5, 2008) (declaring Islamic Financial Corporation's loans "free of interest"). In University Bank's "Frequently Asked Questions," the bank attempts to explain that:

> An accountant may argue that rent in the latter two and profit in the former is interest, but in none of these cases is it *riba*. Some accountants argue that anything that may be perceived as generating a benefit from the passage of time has interest in it. The *Sharia'a* scholars have not defined *riba* in this way, rather *riba* necessarily relates to loans of money or exchanges of money like commodities when they are used as money.

University Islamic Financial Corp., FAQs, http://www.universityislamicfinancial.com/faq.html (last visited on Sept. 5, 2008).

Interestingly, in contrast to what one might expect of an argument aimed at the IRS or OCC—which would downplay the "form" and argue that the "substance" of the transaction is a loan—University Bank represents to its customers that its *Shari'ah*-compliant transactions are in fact substantively not loans and that their form is their substance:

> Query: Isn't the Islamic system of purchasing houses the same thing, the same mechanics, as the traditional mortgage system only with different labeling?
>
> SHAPE™: This too is inaccurate. The process of qualifying a consumer and disclosing costs and risks to a consumer is the same as the mortgage system. This process is regulated by federal and state statutes in the United States. Hence, the paperwork is the same or very similar prior to and after making the acquisition, but not the acquisition itself.
>
> The acquisition mechanics are fundamentally different without creating all of the same rights and obligations as in a traditional mortgage. Hence, it is not a question of labeling, but of actual structure.

Id. (latter emphasis added).

[446] *See supra* note 78.

income while marketing them to the public as interest-free *Shari'ah*-compliant non-loan transactions.[447]

Full disclosure requires these banks to indicate that the loans are not interest-free and to fully disclose in all of their advertising the true APR. This would require an explanation that, while a loan might be considered "*riba*-free" for *Shari'ah* purposes, it is considered a standard loan with interest for all secular legal purposes. Unfortunately, even this might not be true. For example, it is unclear how a bankruptcy court would treat the transaction. Much would depend on whether the debtor or the lender was in bankruptcy. How the lender's attorney navigates these issues in print advertisements and on the Internet will likely come to a regulator's or court's attention.[448]

An additional concern for *Shari'ah*-compliant consumer loans is that they are typically more costly than conventional loans. This is true because of the machinations inherent in the transactional documents and because much of the documentation must be duplicated—one set to track *Shari'ah* compliance and one set to track government regulations. In addition, *Shari'ah* supervision adds a cost in most cases, as do some extra taxes attributed to the transfer of title as required by *Shari'ah*.[449] Because these consumer loans are marketed to a specific minority community with a unique cultural affinity to *Shari'ah*, and because the added costs of these loans have no economic value per se, it is possible that the marketing of these products will fall within the scope of the anti-predatory loan laws, such as the

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[447] *See supra* note 445.

[448] Bankruptcy and loan defaults open up an entire Pandora's box of issues that this article will not and cannot address. Legal commentators have discussed this in passing, however, only in the most cursory of terms. *See, e.g.*, McMillen, *supra* note 12, at 453–54 (discussing some of the issues surrounding *Shari'ah* and separateness covenants in the context of bankruptcy).

[449] *See, e.g.*, Devon Bank, Frequently Asked Questions, http://www.devonbank.com /Islamic/faq.html (last visited Aug. 5, 2008). Specifically, the bank explains:

> Why are your costs higher than conventional loans?
>
> To be Shariah-compliant, our costs must be related to our actual expenses. Our products have a higher documentation fee due to the extra work in product design and assembling documents for a closing—it is not an automated process as it is for a conventional loan. Our profit rate is otherwise the same as an equivalent traditional mortgage. There are a few transaction costs that are higher because of the dictates of the specific deal structure needed to satisfy the requirements of an Islamic financing transaction, such as two deeds to record instead of one. Otherwise, all our costs are the same as a traditional mortgage. We do not charge a premium for religious accommodation.

Id.

Home Ownership and Equity Protection Act of 1994 (HOEPA)[450] or the state versions of HOEPA, which are typically more aggressive and have lower thresholds for offending predatory high-cost loans.[451]

VI. CONCLUSION

Shari'ah-compliant finance exposes financial institutions and other businesses to a host of disclosure, due diligence, and compliance issues, all of which elevate the civil liability and criminal exposure such companies otherwise factor into their business risk profiles. Preliminary legal analysis indicates that little of this increased civil and criminal exposure has been recognized, analyzed, or guarded against in any meaningful way. Rather than confronting issues material to a typical post-9/11 investor, lawyers and accountants have placed SCF in a secular "black box," immune from the exacting scrutiny required of professional advisors in the modern U.S. legal regime. But failure of companies to diligently investigate their investments, and failure to disclose the risks caused by these investments, may ultimately result in massive liability to those who remain willfully ignorant of the realities of the SCF industry.

In pursuing SCF, U.S. businesses face civil liability in the realms of tort law, securities law, and antitrust. Furthermore, these businesses face criminal exposure in securities, antitrust, anti-sedition, racketeering, and money-laundering statutes. The failure by corporate management and their legal advisors to confront these issues in serious fashion is not surprising given the wholesale failure of the participants and facilitators in this industry to undertake a serious analysis of the risks. The extant academic and professional literature reads more like promotional material and not serious legal analysis conducted by those trained to protect clients from their own blind enthusiasm. The legal industry has gone down this road too many times in the past. This time, the risk is not simply financial; it is existential. Lawyers, academics, and regulators alike must acknowledge the potentially dire consequences of *Shari'ah*-compliant financing and take steps to address its legal and ethical issues.

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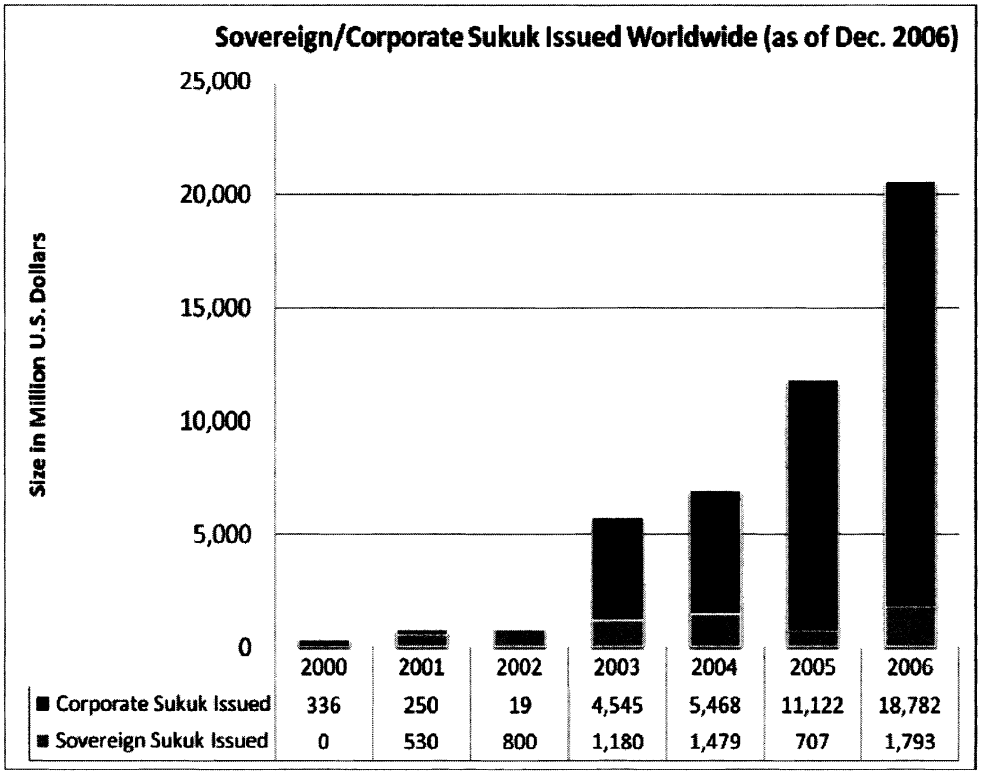
[450] Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2190 (1994) (codified as amended in scattered sections of 15 U.S.C. §§ 1601–1667f).

[451] *See generally* C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617 (2006) (discussing conditions in Arizona, reviewing federal and state regulations, and encouraging Arizona to regulate predatory lending).

APPENDIX A: DOLLAR-GROWTH OF *SHARI'AH*-COMPLIANT BONDS ISSUANCES



Source: Ijlal A. Alvi, *Increasing the Secondary Markets for Sukuks: Overview and Considerations*, at 3, http://www.iifm.net/download/Presentations/Increasing%20the%20secondary%20market%20for%20Sukuk.pdf (last visited Sept. 5, 2008).

SUBPRIME MELTDOWN: THE LAW AND FINANCE OF THE AMERICAN HOME MORTGAGE FORECLOSURE CRISIS

SYMPOSIUM INTRODUCTION

Christopher L. Peterson *

Nearly seventy years ago the United States federal government under the leadership of Franklin Roosevelt took the first steps in establishing a public financial infrastructure for residential home mortgage loans.[1] For the balance of the twentieth century, investment in home loans made to middle class American families was ultimately backstopped by formal or informal federal guarantees.[2] While the federal government did not involve itself in the day-to-day business of making loans, it did exercise a distant but firm hand mandating relatively uniform and sound underwriting.[3] In the 1990s and especially in the opening years of the twenty-first century, Wall Street financiers opened up a new frontier of home mortgage lending to Americans of relatively modest means, with minimal down payments, through exotic, untested financial products.[4] Financiers justified this new private "subprime" home mortgage market to leaders and to the American people with a promise of new and lower-cost opportunities for home ownership.[5]

Today, the course of events has proven this promise to be, at least for the time being, empty.[6] Millions of Americans borrowed money against their homes and

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[1] *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2194–97 (2007) (stating Depression-era legislation grew out of the fact that "half of all single-family mortgages fell into default" and home prices were so low that "lenders could not recoup their investment by selling seized homes").

[2] *See id.* at 2195–99 (stating the federal government backstopped some loans with money under U.S. Treasury authorization and "purchased and held consumer borrowers' promissory notes" for other loans).

[3] *See id.* at 2195–96 (stating the Federal Housing Administration imposed federal underwriting guidelines creating industry standards that promoted "cautious and profession behavior in loan origination").

[4] DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 33–44 (2004).

[5] *See* Richard A. Oppel, Jr. & Patrick McGeehan, *Lenders Try to Fend Off Laws on Subprime Loans*, N.Y. TIMES, April 4, 2001, at C1 (arguing subprime lenders imposed loans with high interest rates—sometimes nearly double the prevailing rates—to make credit available for more families).

[6] *See* CTR. FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf (stating that over a nine year period, the $2 trillion dollars of subprime mortgages has "not resulted in a net gain in homeownership").

now cannot afford to repay.[7] Current estimates suggest that over six million mortgages—nearly 13 percent of all American residential loans—will end in foreclosure by 2012.[8] After years of frenzied investment in risky home mortgages sold to investors outside the traditional public secondary market channels, the American financial markets are now facing financial upheaval and the prospect of structural change of a magnitude not seen since the Great Depression—ironically the very financial event that spurred the original public mortgage infrastructure in the first place.

It should come as no surprise then that the need for cogent financial and legal scholarship concerning mortgage finance has never been greater. This symposium combines recent thoughts of several leading scholars of consumer finance law, each of whom provide important and distinct perspectives on the causes and consequences of, as well as potential solutions to, the American home foreclosure crisis. First, Professor Steven Schwarcz provides a partial diagnosis of the current of the subprime mortgage market malaise. Beginning with an introduction of some of the crucial terminology necessary to understand the private secondary mortgage market, Professor Schwarcz then focuses on the complexity of subprime mortgage securitization structures. Structured finance of residential mortgages, in Professor Schwarcz's view, became so complex that even sophisticated Wall Street analysts had difficulty accurately measuring risk, which led to miscalculation and inefficiency.

Second, Professor Creola Johnson, explores the human consequences of market failure in subprime mortgage lending. As millions of American families are facing foreclosure, property values in many communities have plummeted, leading to a growing number of abandoned homes that are rapidly deteriorating into urban blight. Examining in particular the ongoing litigation in Baltimore, Buffalo and Cleveland, Professor Johnson discusses measures that municipalities and legislatures might take to prevent home abandonment.

Finally, John Eggum, Katherine Porter, and Tara Twomey consider how the federal bankruptcy system might be used to preserve homeownership. Among other empirical conclusions drawn from an original dataset, Eggum, Porter, and Twomey find that bankrupt families face higher housing costs relative to their income than other Americans. Reflecting on this finding, they argue that Congress should amend federal law to permit modification of home mortgages in bankruptcy.

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[7] *See id.* (stating that millions of homeowners will lose their homes after purchasing or refinancing under "lax underwriting practices, dangerous loan products, and a disregard for affordability").

[8] *Foreclosures to Affect 6.5 Mln by 2012-Report*, REUTERS, Apr. 22, 2008, http://www.reuters.com/article/bondsNews/idUSN2233380820080422.

DISCLOSURE'S FAILURE IN THE SUBPRIME MORTGAGE CRISIS[1]

Steven L. Schwarcz*

I. INTRODUCTION

This article examines the "finance" part of the subprime mortgage crisis. In a separate article, I examined financial-market anomalies and obvious market protections that failed, seeking insight into the subprime mortgage crisis.[2] The crisis, I argued, can be attributed in large part to three causes: conflicts, complacency, and complexity.[3] This article focuses on the third cause—complexity—and, in particular, on complexity's undermining of the disclosure paradigm of securities law, causing investors such as commercial and investment banks to lose many billions of dollars on securities backed by subprime mortgages.[4]

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[1] This article is partly based on portions of Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1 [hereinafter, Schwarcz, *Disclosure Paradigm*], and Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107444 [hereinafter Schwarcz, *Protecting Financial Markets*].

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[2] *See* Schwarcz, *Protecting Financial Markets, supra* note 1.

[3] *Id.* at 33–35. Running throughout these causes is a fourth cause: cupidity, but greed is "so ingrained in human nature and so intertwined with the other categories that it adds little insight to view it as a separate category." *Id.* at 34–35.

[4] *See, e.g.*, Jenny Anderson, *Wall St. Banks Confront a String of Write-Downs*, N.Y. TIMES, Feb. 19, 2008, at C1 (reporting that "major banks . . . have already written off more than $120 billion of losses stemming from bad mortgage-related investments"); Daniel Gross et al., *How a Lack of Faith Pounded the Markets*, NEWSWEEK, Mar. 31, 2008, at 48 (reporting that Bear Stearns was worth $20 billion in January 2007 and that JP Morgan agreed to buy Bear Stearns for $236 million in March 2008); *Wall Street Banks Slashing Workforces*, CHI. TRIB., Mar. 25, 2008, at C2 (reporting that "[t]he collapse of the subprime mortgage market last year and the ensuing credit contraction have saddled the world's largest financial institutions with at least $200 billion

Most, if not all, of the risks giving rise to the collapse of the market for securities backed by subprime mortgages were disclosed,[5] yet the disclosure was insufficient, in part because complexity made the risks very difficult to understand. The prospectus itself in a typical offering of these securities is, in my experience, hundreds of pages long.[6] Thus, "a lot of institutional investors bought [the subprime mortgage-backed] securities substantially based on their ratings [without fully understanding what they bought], in part because the market has become so complex."[7]

This article will explain why these risks were so difficult to understand, even to sophisticated institutional investors, and then will analyze how to address disclosure's insufficiency. As groundwork for this explanation and analysis, the article next lays out some basic industry terminology.

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of write-downs and losses"). These losses have been mostly from investments in securities backed by subprime mortgages and not from making subprime mortgage loans. *See* David Bogoslaw, *A Red Flag for Bank Liquidity*, BUS. WK., Mar. 17, 2008, http://www.businessweek.com/investor/content/mar2008/pi20080316_508940.htm (reporting that Bear Stearns' "exposure to the toxic securities backed by subprime mortgages, such as collateralized debt obligations (CDOs), has hardly been unique").

[5] In certain pending lawsuits, plaintiffs argue that disclosure regarding the "quality of the [underlying mortgage] loans" was insufficient. Stephen J. Crimmins, Andrew J. Morris & Daniel T. Brown, *Subprime Mortgage Lending: Possible Securities Litigation Exposure*, SEC. REG. & LAW, Sept. 24, 2007. Thus,

> plaintiffs [generally] appear to be focusing on disclosures relating to the quality of the loans, and adherence to procedures designed to ensure loan quality. Shareholders suing Accredited Home Lenders Holding Co. claim that it misrepresented that it was committed to originating "high-quality loans" and would "constantly track the factors that impact portfolio quality"; that it instead permitted "rampant overrides" of negative credit appraisals; and that it "manipulated" reserves for bad loans in violation of GAAP. A shareholder suit against Fremont General Corp. claims that it failed to disclose that it had "inadequate underwriting criteria," "a large volume of poor quality loans," and "unsatisfactory lending practices," and that it marketed adjustable rate mortgages "to subprime borrowers in an unsafe and unsound manner" and "without adequately considering the borrower's ability to repay."

Id. (citations omitted).

[6] The disclosure documents ordinarily consist of a prospectus and a prospectus supplement, each close to two-hundred pages long.

[7] *Credit & Blame: How Rating Firms' Calls Fueled Subprime Mess*, WALL ST. J., Aug. 15, 2007, at A1 (quoting a market observer). *See also* Alan S. Blinder, *Six Fingers of Blame in the Mortgage Mess*, N.Y. TIMES, Sept. 30, 2007, at BU4 (arguing that the securities backed by subprime mortgages "were probably too complex for anyone's good").

II. TERMINOLOGY

The issuance of securities backed by subprime mortgages constitutes a form of "securitization."[8] In a securitization transaction, rights to payment from income-producing financial assets—in our case, subprime mortgage loans—are transferred to a special-purpose vehicle, or "SPV" (sometimes called a special-purpose entity, or "SPE").[9] The SPV, directly or indirectly, issues securities to capital market investors and uses the proceeds to pay for the mortgage loans. The investors, who are repaid from collections of the mortgage loans, buy the securities based on their assessments of the value of those loans.[10]

In the securitizations involving subprime mortgages, the companies originating the mortgage loans were almost always different than the companies that (after purchasing those loans) created and transferred those loans to the SPVs.[11] For discussion purposes, this article will refer to all these companies collectively as "originators," in contrast to "investors" who buy the securities issued by the SPVs.

Actual securitization transactions are extremely complex and often rely on multiple SPVs.[12] Furthermore, in order to integrate disparate disciplines such as bankruptcy, tax, securities law, commercial law, accounting, and finance, securitization transactions often appear to be highly convoluted.[13]

The securities issued in securitization transactions add to the complexity. Securities backed directly or indirectly by subprime mortgages "are customarily categorized as MBS, . . . CDO, or ABS CDO" securities.[14]

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[8] *See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1, 6 (1999).

[9] *Id.*

[10] *Id.* For a more complete analysis of securitization, *see* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2003 & supp.); Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1540–43 (2004) [hereinafter Schwarcz, *Securitization Post-Enron*]; Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135–44 (1994).

[11] *See* Kurt Eggert, *Role of Securitization in Subprime Mortgage Market Turmoil*, CONG. Q., Apr. 17, 2007 (explaining that mortgage brokers and banks made the loans, and that investment banks generally bought those loans, created the SPVs, and transferred the loans to the SPVs).

[12] *See, e.g.*, Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1063 (1996).

[13] *See* Schwarcz, *Disclosure Paradigm*, *supra* note 1, at 5 (illustrating a "simplified" schematic of a healthcare securitization conduit established by a leading investment firm, with the author's counsel, in order to provide low-cost financing to hospitals).

[14] Schwarcz, *Protecting Financial Markets*, *supra* note 1, at 4–5. There are arcane variations on the CDO categories, such as CDOs "squared" or "cubed," but these go beyond this article's analysis.

> MBS means mortgage-backed securities, or securities whose payment derives principally or entirely from mortgage loans owned by the SPV. . . . CDO, or collateralized debt obligation, securities are backed by—and thus their payment derives principally or entirely from—a mixed pool of mortgage loans and/or other [income-generating assets] owned by an SPV.[15]

"ABS CDO securities, in contrast, are backed by a mixed pool" of MBS and other asset-backed securities owned by the SPV,[16] and thus their payment derives principally or entirely from the underlying mortgage loans and/or other assets ultimately backing those securities.[17]

> The classes, or tranches, of MBS, . . . CDO, and ABS CDO securities issued in these [securitization] transactions are typically ranked by seniority of payment priority. The highest priority class is called senior securities. In MBS . . . transactions, lower priority classes are called subordinated or junior securities. In CDO and ABS CDO transactions, lower priority classes are usually called mezzanine securities—with the lowest priority class, which has a residual claim against the SPV, being called the equity. The senior and many of the subordinated classes of these securities are more highly rated than the quality of the underlying mortgage loans. For example, senior securities issued in a CDO transaction are usually rated AAA even if the underlying [income-generating assets] consist of subprime mortgages, and senior securities issued in an ABS CDO transaction are usually rated AAA even if none of the MBS and ABS securities supporting the transaction are rated that high. This is accomplished by allocating cash collections from the receivables first to pay the senior classes and thereafter to pay more junior classes. In this way, the senior classes are highly over-collateralized to take into account the possibility, indeed likelihood, of delays and losses on collection.[18]

Before engaging in the analysis below, it is helpful to distinguish the scope of this symposium article from that of an earlier article examining disclosure's insufficiency in the face of complexity.[19] The earlier article examined disclosure's insufficiency from the standpoint of investors in an originator's securities, such as shares of stock. In contrast, this symposium article examines disclosure's insufficiency from the standpoint of investors in an SPV's securitized securities.

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[15] *Id.* at 4–5.

[16] Securities backed by assets other than mortgage loans are typically referred to as asset-backed securities or ABS. *Id.* at 4.

[17] *Id.* at 5.

[18] *Id.* at 5–6.

[19] That earlier article is Schwarcz, *Disclosure Paradigm*, *supra* note 1.

These different focuses lead to different potential solutions. For example, the earlier article proposes as a partial solution to disclosure's insufficiency that originators should mitigate any material conflicts of interest that create the risk that their management will structure transactions contrary to the interests of investors, at least in those transactions for which disclosure may be insufficient.[20] The reasoning of that article is that, "absent conflicts, investors should be able to rely on the business judgment of the originator's management," which has a fiduciary duty to those investors, in "setting up structured transactions for the originator's benefit."[21] However, that solution is inapplicable to this symposium article because originators have no such duty to investors in an SPV's securities.

III. ANALYSIS

A. Disclosure's Insufficiency

In the subprime mortgage crisis, there is to date relatively little dispute that the disclosure documents describing the MBS, CDO, and ABS CDO securities and their risks generally complied with the federal securities laws.[22] The complexity of the transactions, however, caused the disclosures to be insufficient, cutting into the very heart of federal securities regulation, whose "exclusive focus is on full disclosure."[23] The rationale for this focus is that investors are adequately protected if all relevant aspects of the securities being marketed are fully and fairly disclosed. The reasoning is that full disclosure provides investors with sufficient opportunity to evaluate the merits of an investment and fend for themselves. It is a basic tenet of federal securities regulation that investors' ability to make their own evaluations of available investments obviates any need for the more costly and time-consuming governmental merit analysis of the securities being offered.[24]

There are two levels of reasoning that explain the insufficiency of disclosure in the subprime crisis. On an institutional level (most investors in MBS, CDO, and ABS CDO securities being institutional investors[25]), some investors simply may

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[20] *Id.*, at 30–37.

[21] *Id.*, at 32.

[22] *Cf. supra* note 5 and accompanying text (observing that most if not all of the risks giving rise to the collapse of the market for these securities were disclosed, though discussing several lawsuits alleging failure to disclose certain risks about the quality of the underlying mortgage loans).

[23] 2 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 8.1[1][B] (5th ed. 2005); *see also id.* § 1.2[3] (explaining that "[t]he focus on disclosure was based on the conclusion that sunlight is the best disinfectant").

[24] 1 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2[3][A] (5th ed. 2005).

[25] *See* SEC Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets (Jan. 2003), http://www.sec.gov/news/studies/mortgagebacked.htm (reporting that investors in MBS are "overwhelmingly institutional").

not have the staffing to evaluate complex securitization transactions.[26] This begs the question whether institutional investors will hire securitization experts as needed to decipher complex deals. The evidence suggests they do not always do so,[27] and theory explains why. Although experts may be hired to the extent that their costs do not exceed the benefits gained from more fully understanding the complexity, at some level of complexity those costs will exceed, *or at least appear to exceed* any potential gain. This is because the cost of hiring experts is tangible, whereas the benefit gained from fully understanding complex transactions is intangible and harder to quantify. Managers attempting a cost-benefit analysis may well give greater weight to the tangible cost and less credence to any intangible benefit.[28] The more complex the transaction, the higher the costs, and thus the more likely it is that the cost-benefit balance will be out of equilibrium.

The second level of reasoning goes to agency costs stemming from a conflict between the interests of individual employees and the institutions for which they work.[29] In assessing the investment-worthiness of highly complex MBS, CDO, and ABS CDO securities, individuals sometimes take a shortcut, over-relying on the fact that these securities may be rated "investment grade" by rating agencies such as Standard & Poor's and Moody's[30] and not spending the time and effort needed to fully understand the hundreds of pages of disclosure for each investment.[31]

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[26] In this context, some commentators have questioned whether some structures are getting so complex that they are incomprehensible. *See, e.g.*, David Barboza, *Complex El Paso Partnerships Puzzle Analysts*, N.Y. TIMES, July 23, 2002, at C1 (discussing that "one industry giant, the El Paso Corporation, is growing ever more reliant on deals [using off-balance sheet partnerships] so complex that securities experts call them incomprehensible"). That appears hyperbolic, however, since if humans create the structures then humans can decipher them. The problem, however, is that relatively few can do so and some structures may not even be able to be understood by any single person. *See, e.g.*, KARL R. POPPER & KONRAD LORENZ, DIE ZUKUNFT IST OFFEN 74, 75–76 (Franz Kreuzer ed., 1985) (arguing that some structures, like airplanes, contain so many ideas that they are not comprehensible to any one individual; hence they require collaboration).

[27] *See, e.g.*, Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1238–39 (2002) (noting the failure of investors to draw proper conclusions from their lack of understanding).

[28] The difficulties associated with balancing tangible costs against intangible benefits have been examined extensively in the context of corporate information-system ("IS") decision-making. *See, e.g.*, Edward Rivard & Kate Kaiser, *The Benefit of Quality IS*, DATAMATION, Jan. 15, 1989, at 53–58 (emphasizing the need to educate management, "especially conservative management, on the importance of intangible benefits").

[29] *See* Schwarcz, *Protecting Financial Markets*, *supra* note 1, at 12.

[30] *See* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 6–8 (discussing ratings and the concept of "investment grade").

[31] *See supra* note 6 and accompanying text.

Over-reliance on ratings appears to have been endemic in the subprime mortgage crisis.[32]

This over-reliance is not surprising, particularly where the type of investment securities are generally accepted in the marketplace, as were securities backed by subprime mortgages prior to the meltdown. Professors Healy and Palepu have found, for example, that investment-fund managers who believe a stock is overvalued, but nonetheless follow the crowd, will not be blamed if the stock ultimately crashes.[33] Moreover, the very complexity of securities backed by subprime mortgages makes it difficult to assess their suitability for investment, potentially seducing individuals into seeing what they are already inclined to believe—that these securities are creditworthy.[34] For these reasons, disclosure of the subprime mortgage securitizations, and by analogy, of other complex financing transactions, has inherent limitations.

B. Addressing Disclosure's Insufficiency

There are at least three ways to respond to disclosure's insufficiency: to tolerate insufficient disclosure; to proscribe transactions for which disclosure is insufficient; or to require supplemental protections to minimize disclosure's insufficiencies. This article next examines each of these possible responses.

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[32] Aaron Lucchetti, *Moody's Weighs Warning Labels For Its Ratings—Firm Aims to Appease Regulators, Rehabilitate A Battered Reputation*, WALL ST. J., Feb. 5, 2008, at C1 (reporting that Moody's believes investors relied too much on its ratings).

[33] Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSP. 3, 19 (2003) (noting that nonindex fund managers are rewarded based on fund size and relative performance; fund manager who estimates a stock is overvalued but does not act on this analysis and "simply follows the crowd will not be rewarded for foreseeing the problems," "but neither will [he] be blamed for a poor investment decision when the stock ultimately crashes, since [his peers] made the same mistake").

[34] It is reported, for example, that King Croesus of Lydia wanted to make war on Cyrus, but was wary of doing so without heavenly sanction. After singling out the Delphic Oracle as the most reliable, the king's messengers "asked the practical question about the advisability of Croesus' going to war, and received the famous [and famously ambiguous] response that 'Croesus by crossing the Halys would destroy a mighty kingdom.'" REV. T. DEMPSEY, THE DELPHIC ORACLE: ITS EARLY HISTORY, INFLUENCE, AND FALL 70 (1972). Croesus interpreted this to mean what he wanted to hear—that Cyrus would fall—but in fact the empire that fell was his own. *Id.* at 71; *see also id.* at 71, 107 (discussing the historical method of the oracles as sheltering ignorance behind a "studied ambiguity" and vagueness). This same method of response is said also to be used today by fortune tellers. *See* J. Barkley Rosser Jr., *Alternative Keynesian and Post Keynesian Perspectives on Uncertainty and Expectations*, 23 J. POST KEYNESIAN ECON. 545, 554–57 (2001) (arguing that uncertainty leads to self-fulfilling mistakes).

1. Tolerating Insufficient Disclosure

Under this response, disclosure would remain the sole paradigm for remedying the information asymmetry between originators and investors. This has been the historical response to complexity since, in an efficient market, it has been believed that stock prices virtually "instantaneously reflect all publicly available information relevant to the value of traded stocks."[35] But complex securitization transactions can undermine this result—as the subprime mortgage crisis has well illustrated—because many securitization deals are *sui generis*, obviating creation of a thickly efficient market. Thus, Professors Gilson and Kraakman observe that an innovative investment contract, for example, would take the market more time to understand and reach price equilibration than, say, a change in Federal Reserve Board policy.[36] Furthermore, the efficient market hypothesis might not even apply to debt markets[37] and certainly should not apply to private debt markets.[38] The securities issued in securitization transactions are virtually always debt securities,[39] and many CDO and ABS CDO securities were issued in private placements.[40] It does not even appear that ABS CDO securities always had a secondary market for trading.

The other possible argument for tolerating insufficient disclosure is that—at least after the subprime mortgage crisis—originators engaging in complex transactions may find their share price discounted by investors.[41] This is not,

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[35] CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 170–71 (3d ed. 1999) (referring to this belief as the "semi-strong" form of the efficient market hypothesis).

[36] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 568, 585, 615–16 (1984).

[37] *See* Yedidia Z. Stern, *A General Model for Corporate Acquisition Law*, 26 J. CORP. L. 675, 709 (2001) ("[S]tudies show that the bond market is not efficient; and therefore, one cannot expect the market prices to compensate bondholders for the risks to which they are exposed."); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 242 (1988) ("There is evidence that the market for corporate bonds is not very efficient. For many bond issues, it is not unusual to find infrequent trading activity and large spreads between bid and asked prices.") (citations omitted).

[38] *See* Camden Asset Mgmt., L.P. v. Sunbeam Corp., No. 99-8275-CIV, slip op. at 31–36 (S.D. Fla. July 3, 2001) (stating that privately placed Rule 144A-exempt securities, being thinly traded, do not have an efficient market).

[39] *See* Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161, 164 (2005) (explaining that the typical securitization transaction involves the issuance of debt or debt-like securities).

[40] *See* Jennifer Bethel & Allen Ferrell, *Policy Issues Raised by Structured Products*, at 12 (Harvard Law School John M. Olin Center for Law, Economics and Business, Discussion Paper 560, 2006), *available at* http://lsr.nellco.org/harvard/olin/papers/560 (explaining that "collateralized debt obligations are now overwhelmingly privately placed").

[41] *See* Schwarcz, *Disclosure Paradigm*, *supra* note 1, at 20.

however, a long-term solution because investors have short memories. Once past financial crises recede in memory and investors are making money, investors always "go for the gold."[42] Furthermore, discounting share price based on complexity per se is inefficient since complexity sometimes is justified. Where investors do not or cannot differentiate between justifiable and fraudulent or excessive complexity, the market will discount in both cases—thereby driving out otherwise beneficial complexity.[43]

For these reasons, it would be inexpedient to continue to tolerate disclosure as the sole paradigm for remedying the information asymmetry between originators and investors. The converse proposition, proscribing transactions for which disclosure would be insufficient, is equally problematic, as discussed below.

2. Proscribing Transactions for Which Disclosure Would Be Insufficient

If government proscribed or banned transactions for which the information asymmetry exceeds certain bounds, the most immediate consequence potentially would be to eliminate many, if not most, securitization transactions. From a societal standpoint, that result would be unfortunate. Securitization transactions are

> widely used and accepted in the United States . . . . Often, these transactions are efficient means of obtaining funding for their participants while simultaneously achieving accounting, tax and regulatory benefits of various types . . . . [They] reflect the innovation for which the U.S. capital markets are known[,] . . . have many legitimate uses and comprise a significant part of our capital markets.[44]

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[42] Larry Light, *Bondholder Beware: Value Subject to Change Without Notice*, BUS. WK., Mar. 29, 1993, at 34 ("Bondholders can—and will—fuss all they like. But the reality is, their options are limited: higher returns or better protection. Most investors will continue to go for the gold.") (discussing, in the context of but several years after the "Marriott split," that investors favor higher interest rates over "event risk" covenants once examples of events justifying the covenants have receded in memory, even though they could reoccur).

[43] *See* Charles Wilson, *Adverse Selection*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS 32, 32–33 (John Eatwell et al., eds., 1987) (noting that, in this scenario, "the market allocation is almost always inefficient").

[44] First Interim Report of Neil Baston, Court Appointed Examiner at 22, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002), *available at* http://www.enron.com/media/1st_Examiners_Report.pdf (noting, for example, that "total outstanding mortgage-backed and asset-backed securities in the United States alone exceed $6 trillion").

Indeed, securitization transactions are normally viewed as socially desirable.[45] Despite the subprime mortgage crisis, securitization generally creates overall value in the financial markets.[46]

Another reason that government should not want to proscribe transactions as a means of controlling information asymmetry is that any such proscriptions could create regulatory arbitrage incentives: parties would want to make transactions appear to meet the regulatory requirements.[47] For example, if the government were to proscribe transactions for which the information asymmetry exceeded a threshold level, then parties would attempt to structure those transactions in ways that appear to reduce the asymmetry, as measured by the regulatory ban, below that threshold. The end result could be socially undesirable: the regulatory proscription is effectively bypassed, but the overall transaction costs rise due to the expenses of lawyers and other advisors hired for that purpose. For these reasons, regulators should not want to proscribe securitization transactions as a means of controlling disclosure's limitations.[48]

3. Requiring Supplemental Protections

The third possible response is to consider whether disclosure can be buttressed by cost-effective, supplemental protections that minimize information asymmetry or mitigate its consequences. Any such supplemental protections would be *in addition to*, not in place of, disclosure since even insufficient disclosure provides value by reducing information asymmetry, and disclosure has other justifications beyond the asymmetric information problem.[49]

In thinking about supplemental protections, it is useful to take into account economic theory on asymmetric information, especially that dealing with the so-

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[45] *See, e.g.*, Hill, *supra* note 12, at 1085–111; Schwarcz, *Securitization Post-Enron, supra* note 10.

[46] *See* Xudong An, Yongheng Deng & Stuart A. Gabriel, *Value Creation Through Securitization: Evidence from the CMBS Market* 3 (Feb. 18, 2008) (unpublished article, electronic copy available at http://ssrn.com/abstract=1095645).

[47] Regulatory arbitrage occurs when parties design transactions—in this case, financial transactions—to try to "reduce costs or capture profit opportunities created by differential regulations or laws." Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. CORP. L. 211, 227 (1997).

[48] Regulatory philosophy in the United States is also shying away from prohibiting categories of transactions. For example, the Commodity Futures Modernization Act of 2000 lifted the ban on over-the-counter derivatives and also eliminated the ban on single security futures contracts. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, §1(a)(5), 114 Stat. 2763A-365 (codified as amended in scattered sections of 7, 11, 12, and 15 U.S.C.).

[49] Disclosure also can be seen as a means to break the management monopoly over corporate information, and is necessary because separation of ownership and control can cause managers to maximize their own utility at the expense of investors. JAMES D. COX ET AL., SECURITIES REGULATION 246 (4th ed. 2004).

called Lemons problem. Economists have asked: How do transactions ever occur if the seller has more information than the buyer, and the information disparity cannot be cured (at least at reasonable cost)? Why would a buyer ever be willing to enter into a transaction? These same questions pertain to the problem of disclosure in the face of complexity.

The Lemons problem was introduced and first systematically studied by using the crude but intuitive example of the used-car market.[50] One obvious solution is for the seller to make guaranties, such as warranties on the sale of goods, in order to shift the risk from the buyer to the seller. Other potential solutions include governmental and private-sector certification of quality.

(a) Guaranties

In a securitization context, guaranties would likely take some form of investor recourse to originators, including perhaps a "put" of securities back to the investment banks structuring the transactions[51] or requiring these investment banks to retain at least a portion of the lowest ranked tranche of securities being sold. Requiring originators to take a reasonable first-loss position generally makes sense and typically is mandated by investors in securitizations of non-mortgage assets.[52] Subject to the caveat discussed below, investors should consider extending this mandate to securitizations of mortgage loans.

In the subprime mortgage crisis, however, this concept actually backfired. In ABS CDO transactions, "[investment bankers] customarily purchased some portion of the equity tranches at least in part in order to demonstrate their (subsequently unjustified) confidence in the securities being sold."[53] This induced many investors who otherwise might not have done so to purchase these securities, thereby working against investor caution.[54]

This incongruity raises an important point about complexity: sometimes things are so complex that the problem is not merely information asymmetry but also information failure *on both sides*—in our case, originators as well as investors. Thus, "[e]ven the people running Wall Street firms didn't really [always] understand what they were buying and selling."[55]

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[50] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

[51] *See supra* note 11; Daniel Andrews, *The Clean Up: Investors Need Better Advice on Structured Finance Products*, 26 INT'L FIN. L. REV. 14, 14 (Sept. 2007) (quoting David Doble, an industry professional, as suggesting some type of a put).

[52] *See* Schwarcz, *Protecting Financial Markets, supra* note 1, at 17.

[53] *Id.*, at 9.

[54] *Id.*, at 9.

[55] Nelson D. Schwartz & Julie Creswell, *What Created This Monster?*, N.Y. TIMES, Mar. 23, 2008, at BU 1, 8 (quoting Byron Wien, Chief Investment Strategist, Pequot Capital).

(b) Certification of Quality

Another approach to protecting a buyer of securities is certification of their quality either by the government or reputable private-sector entities. Governmental certification is a form of merit regulation, and can be expensive. In the context of the original enactment of the federal securities laws, it was explicitly rejected as unworkable.[56] There is little current literature on government certification of securities quality because, until recently, disclosure was seen as the complete answer.

Should we now reconsider some form of substantive governmental merit regulation? Such merit regulation would by definition rely on government employees to assess the quality of securities. It is doubtful that government employees would do a better job than private-sector analysts, who already perform this function for investors. The private-sector analysts are likely to be more capable, on average, and also more accountable, because the government generally pays lower salaries than the private sector,[57] and government employees are often harder to fire if they perform poorly.[58] Furthermore, the imposition of governmental merit regulation could perversely undermine the market for private securities analysts, thereby eliminating any reduced information asymmetry resulting from their analysis.

Private-sector certification of quality, in contrast, already exists in the form of rating agencies (which are private companies notwithstanding the "agency" moniker[59]), which rate debt securities based on their likelihood of timely payment.[60] Rating agencies, however, have not always proved effective in the face of complexity.[61] It is even being argued that rating agencies contributed to the subprime mortgage meltdown by failing to downgrade securities backed by subprime mortgages on a timely basis.[62] Although rating agencies are now

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[56] *See* Robert L. Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 615 (1964) (arguing that "[t]he main argument for disclosure was that a regulatory approach was not administratively practical").

[57] *See* Craig A. Olson et al., *The Effects of Local Market Conditions on Two Pay-Setting Systems in the Federal Sector*, 53 INDUS. & LAB. REL. REV. 272 (2000).

[58] *See, e.g.*, Kathryn Moss et al., *Unfunded Mandate: An Empirical Study of the Implementation of the Americans with Disabilities Act by the Equal Employment Opportunity Commission*, 50 U. KAN. L. REV. 1, 71 (2001).

[59] *See supra* note 33, at 2.

[60] *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999); *supra* note 30, at 3. Recall that securities issued in securitization transactions are virtually always debt securities. *See supra* note 39.

[61] *See, e.g.*, *Rating the Raters: Enron and the Credit Rating Agencies Hearing Before the S. Comm. on Governmental Affairs* 107th Cong. (2002) (hearing on rating agency failure to predict Enron's collapse).

[62] *The Role of Credit Rating Agencies in the Structured Finance Market Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the*

attempting to improve their credit rating capabilities,[63] it is too soon to predict the outcome.[64] It is, however, important to strive to improve these capabilities because rating agencies constitute a public good, creating an economy of scale to help individual investors assess the creditworthiness of complex securities.[65]

Certification of the quality of securities, especially by private parties, therefore can help but may not fully solve the asymmetric-information problem. And in cases where there is not merely information asymmetry between originators and investors but also information failure on the part of originators, certification by originators can actually mislead investors.

IV. CONCLUSIONS

As complexity increases, the disclosure paradigm of securities law has been diminishing in effectiveness. This article suggests possible responses. For example, investors could require originators to take a reasonable first-loss position, although this backfired in the subprime mortgage crisis due to information failure by originators. Institutional investors should also try to reduce agency costs stemming from the conflict between the interests of individuals and the institutions for which they work.[66] Rating agencies should also try, as they now appear to be doing, to increase the quality of their "private certification" via ratings of securities.[67]

These are, admittedly, only second-best solutions, but there do not appear to be any perfect solutions. "Government already takes a somewhat paternalistic stance to mitigate disclosure's inadequacy by mandating minimum investor sophistication for investing in complex securities, yet sophisticated investors and qualified institutional buyers (QIBs) are the very investors who lost the most money in the subprime financial crisis. And any attempt by government to restrict

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H. Comm. on Financial Services, 110th Cong. 47 (2007) (investigating the extent to which credit rating agencies may have contributed to the subprime mortgage meltdown).

[63] *See, e.g.*, Standard & Poor's, *Descriptions of New Actions to Strengthen Ratings Process and Better Serve Markets,* http://www2.standardandpoors.com/ spf/pdf/media/ Leadership_Action_Details.pdf (Feb. 7, 2008) (proposing various procedural review steps to improve rating capability).

[64] One scholar has proposed that Big Four auditing firms should consider providing "[r]atings based on an audit-like inquiry" which would, he claims, "make much more sense than our current system under which the rating agency's letter grade is wholly based on information provided by the issuer that it assumes to be true." John C. Coffee, Jr., *The Securitization Bubble*, NAT'L L. J., Mar. 17, 2008, at 14.

[65] Schwarcz, *Protecting Financial Markets*, *supra* note 1, at 10 n.31.

[66] For example, "individuals should be paid in a manner that better aligns their interests with the interests of the institutions for which they work." *Id.* at 13.

[67] *See supra* notes 62–65 and accompanying text.

firms from engaging in complex transactions would be highly risky because of the potential of inadvertently banning beneficial transactions."[68]

There is, finally, another way that disclosure failed in the subprime mortgage crisis. Because "the motivation of market participants 'is to protect themselves but not the [financial] system as a whole,'"[69] I have argued that "[d]isclosure alone will be inadequate to prevent [a] systemic" collapse of the financial system.[70] Investors are simply unlikely to care about disclosure to the extent it pertains to this systemic risk. The remedy for disclosure's failure in this case must depend on separate protections to deter a systemic collapse.[71]

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[68] Schwarcz, *Protecting Financial Markets, supra* note 1, at 13–14.

[69] Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 206 (2008) (quoting THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 31–32 (1999).

[70] Schwarcz, *Protecting Financial Markets*, *supra* note 1, at 14 (explaining that "like a tragedy of the commons, the benefits of exploiting finite capital resources accrue to individual market participants, each of whom is motivated to maximize use of the resource, whereas the costs of exploitation, which affect the real economy, are distributed among an even wider class of persons").

[71] *See* Schwarcz, *supra* note 69.

SAVING HOMES IN BANKRUPTCY: HOUSING AFFORDABILITY AND LOAN MODIFICATION

John Eggum, Katherine Porter & Tara Twomey*

TABLE OF CONTENTS

I. INTRODUCTION

Nationwide, millions of families are expected to lose their homes to foreclosure over the next several years.[1] Falling home prices and tighter credit

 The authors' names are listed in alphabetical order to reflect equal contribution to this article and the data presented herein. John Eggum is a 2008 graduate of the University of Iowa College of Law. Katherine Porter is an Associate Professor of law at the University of Iowa. Tara Twomey is a consultant to the National Consumer Law Center and a Lecturer in Law at Stanford Law School. The authors thank Ann Casey, Gina Lavarda, Brian Locke, and Nece McDaniel for their research assistance.

markets have made it difficult or impossible for families to refinance their way out of unaffordable home loans. The safety net provided by appreciating real property values has crumbled, leaving homeowners at risk of serious financial distress. For many families, homeownership has become a financial liability, rather than a financial asset.

To date, responses to the foreclosure crisis have left homeowners who are in default on their mortgage loans with few options. Foreclosures continue to outpace loan modifications,[2] despite being identified as a preferred strategy for reducing the number of foreclosures.[3] The federal government and the credit industry largely have confined their efforts to voluntary programs that offer, at best,

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[1] *See* ELLEN SCHLOMER ET AL., LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 3 (2006) (estimating that 2.2 million families with subprime loans have lost or will lose their homes to foreclosure over the next few years); *Foreclosures to Affect 6.5 mln Loans by 2012-Report*, REUTERS, Apr. 22, 2008, http://www.reuters.com/article/bondsNews/ idUSN2233380820080422 (citing the Credit Suisse Report dated April 22, 2008, that estimated as many as 6.5 million foreclosures by the end of 2012, equating to 12.7% of all residential borrowers). In May 2008, Federal Reserve Chairman Ben Bernanke observed that 1.5 million homes were in some stage of foreclosure in 2007, an increase of 53% over the previous year. Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Columbia Business School's 32nd Annual Dinner (May 5, 2008), *available at* http://www.federalreserve.gov/news events/speech/Bernanke20080505a.htm). Foreclosures continue to surge in 2008. *See* Press Release, RealtyTrac Staff, U.S. Foreclosure Activity Increases 23 Percent in First Quarter (Apr. 29, 2008), *available at* http://www.realtytrac.com/ContentManagement/ pressrelease .aspx?ChannelID=9&ItemID=4566&accnt=64847 (stating that foreclosure filings for first quarter 2008 were up 23% from the previous quarter).

[2] In September 2007, Moody's Investor Services surveyed sixteen mortgage servicers that accounted for 80% of the market for subprime loans and found that most of those companies had modified only about 1% of loans with interest rates that reset in January, April, and July 2007. MICHAEL P. DRUCKER & WILLIAM FRICKE, MOODY'S SUBPRIME MORTGAGE SERVICER SURVEY ON LOAN MODIFICATIONS 1 (Sept. 21, 2007), *available at* http://americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf. In a December 17, 2007 update, Moody's reported that the number had only slightly increased to 3.5%. AASHISH MARFATIA, U.S. SUBPRIME MARKET UPDATE: NOVEMBER 2007, STRUCTURED FINANCE 2 (2007). Recent data from the HOPE NOW Alliance indicates that foreclosure starts in the third quarter of 2008 (575,000) are nearly double the number of loan modifications for the same period (264,000). HOPE NOW Loss Mitigation National Data July 07 to October 2008, *available at* http://www.hopenow.com/site_tools/data.php. Similarly, recent information from the Federal Housing Finance Agency shows that in August 2008 servicers modified a mere 4,402 loans out of the 31 million loans guaranteed by Freddie Mac and Fannie Mae while delinquencies climbed to 2.03% of the total loans. *See* Emily Flitter, *Loan Mods at 4k in August for GSEs*, American Banker (Nov. 26, 2008).

[3] *See, e.g.*, Shelia C. Bair, Chairwoman, Fed. Deposit Ins. Corp., Remarks at American Securitization Forum Annual Meeting (June 6, 2007) ("The immediate task is to sustain homeownership by ensuring that servicers have the flexibility they need to make prudent loan modifications.").

temporary or limited aid, such as forbearance agreements or short-term modifications.[4] When other alternatives are unavailable or insufficient, families may turn to bankruptcy to prevent the loss of their home.[5] Bankruptcy permits homeowners to halt foreclosures and cure defaults on their mortgage loans by repaying missed payments over a period of years. However, families face serious challenges in saving their homes using bankruptcy law. In today's market, a large fraction of struggling homeowners may have mortgage obligations that are not affordable.[6] Bankruptcy law does not permit debtors to modify the terms of mortgages secured by a principal residence.[7] This limitation on restructuring home mortgage loans may pose an insurmountable barrier to families who are trapped in unaffordable loans. Such families may be unable to avoid foreclosure using the bankruptcy process because they cannot keep up with their ongoing mortgage payments or cannot do so while curing the defaults on their mortgage loans.

This Article explores the intersection between home affordability and the potential of bankruptcy to help families save their homes from foreclosure. Using an original data set of homeowners who filed chapter 13 bankruptcy, this Article analyzes the relationship between housing costs and income for bankrupt families. This Article finds that more than two-thirds of bankrupt families live in unaffordable or severely unaffordable housing according to standards used by the Department of Housing and Urban Development.[8] These families must devote a large proportion of their incomes to housing costs, which could jeopardize their chance to save their homes and lower the odds that they complete their bankruptcy cases successfully. Amending bankruptcy law to permit the modification of the terms of home mortgages could reduce unaffordable housing costs and enhance the usefulness of bankruptcy as a tool to address the current foreclosure crisis.

Part II of this Article explains the benefits and limitations of using chapter 13 bankruptcy as a home-saving device. Part III describes the methodology of a mortgage studythat contains over 1700 chapter 13 bankruptcy cases filed by homeowners ("Mortgage Study"), and explains the metrics used to assess the affordability of these debtors' housing costs. Part IV presents the Mortgage Study data on the housing affordability for bankrupt families. Part V considers the

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[4] *See, e.g.*, Anna Marie Kukec, *Trend Won't End Soon, So What's Being Done?*, DAILY HERALD, Nov. 28, 2007, at 1, (highlighting the temporary and limited extent of programs intended to help with the foreclosure crisis).

[5] *See* Posting of Bob Lawless to Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2008/05/foreclosures-an.html#more (May 21, 2008, 19:39) (suggesting higher bankruptcy filing rates may be tied to the foreclosure crisis).

[6] Some of these families may have unaffordable loans because of easy underwriting standards used at the time of loan origination. Another large subset of families may have adjustable-rate loans with mortgage payments that have sharply escalated after loan origination.

[7] 11 U.S.C. § 1322(b)(2) (2006). By contrast, bankruptcy debtors may modify mortgage debt on investment property and second homes. *See id.*

[8] *See infra* Part IIIB.

implications of these findings for improving the bankruptcy system and for crafting effective policy responses to the rising number of foreclosures.

II. BANKRUPTCY AS A HOME-SAVING DEVICE

Since the enactment of the Bankruptcy Code in 1978, homeowners facing foreclosure have often turned to bankruptcy as a last resort to try to save their homes.[9] A bankruptcy filing halts a pending foreclosure.[10] Debtors who file a chapter 13 bankruptcy case can cure any defaults on mortgage loans over a period of years.[11] This right to cure is applicable even if the creditor has accelerated the loan and even if state law or the loan contract does not provide such a right.[12] This right to repay mortgage arrearages over time offers families the opportunity under federal law to save their homes from foreclosure.

To retain a home in chapter 13 bankruptcy, the law generally requires bankruptcy debtors to make their ongoing monthly mortgage payments as well as to make additional periodic payments to repay any arrearages on the mortgage loan.[13] As a result, chapter 13 bankruptcy is well-suited to aid families who have defaulted on their mortgage loans due to a temporary loss of income (e.g., unemployment, illness, divorce). If debtors have recovered from this temporary setback at the time of bankruptcy, they may have sufficient income to make ongoing mortgage payments as well as make payments under their bankruptcy plans to repay any past due amounts. Homeowners facing foreclosure because they are overwhelmed with unsecured debts, such as credit card or medical bills, may also benefit from a chapter 13 bankruptcy. For these debtors, bankruptcy can reduce the amounts owed to unsecured creditors to a fraction of the total debt, thereby freeing up income to permit debtors to meet their mortgage payments. Debtors who have rebounded from temporary income loss or who need to address large unsecured debts stand the greatest chance of saving their homes in bankruptcy.

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[9] Raisa Bahchieva et al., *Mortgage Debt, Bankruptcy, and the Sustainability of Homeownership*, in CREDIT MARKETS FOR THE POOR 73 (Patrick Bolton & Howard Rosenthal eds., 2005) (stating that chapter 13 bankruptcy is frequently used by families who face foreclosure and explaining its benefits over chapter 7 bankruptcy for homeowners).

[10] *See* 11 U.S.C. § 362. A limited exception to this general rule for repeat filers was enacted in 2005. *See* Pub. L. No. 109-8, § 302, 119 Stat. 23 (codified at 11 U.S.C. § 362(c)(4)).

[11] *See* 11 U.S.C. § 1325(b).

[12] *See, e.g.*, *In re* Robinson, 285 B.R. 732, 738 (Bankr. W.D. Okla. 2002) (stating that federal bankruptcy law right to cure could not be frustrated by state law).

[13] *See, e.g.*, General Motors Acceptance Corp. v. Chapman (*In re* Chapman), 135 B.R. 11, 14 (Bankr. M.D. Pa. 1990) (noting practice of allowing debtors to extend their plans to repay arrearages on mortgages).

Embedded in this description of the benefits of chapter 13 bankruptcy for homeowners in financial distress is a crucial assumption—that these families have incomes at the time of their bankruptcy filings that are sufficient to permit them to meet their future mortgage payments and other living expenses. To receive a bankruptcy discharge and to cure defaults on their mortgage loans, families need to stay current on their ongoing mortgage obligations. A family's success in saving its home in bankruptcy may turn in large part on the relationship between its current income and its housing costs.

An example from a bankruptcy case in the Mortgage Study sample is illustrative.[14] This bankrupt family had a thirty-year fixed-rate mortgage loan with an interest rate of 7.35%. The monthly mortgage payment for principal and interest at the time of the debtor's bankruptcy filing was $503. Other housing costs such as taxes, insurance, water, sewer, electricity and heating fuel added another $286 per month to the housing expenses, which totaled $789. The family's monthly gross income at the time of the bankruptcy filing was $1908. This family's housing costs subsumed 41% of its income. When it filed bankruptcy, the family owed a past due debt to its mortgage creditor of $5234 in principal and interest and $1228 in fees and costs. To cure the default and save its home from foreclosure, this family needed to repay this total arrearage of $6462. Currently, the most common loss mitigation option offered by mortgage companies to struggling homeowners is a repayment plan. Yet, this non-bankruptcy option is not likely to be workable for this family. Under a typical twelve-month repayment plan, this family would have to pay an additional $538 per month for one year. This would increase the family's total housing costs to $1327 per month and push the debtor's housing costs-to-income ratio to 69%. That is, a repayment plan outside of bankruptcy would require the family to commit a little more than two of every three dollars that it earned as income to its mortgage obligations. Additionally, this nonbankruptcy repayment option would leave the debtor with only $581 in residual income after meeting its housing costs to pay for food, transportation, telephone, medical costs, credit card debt payments and other miscellaneous expenses.

By contrast, in bankruptcy, this family could cure the arrearage on the mortgage loan over a period of up to five years as part of a chapter 13 repayment

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[14] This example is based upon the petition, schedules, chapter 13 plan and mortgagee's proof of claim in Mortgage Study case ED VA 38 (on file with Katherine Porter). Each case in the Mortgage Study sample was given a unique identifier assigned by the researchers (ED VA 38, in this instance). The letters signify the judicial district where the case was filed. The numbers represent the sequence of the case in the sample. We do not refer to the cases by their court-supplied case numbers because we do not wish to violate the privacy concerns of the debtors whose cases were randomly selected for inclusion in the Mortgage Study sample. Bankruptcy court records, however, are public documents and all cases are on file with author Katherine Porter, as noted.

plan.[15] The arrearage of $6462 could be repaid over sixty months, which translates to $108 per month to the mortgage creditor to cure the default. This additional payment boosts the family's housing costs-to-income ratio up to 44%. While this increase may still be a challenge for the family to manage, it is likely to pose a significantly smaller obstacle than the most common repayment plan available outside of bankruptcy. In this case, the debtors' actual bankruptcy plan proposed a monthly payment of $328, which covered not only the mortgage arrears, but also tax arrears, the trustee payment,[16] attorney fees and a 100% repayment of all debts owed to unsecured creditors.[17] Two years later this family is faring well in bankruptcy. They appear to be current on their ongoing payments to their mortgage creditor and their bankruptcy repayment plan remains pending.

As the above example demonstrates, bankruptcy can be a powerful tool for fighting foreclosure because it can improve a family's chances for catching up on past, missed mortgage payments. However, the ability of homeowners to cure mortgage defaults in bankruptcy is significantly undermined when their monthly mortgage payments before bankruptcy are severely unaffordable. Debtors who have suffered a permanent decline in income before bankruptcy are less likely to be able to take advantage of their right under bankruptcy law to repay their debts through a chapter 13 repayment plan Similarly, debtors suffering from payment shock as a result of teaser rates on adjustable-rate mortgages,[18] or those who have

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[15] *See* 11 U.S.C. §§ 1322, 1325. The length of the plan is affected by the debtor's income and family size, as well as whether or not unsecured claims will be paid in full. *See* 11 U.S.C. §§ 1322(d), 1325(b)(1), (b)(4).

[16] The chapter 13 trustee collects payments made by chapter 13 debtors and disburses those payments to creditors in accordance with the debtor's confirmed chapter 13 plan. *See* First Bank and Trust v. Gross (*In re* Reid), 179 B.R. 504, 507 (E.D. Tex. 1995). The chapter 13 trustee is generally paid a commission or fee for administering these payments. *See* 9 AM. JUR. 2D BANKRUPTCY § 588 (2006). The fee is typically 4–10% of the amount being paid through the plan. *Id.*

[17] The trustee will pay a dividend to unsecured creditors in accordance with the debtor's chapter 13 plan. *See In re* Phelps, 149 B.R. 534, 535 (Bankr. N.D. Ill. 1993) (noting trustee payment of dividends to unsecured creditors). In chapter 13, debtors may modify claims of unsecured creditors by paying them less than the full value of their claim. *See* 11 U.S.C. § 1322(b)(2). Unsecured creditors may receive a dividend of 0 to 100% on their claims. *See* Branigan v. Bateman (*In re* Bateman), 515 F.3d 272, 280 (4th Cir. 2008) (stating varying range of dividend percentages). A dividend of 100% means the unsecured creditors will be paid in full, a dividend of 50% means the unsecured creditors will be paid fifty cents on the dollar and a 0% dividend will produce no return to the unsecured creditors. After unsecured creditors are paid the dividend specified in the debtor's chapter 13 plan, any remaining debt is discharged upon completion of the plan. *See* 11 U.S.C. § 1328.

[18] *See generally* MAJORITY STAFF OF THE JOINT ECON. COMM., THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 6, 20 (2007), *available at* http://jec.senate.gov/

been saddled with unaffordable loans from the moment of loan origination[19] will find it more difficult to save their homes under the current bankruptcy laws.

Homeowners with mortgage payments that overwhelm their incomes face much greater challenges in saving their homes in bankruptcy. The right to cure a mortgage default under § 1322(b)(5) of the Bankruptcy Code does not itself permit a homeowner to modify terms of a mortgage loan. Section 1322(b)(2) sets forth the general rules regarding modification of claims in bankruptcy, permitting debtors to modify the rights of secured and unsecured creditors. Some of the ways that secured claims may be modified include altering the payment schedule, reducing the contract interest rate,[20] or "stripping down" the amount of the claim to the value of the collateral.[21] However, the rule permitting the modification of secured claims is limited by additional language in the same section that creates an

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archive/Documents/Reports/10.25.07OctoberSubprimeReport.pdf (identifying the root of the subprime mortgage crisis as the prevalence of 2/28 and 3/27 teaser loans).

[19] *See generally* STATE FORECLOSURE PREVENTION WORKING GROUP, DATA REP. NO. 1, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE 10 (2008) (stating that more than 30% of subprime and Alt-A ARMs are already at least thirty days past due before any rate reset). Over the past several years, many borrowers were unwittingly pushed into unaffordable loans by unscrupulous mortgage brokers or lenders. *See, e.g.*, *Mortgage Market Turmoil, Causes and Consequences: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Alan M. White, Community Legal Services, Inc., on behalf of Jennie Haliburton), *available at* http://banking.senate.gov/public/_files/haliburton.pdf (describing elderly homeowner whose monthly payment for principal, interest, taxes and insurance consumed 62% of her social security payment and left her with only $664 a month for all other expenses such as food, medicine, and utilities).

[20] *See, e.g.*, Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004) (holding that in modifying the interest rate on a car claim being paid under a chapter 13 plan, the bankruptcy court should use the prime rate, adjusted to reflect potential risk, taking into account "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan").

[21] "Stripping down" or bifurcating a secured creditor's claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion represented by any amount owed over the value of the collateral. 11 U.S.C. § 506(a)(1); *see* American Gen. Fin. v. Paschen (*In re* Paschen), 296 F.3d 1203, 1206 (11th Cir. 2002) (defining "secured" and "unsecured" portions of a bifurcated claim). Section 506(a), which authorizes such bifurcation, provides that a creditor's claim "is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property." 11 U.S.C. § 506(a). The section serves two purposes: (1) it limits the estate's liability on a secured claim to payment up to the actual value of the collateral, and (2) it permits the under-secured creditor to have an allowed unsecured claim and share on par with the other allowed unsecured claims. Through this process, the secured creditor's rights in the collateral are preserved, but its rights to the debtor's property other than the collateral are limited and no greater than those of other creditors. Thus, the Code prevents the secured creditor from obtaining an unfair advantage in the bankruptcy case over the unsecured creditors out of proportion to the true value of its security interest.

exception for certain mortgage loans. The exception prohibits the modification of "a claim secured only by a security interest in real property that is the debtor's principal residence."[22] This exception is commonly known as the "anti-modification" rule. This language means that bankruptcy debtors cannot change or adjust the terms of their home mortgages. This restriction on loan modification can make it nearly impossible for debtors with unaffordable mortgage payments to save their homes from foreclosure through the bankruptcy process.

Because families remain obligated to make their future mortgage payments according to the original loan terms, those who have severely unaffordable mortgage loans may be more likely to fail in chapter 13 bankruptcy. Sometimes, the high housing costs began at the time of loan origination. For example, a debtor from the Mortgage Study was saddled with a monthly mortgage payment of $2465, which was nearly equal to her monthly gross income of $2699.[23] The debtor's mortgage loan was a six-year fixed-rate loan with an interest rate of 11%. The loan was an "interest only" obligation with a $271,465 balloon payment due at the end of the six-year term. The debtor's bankruptcy court records listed an additional monthly contribution from a family member of $1322. However, even with these additional funds the monthly mortgage payment consumed 62% of household income without taking into consideration real estate taxes, insurance and utilities. Unable to make the monthly mortgage payments going forward, the automatic stay preventing foreclosure on the home was lifted by the court within just a few months of the bankruptcy filing. Despite seeking relief in bankruptcy, this debtor lost her home to foreclosure.[24]

Similarly, debtors suffering from payment shock on adjustable-rate mortgages may also be unable to use bankruptcy to save their homes. The so-called exploding adjustable-rate mortgage is the mortgage product that dominated the subprime market from 2004 to 2006.[25] It is usually characterized by a fixed interest rate for the first two years of the loan, followed by an adjustment of the interest rate every

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[22] 11 U.S.C. § 1322(b)(2); *see* Nobleman v. Am. Sav. Bank, 508 U.S. 324, 331–32 (1993).

[23] This example is drawn from the bankruptcy court records of Mortgage Study case ND CA 5 (on file with Katherine Porter). Notably, the debtor's Statement of Financial Affairs reveals that the debtor's income between 2002 and 2005 never exceeded $28,000 per year ($2333 per month), yet the loan, which was originated in September 2005, from the outset had a monthly mortgage payment of $2465.

[24] The bankruptcy court records do not reveal the house's ultimate disposition but the county records show a trustee's deed was filed after a notice of default and notice of trustee sale, consistent with a completed non-judicial foreclosure. (land record on file with Katherine Porter).

[25] See CTR. FOR RESPONSIBLE LENDING, A SNAPSHOT OF THE SUBPRIME MARKET 1 (2007), *available at* http://www.responsiblelending.org/pdfs/snapshot-of-the-subprime-market.pdf (reporting 89–93% of subprime mortgages made from 2004 to 2006 had exploding interest rates).

six months thereafter.[26] Often, these loans were structured with an initial "teaser" or discounted interest rate for a period of two or three years. After the initial period of the fixed interest rate expires, the loan's interest rate, and accordingly the borrower's payments, usually increase significantly. In one case from the Mortgage Study, a Minnesota family had an adjustable-rate mortgage with an initial teaser interest rate of 7.99% and a monthly principal and interest payment of $1781.[27] While the debtors' income remained stable from prior years, in the seven months before bankruptcy the interest rate on their loan adjusted twice. These changes caused the interest rate on their loan to escalate to 10.99%, giving the family a monthly payment of $2780. The payment shock from the interest adjustment added $1000 per month to the family's mortgage obligation. After the interest rate adjusted on the loan, the debtors did not make any payments on it. At the time of bankruptcy, the debtors' housing costs, including mortgage payment (principal, interest, taxes, and insurance) and utilities for the home (water, sewer, and garbage) were equal to 67% of the debtors' income. Within one year of filing chapter 13 bankruptcy, this family faced a motion from its mortgage creditor to lift the bankruptcy stay of foreclosure. The court granted the motion, giving the creditor permission to foreclose under state law. Although the bankruptcy court records do not detail the final outcome, this family probably lost its home. Bankruptcy did not permit this family to address the real obstacle to keeping its home—unaffordable ongoing mortgage payments.

Bankruptcy law's current prohibition on modifying home mortgage loans is a serious limitation on bankruptcy's usefulness as a home-saving device. Families who have recovered from temporary income declines or whose primary financial problem is large unsecured debts may succeed in saving their homes in bankruptcy. However, the families who are in financial distress because they are trapped in unaffordable home loans may find little relief under existing bankruptcy law. The remainder of this Article constructs an empirical measure of the affordability of bankrupt families' housing costs in relation to their current incomes and analyzes the implications of these findings for bankruptcy's potential as a foreclosure prevention system.

III. METHODOLOGY

The data presented in this Article comes from the Mortgage Study, an original database of homeowners in bankruptcy. This section briefly describes the

[26] The interest rate on an adjustable-rate mortgage is usually based on the value of an index, such as LIBOR (London Inter-Bank Offered Rate) or comparable U.S. treasuries, plus a fixed amount called the margin. The margin in Mortgage Study case D MN 22 (on file with Katherine Porter) was 7.74%, and the LIBOR index on the date of consummation was 1.186%. *See* BBA, 2003 – HISTORIC LIBOR RATES, http://www.bba.org.uk/content/1/c4/24/38/Aug03.xls. The fully indexed rate on the date of consummation was 8.93%.

[27] This example is based on the bankruptcy court records in Mortgage Study case D MN 22 (on file with Katherine Porter).

methodology of that study[28] and details the affordability standard that we use to measure the housing costs of bankrupt households.

A. Mortgage Study

The Mortgage Study is a large, multi-state study of chapter 13 bankruptcy debtors who are homeowners. The study's main objective was to develop comprehensive data on the intersection of mortgage lending, homeownership, and bankruptcy.[29] The National Conference of Bankruptcy Judges' Endowment for Education, a non-profit and non-partisan organization that funds basic research and education about bankruptcy, provided financial support for the study.[30] Katherine Porter and Tara Twomey are co-principal investigators of the study.

The Mortgage Study built a sample of 1733 chapter 13 bankruptcy cases.[31] To be included in the study, the bankruptcy debtor had to own a home.[32] The cases were filed during the month of April 2006.[33] Because of rapid changes in the mortgage market in the last few years, the data may not reflect the effects, if any, of the current "foreclosure crisis" on the bankruptcy system. For example, the sample may underrepresent the affordability problems created by adjustable-rate mortgages, which continued to grow in popularity until late in 2006. On the other hand, the data may be more representative of the usual situations of households that file bankruptcy to save homes during the thirty-year period since the

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[28] For a more extensive recitation of the Mortgage Study's methodology, see Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. (forthcoming 2008) (manuscript at 13–16, *available at* http://ssrn.com/abstract=1027961).

[29] *Id.* at 15.

[30] The National Conference of Bankruptcy Judges and its Endowment for Education ("Endowment") are not responsible for the data or findings presented in this Article, which are solely the responsibility of the authors. In funding the grant, the Endowment does not endorse or express any opinion about the methodology utilized, or any conclusions, opinions, or results contained in any report, article, book, or other writing based on the research funded by the Endowment.

[31] We excluded chapter 7 cases from the sample because homeowners are less likely to file chapter 7 bankruptcy than chapter 13 bankruptcy. *See* Bahchieva et al., *supra* note 9, at 104 (reporting that homeowners are "nearly 50 percent more likely to file for Chapter 13 than Chapter 7"). Homeowners prefer chapter 13 because it contains special provisions to permit homeowners to cure defaults on their mortgages by repaying arrearages over time through their repayment plan. *See* 11 U.S.C. §§ 1322, 1325 (2006).

[32] While all cases in the sample were filed by homeowners, 4% of these homeowners did not report owing any mortgage debt at the time of bankruptcy.

[33] The initial coding of the data occurred in October or November 2006. We intentionally allowed for this lapse of time to try to ensure that the court records were substantially complete when we coded the data. We rechecked the court records approximately eighteen months after the initial filing to check for any additional objections to mortgagees' proofs of claim.

Bankruptcy Code's adoption in 1978 of the law restricting the modification of home mortgages.

The sampling procedure was to select every fifth case in each judicial district included in the sample. In this way, the sample reflects the number of chapter 13 filings per district, so that districts with higher numbers of chapter 13 filings are represented accordingly.[34] The sample includes bankruptcy cases filed in forty-four judicial districts, which represent twenty-four different states.[35] These states all permit non-judicial foreclosure of residential mortgages. We limited the sample in this regard because we believe that homeowners may be more likely to file bankruptcy as an anti-foreclosure measure in non-judicial foreclosure states where foreclosure is usually easier and faster.[36]

The data come from the public court records in each debtor's case. The electronic filing system for federal court pleadings, PACER,[37] was used to access most of the records.[38] In each case, data was coded from the debtor's bankruptcy petition and schedules of assets and liabilities. Data was also drawn from the case docket and from any proofs of claim and attachments thereto filed by mortgage creditors or their agents. Approximately 150 pieces of data were coded for each case.

This Article analyzes the housing affordability of bankruptcy debtors in 1713 cases. Twenty cases were eliminated from the complete Mortgage Study sample because of irregularities in these few debtors' schedules.[39] To calculate home affordability, we adopted the standard of the Department of Housing and Urban

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[34] For example, in a district with few chapter 13 filings, such as Wyoming, only two cases are in the sample. At the other extreme, the sample contains 164 cases from the Northern District of Georgia because that district has a large number of chapter 13 cases filed.

[35] In 2006, the chapter 13 bankruptcy filings in these states accounted for 61% of all chapter 13 filings in the nation.

[36] *See* Porter, *supra* note 28, at n.83 (citing BARLOW BURKE, REAL ESTATE TRANSACTIONS 336 (2006) ("[Power of sale foreclosure] is cheaper than judicial foreclosure and takes less time.")); *see also* 1 GRANT NELSON & DALE WHITMAN, REAL ESTATE FINANCE LAW 635 (2002) (discussing the extensive procedures involved in judicial foreclosures).

[37] PACER is an acronym for Public Access to Court Electronic Records, the online system for accessing federal court records.

[38] We thank the chief judges of each district (with one exception) in the Mortgage Study for granting us a research waiver of PACER fees. The Southern District of Texas, a consolidated court in which the District Court determines whether to grant a fee waiver, denied our application for a fee waiver. When PACER did not appear to contain complete court files, we obtained paper records.

[39] Some cases were eliminated because of missing information, such as no income given on the appropriate schedule despite an indication that the debtor was employed. Others were eliminated because the debtor reported a mortgage payment of zero despite listing a mortgage debt on the schedule of secured debt. Before elimination, each of these cases was individually reviewed for coding error.

Development ("HUD") as detailed *infra* in the next section. That metric requires two main pieces of data: income and housing costs.

Data on income were coded from Schedule I of each debtor's bankruptcy schedules.[40] This income figure represents the debtor's actual monthly income at the time of the bankruptcy filing. Comparing these income data with debtors' housing costs provides a robust measure of debtors' abilities to pay their housing expenses at the time they filed chapter 13 bankruptcy.[41]

A debtor's "housing cost" as referred to in this Article is a combination of four expenses. Each of these expenses is reported on debtors' bankruptcy records on Schedule J: (1) mortgage payment;[42] (2) property tax payment; (3) insurance payment; and (4) utility payments.[43] The coding procedure accounted to the greatest extent possible for whether tax or insurance were included in a debtor's mortgage payment.[44] Payments that were included in the utility expense were electricity, gas or oil, water, and sewer.[45]

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[40] The Mortgage Study also coded data on income from each debtor's Form B22, which is the form that collects the data for the "means test" used to determine a bankruptcy debtor's eligibility for bankruptcy relief and their repayment obligations in chapter 13. The Form B22 income figure, although labeled "current monthly income," is in fact an average of the debtor's historical income for the six months before the bankruptcy filing. *See* 11 U.S.C. § 101(10A) (2006); *see also* B22C (Official Form 22C) (Chapter 13) (01/08) (2008), *available at* http://www.uscourts.gov/rules/BK_Forms_08_Official/B_022C_0108f .pdf. Thus, the Schedule I income data are more representative of a debtor's income when a debtor decided to file chapter 13 and attempted to retain their homes. To satisfy our curiosity, we did analyze debtors' B22 income in relation to housing costs. The results were largely similar, but because Schedule I income (time of bankruptcy filing) was often somewhat lower than Form B22 income (average income in months before bankruptcy), the findings on housing affordability were somewhat less grim than those that are the focus of this Article. We note that we have no reason to know the direction of change of debtors' incomes after bankruptcy filing. While some households may improve their financial prospects, others may find that their incomes continue to decline.

[41] Knowing debtors' income at the time they took out their mortgage loans would provide an additional perspective on debtors' decision-making in borrowing and the lenders' original terms for underwriting the loan with regard to income. These data are difficult, if not impossible, to derive from the bankruptcy court records. A major barrier in this regard is the failure of many mortgagees to attach a note to their claim from which a loan date could be obtained. *See* Porter, *supra* note 28 (manuscript at 17) (showing that 41.1% of mortgage creditors did not file a note with their proofs of claim). The other difficulty is that the Statement of Financial Affairs that is part of debtors' schedules provides income data for, at most, the three years that preceded the bankruptcy, and loan origination often preceded that period.

[42] If a debtor had more than one mortgage loan, we combined the payment on each obligation to calculate their total housing obligations.

[43] *See* B6J (Official Form 6J) (12/07) (2007), *available at* http://www.uscourts.gov/ rules/ BK_Forms_1207/B_006J_1207f.pdf.

[44] Some debtors included taxes and/or property insurance in their reported mortgage payment. To prevent double-counting, the Mortgage Study coding noted whether each

B. Calculating Affordable Housing

"Affordable housing" is a flexible and nebulous concept. The term has been invoked in several ways, depending on context and objective.[46] HUD has made the concept of affordability more concrete by creating a measure that reflects the percentage of income that a household spends on housing costs.[47] HUD then categorizes housing as affordable, unaffordable, or severely unaffordable based on whether housing cost divided by household income exceeds certain thresholds.[48] A household is deemed to be living in affordable housing if its housing costs subsume no more than 30% of its income.[49] A household is termed to have unaffordable housing if it commits between 30% and 50% of its income to paying housing costs.[50] Severely unaffordable housing is defined as requiring a household to expend more than half (50%) of its income.[51]

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debtor had indicated in the pre-printed box on the schedule that the mortgage payment included tax or insurance. The utilities coded were electricity, water/sewer, and gas.

[45] Schedule J contains an "other" utility field. *See id.* A small fraction (45 of 1713) of debtors in the Mortgage Study sample entered all utilities in this field as a combined number, sometimes including cable television or another expense that is not part of the utility expense in the housing affordability standard. Because we had no way to know what portion of these combined figures was attributable to specific utilities, we used the entire amount of the combined utility. It is unlikely that this had any effect on the analysis because of the small number of schedules completed in this manner and because of the low amounts of combined utilities in relation to the overall housing expense figure. Specifically, the average and median "other" utility expenses were $162 and $113, respectively, for Mortgage Study cases.

[46] *See* J. David Hulchanski, *The Concept of Housing Affordability: Six Contemporary Uses of the Housing Expenditure-to-Income Ratio*, 10 HOUS. STUD. 471, 475–86 (1995) (discussing the historical development and modern use of expenditure-to-income ratios as an affordability metric).

[47] *See* DAVID A. VANDENBROUCKE, HOUSING AFFORDABILITY DATA SYSTEM 11, 14 (2007), *available at* http://www.huduser.org/Datasets/hads/HADS_doc.pdf (explaining the Housing Affordability Data System dataset and detailing the metrics used by HUD to evaluate housing costs and burdens).

[48] *See id.* at 11; OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003) [hereinafter TRENDS IN WORST CASE NEEDS FOR HOUSING], *available at* http://www.huduser.org/publications/PDF/trends.pdf.

[49] The 30% figure is the baseline HUD standard. *See* VANDENBROUCKE, *supra* note 47, at 11. The actual criteria used by HUD incorporates a statistical analysis of regions, area median incomes, housing fair market value, and area poverty levels to analyze what is affordable for a given area. *Id.* at 7–13; *see also* TRENDS IN WORST CASE NEEDS FOR HOUSING, *supra* note 48, at 1.

[50] TRENDS IN WORST CASE NEEDS FOR HOUSING, *supra* note 48, at 1.

[51] *Id.*

HUD's housing affordability standards have shaped federal housing policy for decades.[52] For example, HUD has issued an internal directive to mortgage companies stating that loans insured by the Federal Home Administration (FHA) may be issued only when housing payment-to-income ratios do not exceed 31%.[53] When Congress has legislated, it has demonstrated a special concern for those spending more than 30% of their income on housing.[54] For those with severely unaffordable housing costs (households spending more than 50% of their incomes on housing), Congress has enacted laws that attempt to give even greater aid.[55] The widespread adoption of the HUD affordability standard makes it the best available metric for assessing the challenges that bankrupt households may face in retaining their homes in chapter 13 bankruptcy.

While a concrete, objective benchmark for determining affordability is a useful tool, it is not a perfect measure of whether a family can meet its housing expenses without undue hardship for the following reasons. First, the HUD standard has a fixed-time approach. For example, the HUD affordability benchmark assumes that income is stable and does not consider income volatility. A further assumption is that housing costs are fixed. However, property tax rates, insurance premiums, and utility costs are apt to change over time, usually increasing at least annually. For debtors with adjustable-rate mortgages, even their mortgage payment may change as time elapses. While these are real limitations, such assumptions are an inherent part of the HUD affordability standard. Further, the general analytical model that is used in chapter 13 bankruptcy is also a

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[52] The 30% figure is the end result of an evolving policy begun in the 1920s that suggested that all housing, owned and rented, should cost one week's worth of wages (a 25% of income standard). *See* DANILO PELLETIERE, GETTING TO THE HEART OF HOUSING'S FUNDAMENTAL QUESTION: HOW MUCH CAN A FAMILY AFFORD? 1–2 (2008), *available at* http://www.nlihc.org/doc/AffordabilityResearchNote_2-19-08.pdf. Thirty percent has been the most used standard since the 1970s. *Id.* at 1–5.

[53] Letter from John C. Weicher, Assistant Sec'y for Hous.-Fed. Hous. Commissioner, U.S. Dep't of Hous. & Urban Dev., to All Approved Mortgagees (Apr. 13, 2005), *available at* http://www.fhasecure.gov /offices/adm/hudclips/letters/mortgagee/files/05-16ml.doc. However, that same directive indicates that "compensating factors" may allow this limit to be exceeded, indicating that even HUD views its own concept of affordability as somewhat flexible and dependent on an individual debtor's situation. *Id.*

[54] *See* Housing and Urban-Rural Recovery Act of 1983, Pub. L. No. 98-181, 97 Stat. 1153 (amending, in section 122, the Housing and Community Development Act of 1974, 12 U.S.C. § 1706e (repealed 1990)), to give a special priority to loan applicants currently paying in excess of 30% of income for housing); *see also* 42 U.S.C. § 1490a(a)(2)(A) (2006) (requiring that rental rates not exceed 30% of adjusted income for certain low income persons, in section entitled "[l]oans to provide occupant owned, rental, and cooperative housing for low and moderate income, elderly or handicapped persons or families").

[55] *See, e.g.*, 7 U.S.C. § 2014(e)(6)(A) (giving an "excess shelter expense deduction" for eligible low-income food stamp recipient households spending more than 50% of income on housing).

snapshot, moment-in-time approach that considers what the debtor can afford to pay at the time of the bankruptcy filing or at plan confirmation, which typically occurs a few weeks thereafter. Both the Bankruptcy Code and HUD use static measures to capture what is in reality a dynamic relationship between income and expenses. While the analytical approaches are parallel, the attempt is nonetheless to forecast a household's financial future using limited data from a particular moment in time.

Second, merely because the HUD standard labels housing as unaffordable does not mean that some Americans do not actually succeed in paying for such housing. Studies show that many homeowners exceed HUD's affordability guidelines. The Joint Center for Housing Studies of Harvard University reports that, as of 2006, about 29.5% of all U.S. homeowners, corresponding to over 22 million households, have housing costs that exceed HUD's 30% affordability benchmark.[56] The same study also found that about 40% (8.8 million) of these 22 million households have homes that are severely unaffordable.[57] That translates into 11.7% of all U.S. homeowners spending more than 50% of their incomes on housing.[58]

While some of these homeowners in unaffordable housing will face foreclosure because they cannot sustain their housing costs, it is not inevitable that high-cost homeownership efforts will fail. Some households, by virtue of rising income or housing appreciation, will succeed at homeownership, even if those households met the unaffordable benchmark at one time. Other households will succeed in purchasing their homes by sacrificing goods and services, such as internet and cable television, or by diverting income from other productive uses, such as saving for retirement or their children's college educations.[59] Thus, it is inaccurate to equate all homeownership that is unaffordable under the HUD standards as "unsustainable" because such a label may not mirror the reality of homeownership outcomes. Of course, the converse is equally true. That is, some families will lose their homes after a financial collapse despite having affordable housing costs. Housing affordability is a useful measure for comparing groups of

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[56] JOINT CTR. FOR HOUS. STUD. OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 2008, at 40 [hereinafter JCHS REPORT], *available at* http://www.jchs.harvard.edu/publications/markets/ son2008/son2008.pdf (analyzing housing affordability using the same affordability metrics as this paper). The JCHS Report found that about 34.9% of all U.S. households (including both homeowners and renters) live in housing that exceeds HUD's affordability guidelines. *Id.*

[57] *Id.* 15.8% of all households (homeowners and renters combined) live in housing that is severely unaffordable. *Id.*

[58] *Id.*

[59] *See* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP 133 (2003) (discussing the increasing cost burden that homeowners acquiesce to, and explaining that, over the last generation, "the proportion of *middle-class families* that would be classified as house poor or near-poor has doubled").

Americans and studying homeownership expense at a moment in time, it is not an absolute predictor of outcome in any given situation.

The characteristics of bankruptcy debtors will affect the likelihood that these families can withstand unaffordable housing costs. Most families who file bankruptcy face high debts and earn low incomes.[60] These circumstances ratchet up the risks that such families cannot succeed in saving homes that are unaffordable. The HUD affordability standard is a way to evaluate the risk of home loss for these families in bankruptcy.

People who file bankruptcy earn low incomes.[61] Figure 1 shows that homeowners who file chapter 13 bankruptcies have fewer dollars to spend on expenses than most Americans. The average debtor in the Mortgage Study's sample had an annual income of $43,263. The median debtor earned $36,348.[62] In 2006, when the debtors in the study filed bankruptcy, the average American household earned $65,527.[63] The median household had an annual income of $48,451.[64] The data from the Mortgage Study show that chapter 13 homeowners (a subset of all bankruptcy debtors) earn incomes that are substantially lower than the general population of Americans.

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[60] David Himmelstein et al., *Did BAPCPA Fail? The Impact of the 2005 Amendments on Families in Trouble*, 82 AM. BANKR. L.J. (forthcoming 2008) (reporting financial characteristics of bankruptcy debtors from Consumer Bankruptcy Project studies in 1981, 1991, 2001, and 2007).

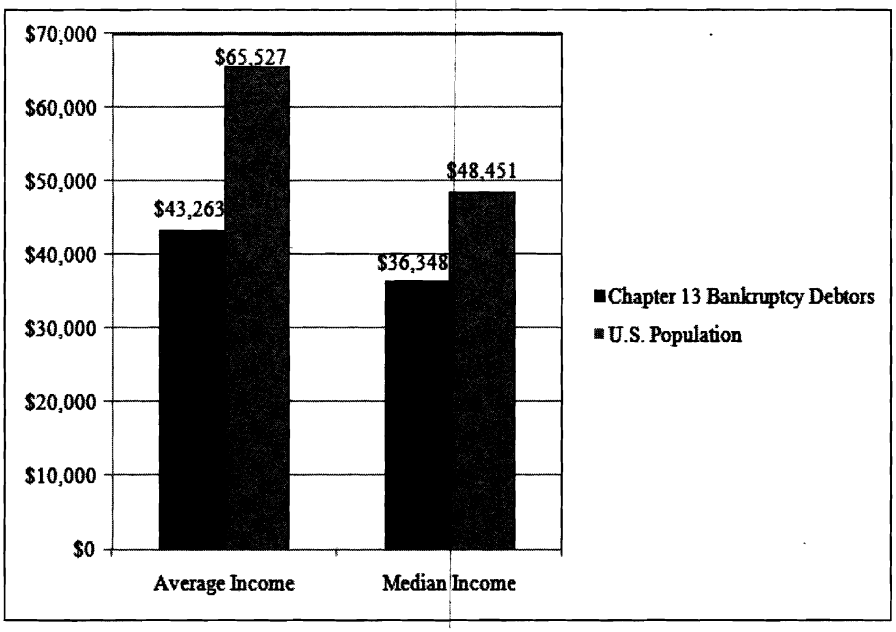
[61] *Id.* at figs. 1 & 2 (reporting incomes of bankruptcy debtors from Consumer Bankruptcy Project studies).

[62] These annual income figures were constructed by multiplying each debtor's monthly income at the time of their bankruptcy filing by twelve months.

[63] U.S. Census Bureau, United States—Selected Economic Characteristics 2006, http://factfinder.census.gov/servlet/ADPTable?-geo_id=01000US&-qr_name=ACS_2006_EST_G00_ DP3&-ds_name=ACS_2006_EST_G00_ (last visited Sept. 3, 2008).

[64] *Id.*

Figure 1: Income of Bankruptcy Debtors and U.S. Population, 2006[65]



This income disparity quite probably decreases the likelihood that families filing bankruptcy are able to comfortably exceed the 30% benchmark of affordability. The reality is that as income levels rise, people can afford to spend a greater percentage of their income on housing. This effect is the result of higher-earning households having enough absolute dollars left over for expenses such as food that are relatively consistent among families of all income levels. While the HUD standards apply to all people, regardless of whether they earn near the poverty line or in the top percentile of all Americans, those with relatively lower incomes will find it harder to maintain housing beyond the affordability benchmark.

As an alternate measure of whether bankruptcy debtors can afford their homes, this Article also analyzes the amount of income debtors have left after they have paid their housing costs. This amount, known as residual income, has consistently been identified as an additional, critical element in determining housing affordability.[66] Unlike the general HUD affordability metric, which is

[65] Sources: Mortgage Study (n=1713); U.S. CENSUS BUREAU, 2006 AMERICAN COMMUNITY SURVEY, SELECTED ECONOMIC CHARACTERISTICS: 2006 (2006),http://factfinder.census.gov/servlet/ADPTable?-geo_id=01000US&-qr_name=ACS_2006_EST_G00_DP3&-ds_name=ACS_2006_EST_G00_.

[66] *See, e.g.*, Steven C. Bourassa, *Measuring the Affordability of Home-Ownership*, 33 URB. STUD. 1867, 1868–69, 1876 n.4 (1996) (explaining one study's approach toward residual income and citing to others).

measured as a percentage of income, residual income is measured as an absolute dollar value. Thus, the residual income standard reflects the reality that some amount of certain baseline expenses (e.g., clothing, medicine or food) are necessarily incurred by all people, regardless of income level.

The Department of Health and Human Services ("HHS") publishes official federal poverty guidelines each year.[67] These guidelines set out, based on family size, the threshold income below which a family is deemed to live in poverty.[68] These guidelines can be used to determine whether families have a minimal level of residual income. Subtracting 30% for housing costs from these poverty guidelines gives the amount of money a poverty-level family would have available to spend on non-housing expenses. These non-housing poverty amounts can be tested against the incomes that bankrupt families have remaining and available after paying their housing costs. If a family that has an above-poverty income in fact has insufficient residual income to spend at the poverty level on non-housing goods, they are deemed to be living in "housing induced poverty."[69] Most families in bankruptcy are middle class and do not earn below the poverty line.[70] Thus, applying the HHS poverty guidelines to bankrupt families is a valuable measure of whether housing costs leave bankrupt families with insufficient residual income. At the heart of the concept of housing affordability is the idea that housing costs should not force families to live in poverty-level conditions.

IV. FINDINGS

In this section, we present four analyses of Mortgage Study data to measure the housing affordability of bankruptcy debtors. First, we determine the proportions of bankruptcy debtors that fit the three categories of HUD housing affordability: those living in affordable housing (less than 30% of income spent on housing), those living in unaffordable housing (30% to 50% of income spent on housing), and those living in severely unaffordable housing (more than 50% of

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[67] 42 U.S.C. § 9902(2) (2006).

[68] U.S. Dep't of Health and Human Servs., 2006 Federal Poverty Guidelines, http://aspe.hhs.gov/poverty/06poverty.shtml (last visited Sept. 3, 2008); *see, e.g.*, Annual Update on the HHS Poverty Guidelines, 70 Fed. Reg. 3848, 3848–49 (Jan. 24, 2006) (establishing 2006 poverty guidelines).

[69] *See* Nandinee K. Kutty, *A New Measure of Housing Affordability: Estimates and Analytical Results*, 16 HOUS. POL'Y DEBATE 113, 123 (2005) (defining "housing-induced poverty" and reporting that in 1999, 4.3% of American households not in poverty were living in housing-induced poverty, meaning that after paying housing costs they could not afford the "poverty basket of nonhousing goods"); *see also* PELLETIERE, *supra* note 52, at 13–14 (discussing the approach used by Kutty and other housing policy commentators).

[70] Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankrupt?*, 41 OSGOODE HALL L.J. 115, 117, 144 (2003) (concluding that families in bankruptcy are "overwhelmingly middle class" after analyzing education, occupation, homeownership and income levels of debtors).

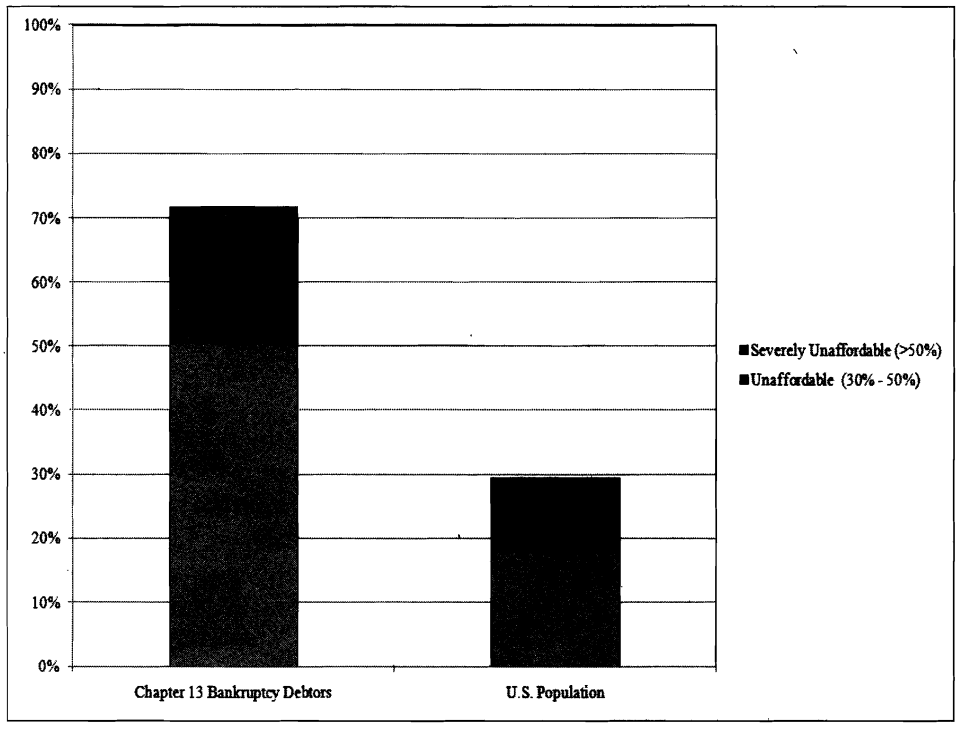
income spent on housing). We then compare the sample of bankruptcy debtors to all U.S. households, breaking down each group's housing costs using the same standards.[71] Second, we parse the housing affordability of bankruptcy debtors in more detail by presenting the distribution of housing affordability by income decile. Third, we offer a regional comparison of housing affordability among bankruptcy debtors. Fourth, we construct a residual income analysis to assess the amount of income, in dollars, that bankrupt households have left for other expenses after paying for housing. Collectively, these analyses are the first detailed examination of the housing costs of bankruptcy debtors who are trying to save their homes. These data offer insights on the challenges that face families that file chapter 13 bankruptcy to prevent foreclosure.

A. Housing Affordability of Bankrupt Homeowners Compared to All U.S. Homeowners

The key finding of this Article is grim. As measured by the HUD standard of housing cost as a percentage of income, fewer than three in ten homeowners in chapter 13 bankruptcy have affordable housing costs. The remaining seven in ten homeowners in bankruptcy face unaffordable housing costs. Compared to the general population of homeowners, families trying to save their homes in bankruptcy are much more likely to be living in unaffordable housing. Figure 2 reports the data on the housing affordability of chapter 13 bankruptcy debtors and compares these results with all American households.

[71] Data on all U.S. households is from the JCHS Report. *See* JCHS REPORT, *supra* note 56 and accompanying text.

Figure 2: Housing Costs as a Percentage of Income of Bankruptcy Debtors and U.S. Population[72]



Only about 28% of homeowners that file chapter 13 bankruptcy live in affordable housing. Even though homeowners very frequently seek bankruptcy relief to save their homes, only a minority of these households have mortgage and other housing costs that subsume 30% or less of their income. The majority of chapter 13 homeowners (over 71%) enter bankruptcy with current housing expenses that are unaffordable or severely unaffordable on their current incomes. These households may find it difficult to keep up with the combination of ongoing housing payments, other expenses allowed under their chapter 13 plans, and their plan payments to repay creditors or cure mortgage arrearages.[73]

[72] Source: Mortgage Study (n=1713); Joint Center for Housing Studies.

[73] Not all chapter 13 debtors are concerned with being current on plan payments until plan completion. Some debtors file chapter 13 intending to cure arrearages and then exit bankruptcy without receiving a discharge. Gordon Bermant & Jean Braucher, *Making Post-Petition Mortgage Payments Inside Chapter 13 Plans: Facts, Law, Policy*, 80 AM. BANKR. L.J. 261, 269 (2006). Also, some debtors are able to confirm plans that pay nothing to their unsecured creditors because after subtracting payments to secured creditors and allocating for expenses, there is no remaining disposable income to pay to unsecured creditors.

For over one-fifth of families (21.25%) trying to save their homes in bankruptcy, more than half of every dollar they earn as income goes to pay for housing costs. These families meet or exceed the HUD criteria for severely unaffordable housing. As a group, those in severely unaffordable housing spend an average of $1775 a month on housing costs and have an average income of just over $2800.[74] This translates into spending nearly two of every three dollars of income on housing, an inversion of HUD's affordability standard that suggests that families need two-thirds of their incomes to meet non-housing costs.

Chapter 13's requirement of living on a strict budget for three to five years will pose a formidable challenge to families in unaffordable or severely unaffordable housing. Assuming these families do not have large increases in income in the next few years, these families will have fixed or escalating housing expenses that limit their flexibility in coping with unexpected expenses. For these families, chapter 13 repayment may represent a lengthy sentence of continued financial hardship. Ultimately, many of these families may just be prolonging their financial distress before eventually losing their homes to foreclosure.[75]

Bankrupt families face steeper housing costs relative to their incomes than the general population of American homeowners. Figure 2 illustrates the disparity between the housing affordability of chapter 13 bankruptcy homeowners and that of all U.S. homeowners. The best available data indicate that about one in three (29.5%) of all Americans own homes that are either unaffordable or severely unaffordable.[76] This level of unaffordable housing is itself troubling for those concerned with the economics of American families.[77] However, bankruptcy debtors fare markedly worse by comparison. Families in bankruptcy live in housing that is either unaffordable or severely unaffordable at more than two and a half times the rate of the general population of homeowners. Unaffordable housing is a common problem for American families, but for bankruptcy debtors, it is the norm, rather than an exception.

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[74] The median debtor in severely unaffordable housing spent $1448 on housing costs, with a median income of $2449.

[75] *See* Sarah W. Carroll & Wenli Li, *The Homeownership Experience of Households in Bankruptcy* 3, 8, and tbl. 2 at 23 (Fed. Res. Bank of Philadelphia, Working Paper No. 08-14, 2008) (reporting that 27.9% of Chapter 13 debtors who owned homes and filed bankruptcy between August 1, 2001 and August 1, 2002 lost their homes to foreclosure by August 2007).

[76] *See* JCHS REPORT, *supra* note 56, at 40, tbl. A-7.

[77] As a matter of general housing policy there has long been recognition of the widespread unaffordability of housing, but these discussions focus only on the general population and not households in bankruptcy. *See, e.g.*, K.E. Hancock, *"Can Pay? Won't Pay?" or Economic Principles of "Affordability,"* 30 URB. STUD. 127, 128–29 (1993) (discussing problems with affordability generally without intimating that there may be special problems for households in insolvency proceedings).

The high homeownership costs of bankruptcy debtors have not been thoroughly documented until now.[78] Bankruptcy scholarship on the subject is sparse, and real estate finance scholars have largely ignored the frequency with which families facing foreclosure seek bankruptcy relief.[79] Yet, the large fraction of families who enter bankruptcy with unaffordable housing costs has serious implications for the bankruptcy system. The widespread problem of housing unaffordability may jeopardize the efficiency of the chapter 13 bankruptcy system. Prior research has shown that only about one in three chapter 13 bankruptcy cases ends in successful plan completion and a discharge.[80] A family in unaffordable housing may fail to make their ongoing mortgage payment, which typically results in the mortgage creditor filing a motion for relief from the bankruptcy stay to foreclose on the family's home. Alternatively, families may divert money earmarked for a chapter 13 plan payment to meet their ongoing housing obligations. Defaulting on a chapter 13 repayment plan usually will lead to the bankruptcy case being dismissed. When this occurs, the debtor does not receive a discharge of any of their pre-bankruptcy debts. The bankruptcy stay is terminated when the case is dismissed, leaving the mortgage creditor free to proceed with foreclosure if there are any unpaid arrearages on the mortgage.[81] Unaffordable housing costs may be an important, yet heretofore unrecognized, factor in determining a family's success in completing a chapter 13 bankruptcy plan.

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[78] While we measure home affordability as a ratio of income to housing costs, one obvious possibility is that bankrupt families purchased houses that were markedly more expensive than most Americans. Analyzing the relative home prices of bankrupt families is beyond the scope of this paper. Such an analysis would be complex, taking into account the year of home purchase and most importantly the variation in home values, preferably at a zip code level of comparison. As a very tentative baseline, we report that the average home value of debtors in the Mortgage Study sample was $ $147,929. The median debtor reported a home value of $111,200. These figures are derived from the debtors' bankruptcy schedules filed under penalty of perjury (on file with Katherine Porter).

[79] *See* Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk*, 2007 U. ILL. L. REV. 323, 325–26 (noting paucity of real estate finance scholarship that mentions bankruptcy).

[80] *See* Scott F. Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13*, 39 CREIGHTON L. REV. 473, 476 (2006) (finding an overall plan completion rate of 33%); Jean Braucher, *An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown*, 9 AM. BANKR. INST. L. REV. 557, 571 (2001) (stating the national chapter 13 plan completion rate is approximately 31%); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS 216–17 (1989) (reporting that only one-third of chapter 13 cases ended in discharge).

[81] Debtors must complete all payments under the plan before a court will enter a discharge of their pre-bankruptcy debts. 11 U.S.C. § 1328 (2006). If a debtor materially defaults with respect to a term of a confirmed plan, such as by failing to make plan payments, a court may dismiss the chapter 13 case. 11 U.S.C. § 1307(c)(6).

Families may file another bankruptcy if their initial filing did not result in a confirmed or completed plan. Repeat filings of bankruptcy among chapter 13 cases are fairly common. In the Mortgage Study sample, 30.88% of debtors reported a prior bankruptcy on their current bankruptcy petitions.[82] As measured by the proportion of filers in each group of affordability, the housing cost burdens of repeat bankruptcy debtors and first-time bankruptcy debtors appear to be similar.[83] In both groups, a majority of debtors have housing costs that require them to expend a high percentage of their incomes.[84]

These first data on housing affordability offer a new insight into the challenges that families face in trying to save their homes in chapter 13 bankruptcy. Further empirical work could usefully explore whether a relationship exists between housing affordability and plan confirmation or plan completion leading to discharge. Additionally, housing affordability may correlate with whether a family is ultimately able to retain their house, whether they remain in chapter 13 or exit the bankruptcy system. The first study of homeownership outcomes of a sample of chapter 13 debtors in Delaware reports that a "higher monthly mortgage payment relative to income increases the probability of foreclosure."[85] If confirmed in a larger study, such findings would have important implications for measuring the effectiveness of chapter 13 bankruptcy and also for assessing how to structure nonbankruptcy relief that seeks to help families address unaffordable housing costs.

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[82] Neither the date nor the chapter of the prior bankruptcy was coded as part of the Mortgage Study. Another study of chapter 13 cases found that over 50% of bankruptcy debtors had filed at least one prior bankruptcy. Norberg & Velkey, *supra* note 80, at 479 (studying 795 chapter 13 cases in seven judicial districts).

[83] A cross-tabulation did not reveal a statistically significant difference between the representation of repeat bankruptcy filers and first-time filers in the three categories of affordability. Pearson chi-square=2.654. p=.265 (on file with Katherine Porter).

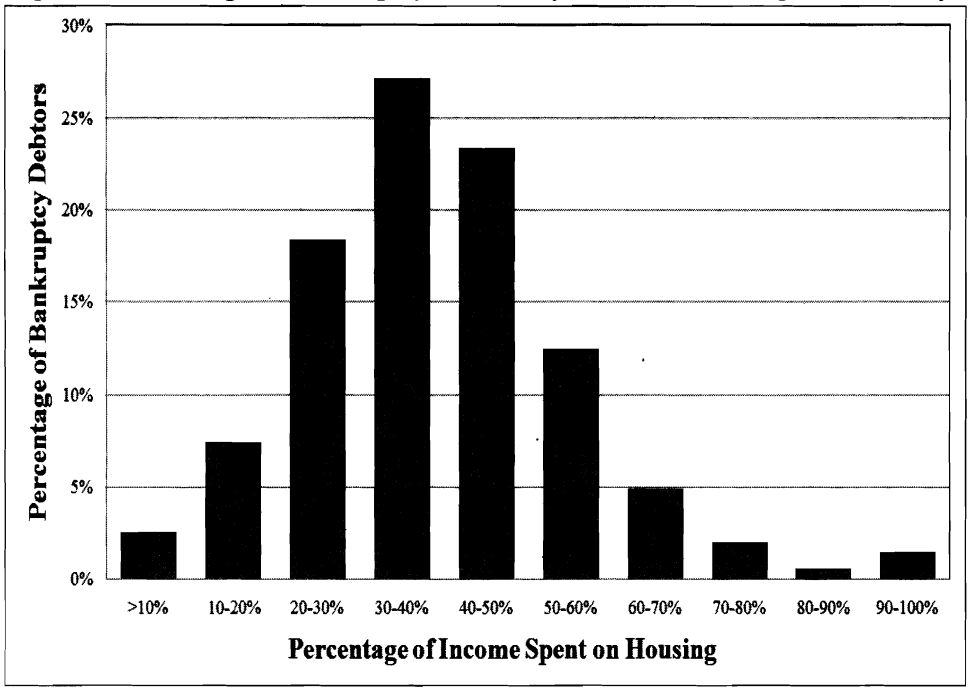
[84] *See* Mortgage Study (on file with Katherine Porter).

[85] Carroll & Li, *supra* note 75, at 15, tbl. 3 (finding that the ratio of monthly mortgage payment to income had a statistically significant effect in a regression model that attempted to measure whether bankruptcy cases ended in home loss from foreclosure).

B. Decile Breakdown of Chapter 13 Debtors' Housing Affordability

The percentage of debtors in the three categories of housing costs—affordable, unaffordable, and severely unaffordable—provides a basic picture of housing affordability. A decile analysis of debtor housing costs in relation to income provides a more detailed picture that reveals more about the distribution of bankrupt families across the affordability spectrum. Figure 3 illustrates the percentage of chapter 13 debtors at each decile of income required to pay their housing costs.

Figure 3: Percentage of Bankruptcy Debtors by Decile of Housing Affordability[86]



Three observations can be made based on this analysis of affordability. First, for the debtors at the lowest end of the affordability spectrum—those spending less than 10% of income on housing—it is unlikely the primary purpose of seeking bankruptcy protection was preventing foreclosure. Of these debtors, 83% had no mortgage, and the remainder had incomes far in excess of their housing costs.[87] These families may have chosen chapter 13 repayment bankruptcy instead of chapter 7 liquidation bankruptcy in part because they wanted to retain their homes, but imminent foreclosure or mortgage arrearage was unlikely the driving factor for their bankruptcy filings. For the one in ten debtors who spends less than 20% of

[86] Source: Mortgage Study, (n=1713).

[87] Mortgage Study data (on file with Katherine Porter.)

household income on housing costs, factors other than housing affordability seem likely to be the principal determinants of success in addressing financial problems in bankruptcy.

Second, at the other end of the affordability spectrum, some bankrupt families are spending 90 to 100% of their incomes on housing.[88] In this top decile, 72% of families had housing costs that exceeded their total incomes. At the time of their bankruptcy filings, these families did not have enough dollars to pay their mortgages and other housing costs, much less purchase subsistence goods such as food, medicine, and clothing. Homeowners filing these bankruptcy cases seem doomed to fail at retaining their homes through a bankruptcy repayment plan.

Despite circumstances that appear to make a repayment plan patently impossible, there are several possible explanations for these debtors' decisions to file chapter 13 bankruptcy.[89] Some debtors may be expecting a significant increase in current income immediately after their bankruptcy filings. As discussed in Part II, the affordability metrics are static, measuring housing costs only as of the date of bankruptcy filing and using the debtor's current actual income at the moment of the bankruptcy. Filing chapter 13 while spending 90% or more of one's income on housing costs may be rational for a debtor whose income on the day of bankruptcy filing is an unemployment check but who is starting a higher paying job in a few weeks.

The second plausible explanation for filing bankruptcy with unfeasible housing costs is that some families may be using bankruptcy to forestall pending foreclosures and gain time to cope with the eventual loss of their homes. Although there is a great deal of state-to-state variety in foreclosure processes, a common feature of nonjudicial foreclosure is its speed. For example, in Texas, as few as forty-one days can elapse between mortgage default and home sale.[90] The rapidity of the foreclosure process may not give families enough time to make a frank assessment of whether they can keep their homes. Alternatively, debtors may know the loss of their homes is imminent, but file bankruptcy to delay that eventual outcome. In such situations, the mortgage company is likely to obtain relief from the bankruptcy stay and be able to proceed with foreclosure. However, this process

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[88] Additional error checking was performed for all records reporting a housing cost to income ratio above 75% to ensure accuracy.

[89] An additional reason could be a debtor's bankruptcy attorney steering the debtor into chapter 13 rather than chapter 7, even though the family has no plausible chance of being able to use chapter 13's specialized home-saving provisions or of being able to confirm a repayment plan. Attorneys may prefer chapter 13 because such cases usually garner higher attorney's fees than chapter 7 and such fees may be paid over time, permitting some families to enter bankruptcy that could not afford to pay the lump-sum filing fee required to enter chapter 7 bankruptcy.

[90] *See, e.g.*, TEX. PROP. CODE ANN. § 51.002 (Vernon 2007) (allowing real property purchased under a deed of trust with a power of sale clause to be sold after debtor is given twenty days to cure the default on the obligation and the property is advertised for twenty one days).

can take a month or more, during which time the debtor can find new housing or may be able to sell the property themselves, which reduces the loss of equity that typically comes with a foreclosure sale.[91]

Another reason that families with extremely high housing costs in relation to income may file chapter 13 bankruptcy is that they are unable to accept that they cannot save their homes. Buying a home is the largest financial investment and greatest financial risk that most people ever make.[92] Losing a home can feel like a major personal failure and often will publicly expose the depth of a families' financial problems.[93] These factors, and others such as a desire to protect their children from changing homes and schools,[94] could cause people to try to save their homes even when a rational analysis would show that such efforts are doomed to failure.[95] The court record data do not reveal the extent to which these three explanations (anticipated increase in income, delay of foreclosure, or unwillingness to accept loss of a home) motivate bankruptcy filings by families whose housing costs are in the top deciles of the unaffordability distribution. While such families make up less than 5% of all debtors in the Mortgage Study sample, their presence in the chapter 13 bankruptcy system is curious given the apparent hopelessness of these debtors' prospects for saving their homes.

A third notable feature of the distribution is the number of chapter 13 debtors who collectively spend more than 50% of their incomes on housing costs. More than one in three of the families in this severely unaffordable category are spending 60% or more of their incomes on housing. That is, a sizeable component of the one in five debtors whose housing costs exceed 50% is not near the demarcation between unaffordable and severely unaffordable. As the distribution in the upper deciles in Figure 2 shows, nearly one in ten families spend 60% or more of its income on housing costs.

The hardship facing such families can be seen in an examination of the actual dollar amounts at issue. Among the top three deciles (families paying 70% or more of their incomes on housing), the average household had a monthly paycheck of

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[91] *See generally* NELSON & WHITMAN, *supra* note 36, at 796–98, 823–25 (discussing the effect of filing a chapter 13 bankruptcy on foreclosure proceedings).

[92] *See* Jacoby, *supra* note 79, at 324 & n.5 (citing a variety of studies to support this contention). A home is also most families' largest non-financial asset. WARREN & TYAGI, *supra* note 59, at 136.

[93] *See, e.g.*, Stephanie Armour, *Foreclosures Take Toll on Mental Health: Crisis Hotlines, Therapists See a Surge in Anxiety Over Housing*, USA TODAY, May 15, 2008, at A1 (telling the story of Raymond and Deanna Donaca, who are believed to have committed suicide after unsuccessfully attempting to prevent the foreclosure of their home).

[94] Eric S. Nguyen, *Parents in Financial Crisis: Fighting to Keep the Family Home*, 82 AM. BANKR. L.J. 229, 237–39 (2008) (presenting findings from empirical analysis showing that parents of school-age children are more likely to retain their homes during a period of financial distress than non-parents).

[95] Jacoby, *supra* note 79, at 334 (citing research on the psychological effects of home loss).

$2181. The same average household in these top three tiers then reportedly spends $1997 of those dollars on housing costs. The funds available for all other expenses after paying housing costs is less than $184 per month, an insufficient amount to even feed a single adult in America. The situation of the typical (median) household in the top three deciles of housing affordability is similarly bleak. This household has a monthly paycheck of $1887 and spends $1723 on housing costs. The depth of the plight of families in severely unaffordable housing and the small but steady distribution of families along the top half of the affordability spectrum suggest that many families may stand little chance of saving their homes under the current bankruptcy system that does not permit the adjustment of ongoing mortgage obligations.

C. Regional Breakdown of Chapter 13 Debtors' Housing Affordability

Across the United States, there is considerable variation in both the number of chapter 13 cases each year and the characteristics of the chapter 13 debtors.[96] The housing affordability of homeowners that file bankruptcy also varies. A regional analysis of the differences in affordability shows that some pockets of the bankruptcy system have particularly large numbers of debtors with unaffordable housing costs.

The Mortgage Study gathered data from bankruptcy cases filed in twenty-four states.[97] To analyze the geographic differences in housing affordability, the

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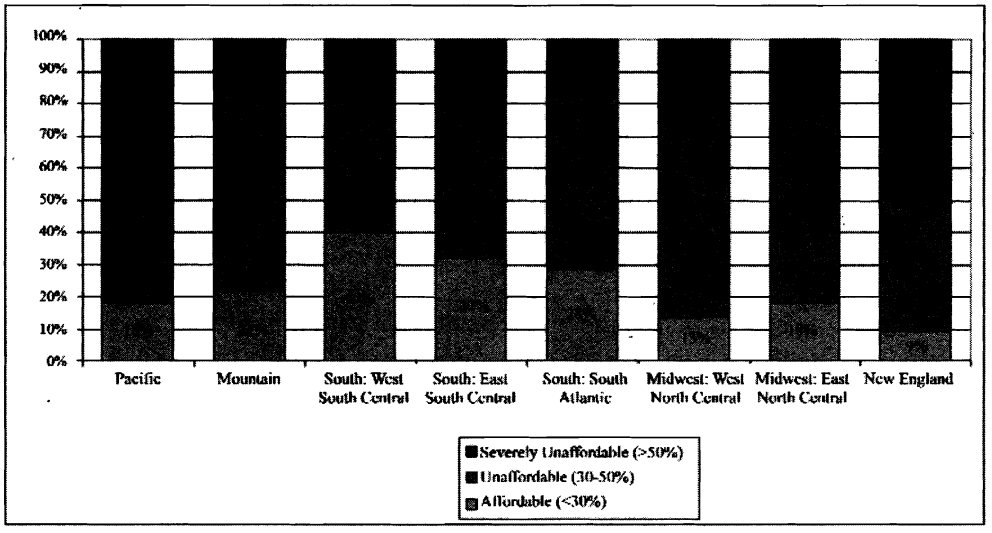
[96] *See* Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 580–82 (1993) (documenting variation in chapter 13 bankruptcy practice).

[97] Table 1 reports the percentage of cases in each region. Two factors explain the disparity in the number of cases per region. One, only non-judicial foreclosure states were selected, as explained in Part III, *supra*. Historical legal developments have resulted in many southern states having non-judicial foreclosure schemes, in part explaining the large percentage of southern states represented in the Study. *See generally* NELSON & WHITMAN, *supra* note 36, at 665 n.1 (listing the states that have adopted non-judicial foreclosure schemes). The other reason there is variation in the number of cases per region is the sample was weighted so districts with more chapter 13 cases had more cases in the sample. As noted in Part II, *supra*, there are large district-to-district variations in the number of chapter 13 cases filed and in the fraction of all bankruptcy filings that are made in chapter 13 rather than chapter 7.

regional divisions of the U.S. Census Bureau were used to categorize each state in the sample.[98] Figure 4 shows the percentage of chapter 13 debtors with affordable, unaffordable, and severely affordable housing costs in each census region.

Figure 4: Housing Affordability of Bankruptcy Debtors by Geographic Region[99]



Bankrupt families who live on either coast are much more likely to live in severely unaffordable housing than their counterparts in the middle of the country. Nearly half of the debtors in the study who reside in the New England or Pacific

Table 1: Percentage of Cases in Mortgage Study Sample by U.S. Census Region

Region	*Cases per Region*
New England	2.57%
Midwest: East North Central	8.76%
Midwest: West North Central	5.78%
South Atlantic	30.71%
East South Central	24.75%
West South Central	17.86%
Mountain	3.74%
Pacific	5.84%

No cases were sampled from the Middle Atlantic Division, consisting of New York, New Jersey, and Pennsylvania because these states require judicial foreclosure of residential mortgages, and the Mortgage Study drew its sample only from states that require judicial foreclosure of mortgages of a borrower's principal residence.

[98] *See generally* U.S. Census Bureau, Census Regions and Divisions of the United States, *available at* http://www.census.gov/geo/www/us_regdiv.pdf (last visited Sept. 3, 2008).

[99] Source: Mortgage Study (n=1713).

region (consisting of families in California)[100] enter bankruptcy with housing costs that exceed 50% of their incomes. The large number of families in severely unaffordable housing in these areas illustrates the affordability problem facing thousands of bankrupt families. These two regions have large populations and constitute a significant portion of all chapter 13 cases each year. Adding to the unaffordability problems in the New England and Pacific regions is the extremely low percentage of debtors in affordable housing. Fewer than one in ten families in New England files bankruptcy with housing costs that consume below 30% of their incomes. In the Pacific region, the ratio is less than two in ten families. In these jurisdictions, the vast majority of debtors will devote more than 30% of their incomes to pay ongoing housing costs, leaving very few dollars to use for current expenses, to repay unsecured creditors or to cure mortgage arrearages.

In contrast, families in the South appear to have much better prospects for saving their homes. Severely unaffordable housing is less common, and affordable housing is more common. The part of the country with the best affordability characteristics is the South: West South Central region,[101] where fully 40% of chapter 13 families spend 30% or less of their incomes on housing. These debtors may be better off than their coastal counterparts in trying to save their homes. However, even this group of bankruptcy debtors still faces much sharper housing costs relative to their incomes than the American population in general.[102]

While scholars have noted variation in chapter 13 plan completion rates among judicial districts and states,[103] none has considered how differences in housing affordability may explain such disparities. Additional empirical research could attempt to gauge the presence of such effects and determine if differences that were previously attributed to "local legal culture"[104] are at least to some degree driven by variation in housing affordability. Moderate housing costs give families more flexibility in their budgets to meet unexpected expenses or cope with drops in income. With less of their earnings committed to a mortgage and other nondiscretionary costs of homeownership such as utilities, these families may appear to have a reasonable chance at completing a chapter 13 plan and earning a discharge in bankruptcy.

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[100] The other states in the Pacific region (Alaska, Hawaii, Oregon, and Washington) were excluded from the Mortgage Study sample because these states all require judicial foreclosure of residential mortgages.

[101] In the Mortgage Study sample, the states in this region are Arkansas and Texas.

[102] *See supra* fig.2.

[103] *See supra* note 77 and accompanying text.

[104] *See* Braucher, *supra* note 96, at 580–82 (studying local legal culture and examining district-by-district variations in the attitudes and expectations of the repeat players in the bankruptcy system—judges, trustees, lawyers, and creditors); Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence From the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 804–05 (1994) (documenting persistence of inter-district variations within states).

Attorneys, trustees, and judges may share the sense, even if unarticulated hereto, that housing costs are an important factor in the viability of chapter 13 bankruptcy cases and may be more likely to promote chapter 13 bankruptcy as a viable option to halt foreclosure and save homes in parts of the country, such as the South, where housing affordability is less of a problem. Even if plan completion rates do not relate to housing affordability, more families may be attracted to chapter 13 and may file bankruptcy in an attempt to save their homes (even if ultimately such an attempt is unsuccessful) if their housing costs subsume less of their incomes. That is, debtors outside the New England and Pacific regions may believe that they stand a better chance of saving their homes in bankruptcy even if no such effect exists.

D. Residual Income Analysis

As the findings in the prior sections illustrate, unaffordable housing is a widespread problem in bankruptcy. Both across the country and across the distribution of bankruptcy debtors, many families are trying to save homes despite being saddled with housing costs that are unaffordable or severely unaffordable under the HUD standards. In this section of the Article, we use an alternate standard of housing affordability, residual income, to examine the hardships imposed by high housing costs. As explained in Part II, *supra*,[105] residual income measures the absolute dollars that a family has remaining to spend on all other expenses after paying its housing costs. The residual income figures used in this Article are the HHS federal poverty guidelines less a 30% allowance for housing.[106] For example, under the HHS guidelines, a family of four was deemed

[105] *See supra* notes 63–68 and accompanying text.

[106] Table 2 shows the annual and monthly income guidelines for the HHS poverty standards and the adjustments made to those standards to allow for housing costs that subsume 30% of income.

Table 2: Residual Income Criteria Using HHS Poverty Guidelines

Family Size	*Annual Income HHS 2006 Poverty Guidelines*	*Monthly Income HHS 2006 Poverty Guidelines*	*Monthly Poverty Threshold Residual Income (HHS minus 30%)*
1	$9,800.00	$816.67	$571.67
2	$13,200.00	$1,100.00	$770.00
3	$16,600.00	$1,383.33	$968.33
4	$20,000.00	$1,666.67	$1,166.67
5	$23,400.00	$1,950.00	$1,365.00
6	$26,800.00	$2,233.33	$1,563.33
7	$30,200.00	$2,516.67	$1,761.67
8	$33,600.00	$2,800.00	$1,960.00

to be living in poverty if its monthly income was less than $1667.[107] If a family spent 30% of that income on housing, it would have approximately $1166 remaining as residual income for other expenses. The federal government considers an income that exceeds that level to be necessary to avoid living in poverty.[108]

To analyze how many families had housing costs that left them with poverty-level incomes, we compared each family's income at the time of its bankruptcy filing, less its actual housing costs, with the HHS poverty benchmarks adjusted to permit a 30% housing expenditure. This measure reveals how many bankrupt families have residual incomes after housing costs that leave them with a poverty-level income to spend on non-housing expenses.

Because the HHS poverty threshold is very low, most bankrupt families had enough residual income to prevent them from being classified as living in housing-induced poverty. While much lower than the average for the American population, the incomes of most bankrupt families still exceed the poverty level. Only a small fraction (3.68%) of the families in chapter 13 bankruptcy could not afford the poverty-line level of goods and services because their incomes at the time of their bankruptcy filings were already below the poverty line.[109] A larger percentage of bankrupt homeowners failed to earn enough to meet the residual income standard. Approximately 8% (7.94%) of families in bankruptcy had incomes above the poverty line, but after paying housing costs, did not have sufficient remaining income to purchase the poverty-level basket of non-housing goods and services. These families' housing costs left them with a poverty or below-poverty subsistence lifestyle. In total, nearly one in eight (11.62%) bankrupt families did not have enough income or residual income at the time of their bankruptcies to avoid poverty.

While only a minority of bankrupt families suffer housing-induced poverty, its presence among chapter 13 debtors is testament to the strength of families' motivation to save their homes. These families are willing to suffer poverty to make a last effort to hang on to their homes. These families' bankruptcies reflect their hope that bankruptcy can help them succeed at homeownership despite housing costs that overwhelm their incomes.

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[107] *See supra* note 106.

[108] *Id.*

[109] Only 0.41% of families whose income put them below the poverty line had enough left after housing costs to afford more than the poverty-line level of goods and services.

V. IMPLICATIONS

The Mortgage Study data highlight the heavy burdens that families face in trying to save their homes in bankruptcy. More than 70% of bankrupt homeowners have housing costs that are unaffordable or severely unaffordable on their incomes. However, current bankruptcy law does not permit families to modify the terms of their home mortgages. To succeed in bankruptcy and save their homes from foreclosure, these families must achieve the difficult task of trying to stretch their incomes both to cure their mortgage arrearages and to make regular mortgage payments. Because the law does not permit courts to address ongoing problems with housing affordability, the anti-modification rule for home mortgages undermines bankruptcy's potential as a home-saving tool. Particularly for today's families, many of whom have adjustable-rate mortgages or other nontraditional loan products, bankruptcy may be an incomplete or inadequate solution to their home affordability problems. To help families sustain their attempt at homeownership and to reduce the harms of the foreclosure crisis, bankruptcy law should be amended to permit courts to modify the terms of the home mortgages of chapter 13 debtors to adjust housing costs to affordable levels. This section examines the antimodification rule in the context of the modern mortgage market and outlines the recent legislation introduced in Congress to empower bankruptcy courts to modify the terms of home mortgages. The section concludes by summarizing the procedural and administrative benefits of using the bankruptcy system to address the housing affordability problem that is a central feature of the foreclosure crisis.

A. The Antimodification Rule in Historical and Current Contexts

The Bankruptcy Code's anti-modification rule prohibits the modification of claims secured by real property that is the debtor's principal residence.[110] The rule has its origins in the Bankruptcy Reform Act of 1978,[111] which created the current Bankruptcy Code.[112] Under bankruptcy law prior to the 1978 Code, chapter XIII of the Bankruptcy Act of 1898, a repayment plan could not be approved unless every secured creditor that would receive payments in the plan consented to it.[113] Additionally, debtors under chapter XIII had no ability to address debts secured by their home residences because the term "claim" expressly excluded "claims

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[110] *See* 11 U.S.C. § 1322(b)(2) (2006).

[111] Pub. L. No. 95-598, 92 Stat. 2549 (1978).

[112] The Bankruptcy Code has been amended several times since its enactment in 1978, most recently by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.). Nevertheless, the Code's overall structure remains very similar to the statute as enacted in 1978.

[113] *See* Bankruptcy Act §§ 651–52, 11 U.S.C. §§ 1051–52 (1976).

secured by estates in real property or chattel real."[114] These limitations made bankruptcy relief of limited or no use for debtors who needed to deal with defaults on loans to mortgage creditors.

In enacting the Bankruptcy Code, Congress sought to improve the ability of bankruptcy debtors to repay their mortgage creditors and save their homes from foreclosures.[115] The new chapter 13 bankruptcy system was designed to provide individuals with the opportunity to repay debts, in full or in part, while retaining assets.[116] An innovation of chapter 13 was enabling the debtor to cure defaults on secured claims through the repayment of loan arrearages over time, even if the terms of the loan or nonbankruptcy law did not give the borrower this right.[117] The new chapter 13 also permitted debtors to modify the rights of holders of secured or unsecured claims.[118] This provision allowed bankruptcy courts to approve repayment plans that changed the prebankruptcy terms of a debt. However, the law contained an important exception to this modification rule for claims "secured only by a security interest in real property that is the debtor's principal residence . . . ."[119] This antimodification rule has endured as a feature of chapter 13 for three decades.

During the current foreclosure crisis, Congress has considered several proposals to eliminate the antimodification rule.[120] Proponents of such change assert that the existing law is a barrier to effective bankruptcy relief for homeowners that face foreclosure.[121] To evaluate the merits of such a change, the antimodification rule should be examined in its historical context. This background highlights the significant changes in the modern mortgage market and the circumstances of the current foreclosure crisis that may undermine the traditional justification for the rule.

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[114] *See* Bankruptcy Act § 606, 11 U.S.C. § 1006(1) (repealed in 1979).

[115] *See, e.g.*, 11 U.S.C. § 1322(b) (2006).

[116] *See* S. REP. NO. 95-989 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5927 ("Chapter 13 is designed to serve as a flexible vehicle for the repayment of part or all of the allowed claims of the debtor."); H.R. REP. NO. 95-595 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6079 ("The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets.").

[117] *See* 11 U.S.C. § 1322(b)(5).

[118] 11 U.S.C. § 1322(b)(2).

[119] *Id.*

[120] *See, e.g.*, Homeowner Assistance and Taxpayer Protection Act, S. 3690, 110th Cong. § 103 (2008); Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101 (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007); Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 101 (2008); HOMES Act, S. 2133, 110th Cong. § 2 (2007); HOMES Act, H.R. 3778, 110th Cong. § 202 (2007).

[121] CTR. FOR RESPONSIBLE LENDING, HR 3609—COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES 1 (2008), *available at* http://www.responsiblelending .org /pdfs/hr-3609-support-brief.pdf.

The legislative history with respect to the antimodification rule is sparse. Section 1322(b)(2) as enacted in 1978 appears to have been a compromise between competing versions of legislation. The Senate bill provided that debtors' plans could "modify the rights of holders of secured claims and holders of unsecured claims, except claims wholly secured by real estate mortgages . . . ."[122] The House version of § 1322(b)(2) took a broader approach and simply stated that the debtors' plan of reorganization could "modify the rights of holders of secured claims or of holders of unsecured claims."[123] Secured creditors objected strenuously to these changes. In particular, advocates for secured creditors argued that debtors should not be able to modify secured claims by reducing the monthly payment or by reducing the amount of the claim to the value of the collateral.[124] Creditors also suggested that a right to modification would discourage savings and loan associations from making home loans.[125] While it is impossible to pinpoint the exact reason why Congress excluded debtors' principal residences from the new rule that permitted the modification of claims, the solvency of the savings and loan industry probably was a pressing concern for Congress at the time that it was considering the adoption of the new Bankruptcy Code.

During the 1970s, savings and loan institutions dominated the residential mortgage market in the United States.[126] The secondary mortgage market, in which loans were originated and then sold, was in its nascence. The typical late 1970s home mortgage loan was a thirty-year mortgage with a fixed interest rate and equal monthly payments.[127] While bankruptcy reform was being debated in Congress, the savings and loan industry was being squeezed by a mismatch of high short-term interest rates paid on deposits and lower fixed interest rates and level payments being paid on residential mortgage loans.[128] Because the savings and

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[122] S. REP. NO. 95-989, at 141 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5927.

[123] H.R. REP. NO. 95-595, at 429 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6384.

[124] *See* Grubbs v. Houston First Am. Sav., 730 F.2d 236, 245 (5th Cir. 1984) (citing *Bankruptcy Reform Act, Pt.1: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on Judiciary*, 94th Cong. 124, 127–28, 130, 132–34, 137–38, 139, 141–42, 167–68, 176–80 (1975) (statements of Walter Vaughan on behalf of the American Bankers Association, and of Alvin Wiese, National Consumer Finance Association).

[125] *See id.* at 245 n.13 (citing *Bankruptcy Reform Act of 1978: Hearings Before the Subcomm. on Improvements of the Judicial Machinery of the S. Comm. on the Judiciary*, 95th Cong. 652–53, 703, 707, 714–15, 719–21 (1977) (statements of Alvin Wiese and John V. Kulik, National Association of Real Estate Investment Trusts) (discouraging savings and loan associations from making home loans).

[126] *See* Douglas B. Diamond, Jr. & Michael J. Lea, *Housing Finance in Developed Countries: An International Comparison of Efficiency: United States*, 3 J. OF HOUSING RES. 145, 145 (1990).

[127] *See id.* (explaining that deregulation of lending practices in the late 1970s and early 1980s gave rise to adjustable rate mortgages).

[128] *See id.*; *see also* Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. OF ECON. PERSP. 93, 98 (2005). Fixed-rate

loan institutions funded mortgage loans from federally-insured deposits, trouble for the industry created large potential liability for the federal government.[129] Congress may have created an exception for home mortgage loans from modification in chapter 13 bankruptcy as a concession to the financial challenges facing savings and loan institutions. The special treatment of home mortgages certainly reflects a political compromise, as well as the broader financial context, of the time in which chapter 13 was created.

However, the days in which the savings and loan industry dominated the residential mortgage market in the United States have long past.[130] Efforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by concerns about the growth of abusive lending practices in the late 1980s and early 1990s.[131] During this period, home mortgage lending was profoundly transformed. The secondary mortgage market expanded exponentially, and the securitization of residential mortgage loans became common.[132] Non-depository mortgage lenders, such as finance companies, became

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mortgages paid between 5 and 6% while yield on short term Treasury bills generally did not exceed 4%. *See id.* at 97. The year before the Bankruptcy Code was enacted, the yield rate on three-month Treasury bills had begun a steady climb from a 4–6% range in 1977 to 6–9% in 1978 and into double digit figures to reach an annualized high of over 14% in 1981. *See* Fed. Reserve, Statistical Release H15, 3-Month Auction High Bill Rate by Issue Date (June 30, 2000), http://www.federalreserve.gov/releases/H15/data/Annual/discontinued_AH_M3.txt.

[129] Barbara Randolph, *Special Report: The Savings and Loan Crisis*, TIME, Feb. 20, 1989, at 68 (estimating cost of bailing out struggling savings and loan institutions at $10 billion in 1983).

[130] *See* CYNTHIA ANGELL & CLARE D. ROWLEY, FED. DEPOSIT INS. CORP., FDIC, BREAKING NEW GROUND IN U.S. MORTGAGE LENDING, (2006), http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html (describing decline in savings and loan mortgage originations after regulatory reform).

[131] For example, in 1994 Congress passed the Home Ownership and Equity Protection Act (HOEPA), which created a special class of high cost home mortgages. Pub. L. No. 103-325, §§ 152(a)–(c), 154(a), 108 Stat. 2190, 2191, 2196 (1994). For this class of home loans, HOEPA banned certain practices such as balloon payments, negative amortization, and default interest rates. *See id.* § 152(d).

[132] In 1994, approximately $10 billion worth of home equity loans were securitized. DANIEL IMMERGLUCK & MARTI WILES, TWO STEPS BACK: THE DUAL MORTGAGE MARKET PREDATORY LENDING, AND THE UNDOING OF COMMUNITY DEVELOPMENT, WOODSTOCK INSTITUTE 12 (1999). In 2003, securitization in the subprime market had mushroomed to $203 billion. Derrick M. Land, *Residential Mortgage Securitization and Consumer Welfare*, 61 CONSUMER FIN. L.Q. REP. 208, 217 (2007); *see also* Lei Ding, Janneke Ratcliffe, Michael A. Stegman & Roberto G. Quercia, *Neighborhood Patterns of High-Cost Lending: The Case of Atlanta*, 17 J. AFFORDABLE HOUS. & CMTY. DEV. L. 193, 194 (2008) (reporting that growth in subprime securitization increased over forty-four-fold between 1994 and 2006, from $11 billion to more than $483 billion).

the primary originators of residential mortgage loans, and the subprime market that made mortgage loans on less robust underwriting standards began to flourish.[133]

Early subprime loans, often fixed-rate, were characterized by high interest rates and high points and fees at origination.[134] For example, in 1999 subprime mortgage loans had interest rates as high as 19.99%, with a median interest rate between 11% and 11.99%. By contrast, for the same year the interest rate for conventional prime thirty-year mortgages was 7.43%.[135] The higher interest rates on subprime loans translated into higher monthly mortgage payments for loans of identical amounts. These higher monthly payments increased the incidence of unaffordable housing costs while concomitantly expanding the homeownership markets to lower income families, many of whom had fewer assets and weaker credit histories than traditional homeowners.

Loan-to-value ratios for mortgages also increased during the 1990s as lenders aggressively marketed home equity loans and debt consolidation programs in which the debt on the home exceeded the value of the property.[136] Lenders knowingly allowed borrowers to leverage their homes beyond the current market value of those homes.[137] Rather than relying on equity in the collateral, lenders counted on borrowers' abilities to refinance as home prices appreciated and borrowers' fear of foreclosure to protect their interests.[138] These high loan-to-value lenders also "turned away from traditional mortgage lending standards in favor of underwriting standards similar to those used for unsecured (primarily, credit card) loan products."[139] Despite looser underwriting standards and subprime loan products that put families in home loans that greatly exceeded affordability criteria, lenders nevertheless had some modicum of protection from loss because

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[133] *See* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 527–28 (2000).

[134] *See id.* at 536–37 (providing data on interest rate range for subprime loans).

[135] *See id.*

[136] In 1998 the Office of Thrift Supervision issued a warning to lenders about the risks of high-loan to value ratios. OFFICE OF THRIFT SUPERVISION, DEPT. OF THE TREASURY, THRIFT BULLETIN TB 72 at 1–3 (1998) ("An increasing number of lenders are aggressively marketing home equity and debt consolidation loans, where the loans, combined with any senior mortgages, are near or exceed the value of the security property. . . . Until recently, the high LTV [loan to value] home mortgage market was dominated by mortgage brokers and other less regulated lenders. Consumer groups and some members of Congress have expressed concern over the growth of these loans, and the mass marketing tactics used by some lenders.").

[137] *See id.*

[138] *See* CHARLES CALOMIRIS & JOSEPH MASON, HIGH LOAN-TO-VALUE MORTGAGE LENDING: PROBLEM OR CURE? 11 (1999), *available at* http://www.aei.org/doclib/20021130_71252.pdf; Posting of Elizabeth Warren to Credit Slips: A Discussion on Credit and Bankruptcy, http://www.creditslips.org/creditslips/2007/11/hostage-value.html (Nov. 21, 2007, 16:54).

[139] CALOMIRIS & MASON, *supra* note 138, at 11.

bankruptcy's antimodification rule limited the attractiveness and scope of chapter 13 relief for homeowners in financial distress. During the late 1990s and early 2000s, however, lenders primarily escaped foreclosure because of borrowers' ability to refinance as home prices appreciated and because of strong demand for mortgage-backed securities that expanded underwriting standards. While Chapter 13 bankruptcy could do little to help homeowners during the early 2000s, the market largely provided a safety valve for families in unaffordable loans.

The more recent advent of "exotic" or "non-traditional" subprime loan products has exacerbated the extent to which the antimodification rule hampers bankruptcy's effectiveness as a home-saving tool. Many of these new mortgage products become severely unaffordable within a few years of origination by virtue of changing terms. The most dominant non-traditional mortgage product is the adjustable-rate mortgage (ARM). The most common product, the 2/28 ARM, is characterized by a fixed rate for the first two years, followed by an adjustment every six months thereafter. Often these loans are structured with an initial "teaser" or discounted rate. After the two-year fixed period for these loans expires, the interest rate, and accordingly the borrower's payments, can increase significantly.[140] To determine whether the borrower had the ability to make payments on the 2/28 ARM loan, lenders typically considered only whether the monthly payment based on the teaser rate would be affordable.[141] The expiration of the fixed-rate period brings with it a sharp increase in monthly payment, often referred to as "payment shock."[142] By mid-2006, hybrid ARMs such as 2/28s or 3/27s, made up 81% of the securitized subprime market.[143]

Similarly, borrowers with option ARM loans are also subject to payment shock. With an option ARM, borrowers have the "option" of making a minimum payment, an interest-only payment, or a fully amortized payment. For most borrowers who took out such loans, the minimum payment is the only affordable payment on their incomes. However, this payment is insufficient to cover accrued interest on the loan, which results in any unpaid interest being added to the principal balance. As a result, the loan balance increases with time (i.e., negatively amortizes). Despite making payments over a period of months or years, the

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[140] Typically, there is a cap on the increase in the first adjustment of 2% and caps on subsequent adjustments of 1%.

[141] Beverlea (Suzy) Gardner & Dennis C. Ankenbrand, *Hybrid ARMs: Assessing the Risks, Managing the Fallout*, SUPERVISORY INSIGHTS, Summer 2008, at 14, 17, *available at* http://www.fdic.gov/regulations/ examinations/supervisory/insights/sisum08/sisum08.pdf (listing underwriting weakness with hybrid ARM originations from 2004 until 2007, including qualifying buyers based on introductory payment); Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007) ("The Agencies are concerned that many subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment.").

[142] Gardner & Ankenbrand, *supra* note 141, at 17.

[143] DERIVATIVE FITCH, STRUCTURED FINANCE: U.S. SUBPRIME RMBS IN STRUCTURED FINANCE CDOS 2 (2006).

homeowner will find herself owing an increasing amount of mortgage debt, rather than building equity. Almost all option ARMs have trigger points that cause the loans to recast so that they will fully amortize over the remaining duration of the loan terms. Most option ARMs will recast five years from origination (a time trigger) or if the loan balance exceeds 110% of the original loan amount (a loan balance trigger.)[144] Like the expiration of the teaser rate on a 2/28 ARM, the recasting of an option ARM leads to a very large increase in the monthly payment amount for most borrowers.

Additionally, weaker underwriting standards have led to the rapid growth of no documentation or low documentation loans that require no or limited verification of ability to repay the loan.[145] As a result of these changes in the modern mortgage market, traditional tools for preventing foreclosures such as nonbankruptcy forbearance agreements or chapter 13 bankruptcy repayment plans are much less effective than in the past. The bankruptcy right to repay mortgage arrearages over time does not address the ongoing increase in mortgage payments that millions of homeowners face with the nontraditional loan products originated in the last decade.

The antimodification rule enacted in 1978, at least in part to protect the savings and loan industry, has not been amended in thirty years, despite these vast changes in the residential mortgage market. The dramatic growth of high interest rate loans and nontraditional loan products has translated into far more unaffordable home loans. Particularly as the new products age, the changes in these loan terms have created sharp upticks in mortgage payments that cannot be met by families whose incomes rarely have experienced similar, dramatic increases. Unaffordable housing costs are a widespread feature of today's American homeownership experience and are the driving factor of the foreclosure crisis. Absent the ability to address exploding interest rates, negatively amortizing loans, and over-leveraged homes, bankruptcy will be an incomplete or inadequate solution to the current problem of homeownership affordability.

B. Proposals to Permit Modifying Home Mortgages in Bankruptcy

In the wake of rapidly rising foreclosure rates in late 2007, policymakers struggled to formulate solutions. A popular proposal was to repeal the antimodification provision of the Bankruptcy Code to improve bankruptcy relief as a means to help families struggling with unaffordable home loans. Current law was criticized as a major roadblock to keeping families in their homes. Several bills

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[144] If the borrower makes only minimum payments every month, the loan balance trigger will usually be reached before the time trigger.

[145] By 2006 no or low documentation loans made up 49% of mortgage loans originated in the United States. *See* CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 38 (2007), *available at* http://billcara.com/CS%20Mar%20 12%202007%20Mortgage%20and%20Housing.pdf.

were introduced in Congress to allow bankruptcy courts to modify the terms of chapter 13 debtors' residential mortgage loans.[146] Consumer advocates backed the legislation, citing a continued escalation in the number of foreclosures and describing the harms that families and communities suffer from foreclosure.[147] The lending industry mounted a strong and continuous opposition to the bills, relying mainly on their predictions that the modification of home mortgages in bankruptcy would cause mortgage rates to rise 1.5% to 2% on future loans.[148] The industry's figures were heavily criticized for being unsupported by empirical analysis,[149] but the industry generated enough concern over mortgage market liquidity that, as of November 2008, none of the bills has garnered sufficient support to succeed in the Senate or the House of Representatives. Notwithstanding concerns about political feasibility, an examination of the proposals to eliminate the antimodification rule illustrates how changing bankruptcy law could help families in unaffordable home loans save their homes and could reduce the incidence of foreclosure.

1. Interest Rate Freezes or Reductions

Each of the proposed bills to permit the modification of mortgage loans in bankruptcy would provide, to some extent, for freezes or reductions of interest rates on mortgage loans. For example, S. 2136 would allow for payment of the mortgage at a "fixed annual percentage rate," even if the actual terms of the promissory note obligate the borrower to pay under an adjustable rate.[150] A bankruptcy court would have the authority to recalibrate the interest rate to be "equal to the most recently published annual yield on conventional mortgages published by the Board of Governors of the Federal Reserve System . . . plus a reasonable premium for risk."[151] If enacted into law, this provision would permit a

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[146] *See supra* note 120.

[147] CTR. FOR RESPONSIBLE LENDING, H.R. 3609: COMPROMISE BILL PERMITTING COURT-SUPERVISED LOAN MODIFICATIONS WOULD SAVE 600,000 HOMES (2008), *available at* http://www.responsiblelending.org/pdfs/hr-3609-support-brief.pdf.

[148] *Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?—Part II: Hearing Before Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. at 3 (2007) [hereinafter Kittle Testimony] (statement of David Kittle, Mortgage Bankers Association), *available at* http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/StatementofDavidKittle.pdf; *see also* Mortgage Bankers Association, Press Release, "Stop the Cram Down Resource Center" Puts a Price Tag on Bankruptcy Reform, Jan. 15, 2007, *available at* http://www.mortgagebankers.org/NewsandMedia/ PressCenter/59343.htm.

[149] Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets* (Georgetown Public Law and Legal Theory Working Paper Series, Research Paper No. 1087816, 2008), *available at* http://ssrn.com/abstract=1087816.

[150] S. 2136, 110th Cong. § 101 (2007).

[151] S. 2136, 110th Cong. § 101(a)(3) (2007); *see also* S. 2636, 110th Cong. § 412 (2008); H.R. 3609, 110th Cong. § 4 (2007); *cf. Till v. SCS Credit Corp.*, 541 U.S. 465

homeowner to file a Chapter 13 bankruptcy case as a tool to stop adjustments on an exploding ARM, convert an ARM into a fixed-rate loan, or reduce the interest rate on a high-cost subprime loan.

The beneficial effect of the ability to modify interest rates is illustrated by reexamining the situation of the Minnesota family in the Mortgage Study that filed bankruptcy.[152] Recall that the family had an adjustable-rate mortgage with an initial teaser interest rate of 7.99% and a monthly payment of $1781.[153] However, after the first two years of the loan the interest rate began to quickly adjust upward so that within seven months the interest rate had reached 10.99% and the payment had climbed to $2780.[154] If the interest rate freeze or reduction provision had been available when this family filed bankruptcy in April 2006, the debtors' chapter 13 plan could have fixed the interest on their mortgage at 6.51%[155] plus a premium for risk of an additional 1 to 2%.[156] The resulting postmodification interest rate range of 7.51% to 8.51% would be very close to the initial rate on the loan of 7.99%, allowing this family to continue with the affordable payment that it had managed to pay before the initial rate adjusted. Given the prevalence of ARM loans and high-rate subprime fixed loans among the loans currently in foreclosure,[157] the ability to adjust or freeze an interest rate likely would give hundreds of thousands of families a fighting chance to prevent foreclosure and save their homes.

2. Reduction of Principal Amount (Strip Down)

"Stripping down" or bifurcating a secured creditor's claim means to divide the claim into two parts: the secured portion, which is equal to the value of the collateral, and the unsecured portion, which is any amount of the debt that exceeds the value of the collateral.[158] This process has the effect of writing down the principal balance on a loan that is secured by the mortgage to the value of the

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(2004) (establishing interest rate for secured claims subject to modification, i.e., those not secured by a debtor's principal residence, at prime rate plus premium for risk).

[152] *See supra* note 27 and accompanying text.

[153] *See id.*

[154] *See id.*

[155] *See* Fed. Reserve Bd., Federal Reserve Statistical Release H.15—Historical Data, http://www.federalreserve.gov/releases/h15/data.htm (last visited Sept. 3, 2008).

[156] Although the starting point for an interest rate that uses conventional mortgage rates as a base would be different than for other secured claims, which use the prime rate as a base, a bankruptcy court could be expected to apply the same set of factors delineated in the Supreme Court's decision in *Till v. SCS Credit Corp.*, 541 U.S. 465, 478–79 (2004), for modifying non-mortgage claims in determining the appropriate risk premium for mortgage loans. According to the Supreme Court, the risk factors include "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Id.* at 479.

[157] *See* CTR. FOR RESPONSIBLE LENDING, *supra* note 25, at 1–3.

[158] 11 U.S.C. § 506(a) (2006).

property as of the time of the bankruptcy. Section 506(a), which authorizes such bifurcation, provides that a creditor's claim "is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property." The interaction between § 506(a) and the antimodification rule of § 1322(b)(2) was once the subject of much debate. The Circuit Courts of Appeals were divided on whether mortgage claims could be stripped down.[159] In *Nobleman v. American Savings Bank*, the Supreme Court held that the antimodification rule prohibited the strip down of claims secured by mortgages on the debtor's principal residence.[160]

Each of the proposed bills would have changed the strip down rules in certain circumstances. A chapter 13 debtor could reduce the amount of outstanding principal on the mortgage to the value of the collateral at the time of the bankruptcy. The secured claim would be based on this new lower amount, reducing the payments that a family would have to make to retain its home. A Mortgage Study case from Texas illustrates how strip down would improve home affordability.[161] In this case, the mortgage creditor filed a claim asserting that it was owed $162,270 in total debt. Its proof of claim accepted the debtor's valuation of the market value of the property as $120,200. Assuming this is an accurate valuation, if the claim were subject to strip down, the secured portion of the claim would be limited to $120,200, the value of the home. The remaining debt of approximately $42,000 would become additional unsecured debt owed by the bankruptcy debtor. For the unsecured portion of its claim, the mortgage company would receive a pro rata distribution of the debtor's payments of his disposable income. The mortgage payment necessary to retain the property would be recalculated based on a principal amount of $120,200, which would be less than the amount of the note's principal at origination, which was $125,115. The effect of the strip down would be to reduce the ongoing monthly mortgage payment and improve the debtor's chances of keeping the house by making the mortgage payments more affordable.

3. Reamortization of Loan Term

Under current law, a secured claim that is subject to strip down must be paid in full within the three- to five-year duration of a chapter 13 plan.[162] While this feat often can be accomplished for claims secured by personal property, few debtors are able to pay the entire amount of their mortgages in that short time period. The proposed bills to repeal the antimodification rule all would permit a bankruptcy

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[159] *See* Bellamy v. Fed. Home Loan Mortgage Corp. (*In re* Bellamy), 962 F.2d 176 (2d Cir. 1992); Eastland Mortgage Co. v. Hart (*In re* Hart), 923 F.2d 1410 (10th Cir. 1991); Wilson v. Commonwealth Mortgage Corp., 895 F.2d 123 (3d Cir. 1990); Hougland v. Lomas & Nettleton Co. (*In re* Hougland), 886 F.2d 1182 (9th Cir. 1989).

[160] 508 U.S. 324 (1993).

[161] This example is from Mortgage Study case ND TX 43 (on file with Katherine Porter).

[162] *See* 11 U.S.C. § 1322(d).

court to authorize payments on a home mortgage to be reamortized over a period extending beyond the three- to five-year term of the chapter 13 plan.[163] By combining an extension of the loan term with an interest rate adjustment or a reduction in principal, many families would be able to cure their arrearages in chapter 13 bankruptcy and avoid foreclosure.

For example, the previously-discussed debtor[164] from the Mortgage Study with a monthly payment nearly equal to her gross monthly income could have used the reamortization and interest rate reduction provisions to create a more affordable, fully amortizing loan. This debtor faced a severely unaffordable monthly mortgage payment even after contributions from a family member. The debtor's original loan had an interest rate of 11% and was a six-year balloon note. Under most bills that would permit the modification of mortgage loans in bankruptcy, the debtor could have reduced the interest rate to 6.51% plus a risk premium and reamortized the loan over a thirty-year period, reduced by the period the loan had been outstanding. Because the loan was originated in September 2005, just seven months before the bankruptcy filing, the new loan term could have been up to twenty-nine years. With a principal balance on the loan of $269,000 at the time of the bankruptcy, the adjusted monthly payment amount for that twenty-nine-year term would have been approximately $1900 after reamortization.[165] While this payment would still be severely unaffordable by HUD standards because it would require the debtor and her household to spend 51% of their combined gross income on the mortgage payment, the reduction is dramatic from the prior situation, in which the family spent more than 60% of its income. Importantly, the modification would also put the debtor on the path to true homeownership because it would make the loan fully amortize. Rather than relying on precarious housing markets to build any equity while the debtor made only interest payments, the debtor could commit fewer dollars and improve her chances of achieving sustainable homeownership.

C. Benefits of Bankruptcy as a Foreclosure Prevention System

The affordability data offer support for the substantive benefits of permitting bankruptcy courts to modify the terms of mortgage loans of chapter 13 debtors. Amending bankruptcy law to improve its efficacy to help families save their homes is also a superior policy response because it would be an administratively and procedurally efficient solution to the foreclosure crisis. Compared to the existing and proposed schemes of foreclosure aid, a bankruptcy-based solution to the problem of housing unaffordability offers the greatest potential of immediate and lasting relief to homeowners that are committed to saving their homes. This section

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[163] *See supra* note 120.

[164] *See supra* note 23 and accompanying text.

[165] This calculation assumes that the court fixed the interest rate at 7.5%, reflecting a risk premium of 1% over the 6.51% rate on conventional prime mortgages in April 2006.

articulates four procedural benefits of allowing bankruptcy courts to modify home mortgages that complement the substantive benefit of addressing the unaffordability problem that threatens families' homeownership.

The first benefit of permitting bankruptcy-based mortgage loan modifications is that the bankruptcy system already contains screening mechanisms to ensure that only needy families are helped. Any proposal for relief will help only some subset of Americans with mortgages. Requiring a bankruptcy filing to receive a loan modification would subject families to the built-in checks in existing bankruptcy law to gauge their need for relief. In 2005, Congress amended the Bankruptcy Code to require that consumers pass a "means test," a stringent mechanical standard to ensure that consumers pay their debts if they can afford to do so.[166] "Good faith" on the part of a debtor is also an explicit statutory requirement for chapter 13 bankruptcy relief,[167] and an experienced cadre of bankruptcy judges is already familiar with this standard. Because all individuals with consumer debt are subject to these screening criteria, there is no need to develop separate standards to determine which homeowners should be eligible for a loan modification. Unlike a program of voluntary modifications, bankruptcy offers uniform federal standards to ensure that only needy families get help. Bankruptcy also requires a debtor to suffer real burdens that prospectively would deter consumers who are looking for a better deal but who could pay according to the existing terms of their mortgage loans. Families that wanted to modify a loan in bankruptcy would incur expenses such as attorney's fees and filing fees and would have to contend with the harm to their credit scores and the stigma of a public bankruptcy filing.[168]

The second benefit of modifying loans in bankruptcy administrative efficiency. As a foreclosure rescue system, a bankruptcy solution would not require any new bureaucracy or the expansion of any government agencies. The costs of such relief to the general public would be nonexistent or negligible. The bankruptcy system is self-financed from fees paid by debtors.[169] Expanding bankruptcy relief to allow the modification of mortgages does not require taxpayer dollars to be spent on creating and implementing a relief system from scratch. Instead, such a solution uses the existing bankruptcy architecture and administration, including judges, the U.S. Trustee, and panel trustees. These personnel are experienced in adjudicating disputes between consumers and creditors, reducing time that would be needed to hire, train, and supervise staff. Compared to a nebulous system of aid such as a foreclosure rescue fund, a

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[166] 11 U.S.C. §§ 707(b)(2), 1325(b)(3); *see* HENRY J. SOMMER, COLLIER CONSUMER BANKRUPTCY PRACTICE GUIDE ¶ 23.02(3)(b) (2006).

[167] 11 U.S.C. § 1325(a)(3) (stating that plan must be proposed in good faith).

[168] *See* Jacoby, *supra* note 79, at 330–31 (detailing costs of chapter 13).

[169] U.S. DEP'T OF JUSTICE, U.S. TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS: FISCAL YEAR 2005 10, *available at* http://www.usdoj.gov/ust/eo/public_affairs/ annualreport/docs/ar2005.pdf (last visited Sept. 3, 2008).

bankruptcy modification solution would not waste time in trying to set eligibility criteria or implement a program of relief.

A third advantage of expanding bankruptcy relief to help homeowners is the way in which a bankruptcy-based system would override mortgage servicers' disincentives to modify loans. Despite contentious opposition to proposals to modify mortgages in bankruptcy, the mortgage industry seems to agree with consumer advocates that homeowners and servicers are not communicating successfully (or at all) about the possibility of voluntary loan modifications. The Mortgage Bankers Association admits that neither lenders nor servicers have any communication with 50% of homeowners in foreclosure.[170] Consumers complain about difficulty in contacting their mortgage servicers, in identifying agents with authority to offer modifications, and in persuading servicers that modification (rather than a repayment or forbearance plan) is the relief that they need to avoid foreclosure.[171] Additionally, mortgage servicers have struggled to provide the kind of high-quality and labor-intensive customer service necessary to do loan modifications. Indeed, servicers have financial incentives to impose fees and charges on struggling homeowners to overcome the costs of servicing loans in default,[172] even if such servicing practices create roadblocks to homeowners trying to cure their defaults and save their homes. If mortgages could be modified in bankruptcy, consumers could affirmatively initiate the modification process by filing a chapter 13 bankruptcy. From this signal, the mortgage company would know that a family is committed to trying to save its home. Instead of missed opportunities to communicate, consumers and servicers would negotiate over possible modification within the structured framework of a bankruptcy case. Mortgage servicers' incentives to pile on default fees and their ability to unreasonably refuse to do loan modifications would be checked by the bankruptcy courts, acting pursuant to a statutory scheme of permissible modifications.

A final benefit of bankruptcy modification is its relative invulnerability to legal attacks. This benefit would protect mortgage creditors or servicers that grant modifications and would give the government a strong argument that its system of aid to homeowners was constitutionally permissible. Today, many residential mortgages are securitized. Mortgage servicers and trustees who are responsible for

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[170] Kittle Testimony, *supra* note 148, at 10 (admitting that servicer had no contact with 50% of homeowners whose mortgages were foreclosed); *see also* Brinkmann, *supra* note 2, at 14 tbl. 1 (reporting that 23% of homeowners did not respond to servicer communication).

[171] *See Possible Responses to Rising Mortgage Foreclosures: Hearing Before the H. Comm. on Financial Servs.*, 110th Cong. 9–14 (2007) (statement of Sheila Bair, Chairman, FDIC), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbair041707.pdf; STATE FORECLOSURE PREVENTION WORKING GROUP, ANALYSIS OF SUBPRIME MORTGAGE SERVICING PERFORMANCE: DATA REPORT NO. 1, at 6 (2008); Kurt Eggert, Comment: *What Prevents Loan Modifications?*, 18 HOUS. POL'Y DEBATE 279 (2007).

[172] *See* Porter, *supra* note 28, at 5–6 (describing how mortgage servicers earn revenue from default charges).

such securitized mortgages are obliged to follow the terms of pooling and servicing agreements and other contracts with investors who own the mortgage-backed securities. While regulators have tried to ease concerns about liability to servicers or trustees that could arise from modifying mortgages, the potential for liability (or at least lawsuits that must be defended) may lead to reluctance to engage in widespread loan modifications. An additional concern is that investors may file lawsuits against trustees or against other groups of investors if loan modifications are made that do not benefit them. Because different tranches of investors face different losses depending on the nature of their investments, the investors' interests are not uniformly aligned to modify mortgages.[173] Loan modifications pursuant to bankruptcy law would not be voluntary and would protect servicers and trustees from allegations that they acted unfairly or unreasonably in modifying mortgages. Congress would also have the protection of its constitutional authority to enact uniform bankruptcy laws to defend a bankruptcy-based solution to the foreclosure crisis.[174] Without this basis, the government may be vulnerable to constitutional challenges if it engages in efforts to force mortgage holders to modify their private contracts with homeowners. A bankruptcy modification solution would greatly reduce the potential of legal liability for modifying loans.

Any effective policy response to the foreclosure crisis will have to grapple with the problem of unaffordable loan terms. Modifying the mortgage loans of bankruptcy debtors would not only provide the needed affordability relief to help families succeed at homeownership, such a solution would also offer administrative advantages that other proposed responses to the foreclosure crisis cannot match. This combination of substantive and procedural benefits may make bankruptcy-based loan modification the most conservative approach that would also provide a viable means to help reduce the number of foreclosures.

VI. CONCLUSION

The record number of foreclosures in 2007 and 2008 is threatening homeownership as a fundamental institution of American middle-class life. The inability of millions of families to afford the strain housing costs place on their incomes is a driving factor in the foreclosure crisis. While chapter 13 bankruptcy offers families the opportunity to repay arrearages on their mortgage loans in a repayment plan, this relief does not address the ongoing struggle with loan affordability that resulted from the loose underwriting standards and non-traditional loan products that characterized the mortgage market in the last several years. The Mortgage Study data show that even in 2006, before the height of the current foreclosure crisis, more than seven in ten homeowners in bankruptcy had mortgage payments and related housing costs that exceeded income affordability standards. Repealing the prohibition on modifying home mortgage loans in

[173] Eggert, *supra* note 171, at 290.
[174] U.S. CONST. art. I, § 8, cl. 4.

bankruptcy would improve the effectiveness of chapter 13 bankruptcy as a home-saving device and reduce the economic and policy consequences of the foreclosure crisis by giving millions of families a chance to save their homes.

FIGHT BLIGHT: CITIES SUE TO HOLD LENDERS RESPONSIBLE FOR THE RISE IN FORECLOSURES AND ABANDONED PROPERTIES

Creola Johnson*

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I. INTRODUCTION

In the aftermath of the subprime mortgage meltdown,[1] Americans have been forced to change the way they view homeownership. Once considered to be the average person's most valuable asset, for many, homes have transformed into a burdensome liability.[2] Spurred by the expansive securitization of the residential mortgage industry, many subprime mortgage lenders dismissed traditional lending standards and issued what some call "liar," "naked," or "no doc" loans, which were loans approved by lenders based on falsified or little-to-no documentation about the borrower's income or assets.[3] Some of these loans were given to borrowers with poor credit histories and in amounts exceeding their ability to repay.[4] These mortgage loans often had adjustable interest rates, which would then "reset" (i.e., increase) after two or three years, resulting in monthly payments greater than what the borrowers could afford.[5]

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[1] *See, e.g.*, KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES, DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET § 9:1, at 435–36 (2007–2008 ed.).

[2] *See* John Leland, *Facing Default, Some Abandon Homes to Banks*, N.Y. TIMES, Feb. 29, 2008, at A1.

[3] *See* Ann M. Burkhart, *Real Estate Practice in the Twenty-first Century*, 72 MO. L. REV. 1031, 1045–46 (2007) (stating that liar loans are loans where "the lender required little or no documentary evidence of the borrower's income" and that roughly 45% of subprime loans were liar loans); Chris Isidore, *"Liar Loans:" Mortgage Woes Beyond Subprime*, CNNMONEY.COM, Mar. 19, 2007, http://money.cnn.com/2007/03/19/news/economy/next_subprime/index.htm. ("Alt. A refers to people with better credit scores (A-rated) who borrow with little or no verification of income, or so-called alternative documentation. But some people in the industry call them 'stated income' loans, or worse, 'liar loans.'").

[4] *The Foreclosure Epidemic: The Costs to Families and Communities of the Predictable Mortgage Meltdown: Interview with Allen Fishbein*, MULTINATIONAL MONITOR, May 1, 2007, at 30 (detailing how the profitability of asset-backed securities pushed banks to greatly relax traditional lending standards in order to generate more mortgages).

[5] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2062 (2007) (stating that lenders started offering adjustable rate mortgages to evade state consumer protection laws regulating high cost loans and that such mortgages were issued without regard to the borrower's ability to repay); Stephen S. Kudenholdt et al., *ASF Streamlined Foreclosure and Loss Avoidance Framework*, 61 CONSUMER FIN. L.Q. REP. 458, 461 (2007) ("A large number of adjustable rate mortgages (ARMs) with introductory interest rates initially fixed for two to three years are scheduled to reset to a higher adjustable rate in the near future, and it is widely expected that a significant number of these borrowers will not be able to afford their mortgage payments at the higher, fully adjusted rates."). Some of these adjustable rate loans are known as "2/28" and "3/27" loans, which refer to loans with two or three years of low payments, followed by twenty-eight or twenty-seven years of higher payments. Sheila C. Bair, *Fix Rates to Save Loans*, N.Y. TIMES, Oct. 19, 2007, at A25.

Now unable to maintain their mortgage payments, millions of homeowners are in default and facing foreclosure.[6] Some are even resorting to abandonment.[7] New companies, such as You Walk Away, LLC, have cropped up to aid homeowners in vacating their homes.[8] Unfortunately, neighboring homeowners immediately suffer the consequences of living in proximity to these empty homes.[9]

Cities are now left with the burden of dealing with dramatic increases in the number of foreclosed and abandoned blighted properties. This article will discuss the toll that rising foreclosures and abandonments have taken on many American communities. Abandoned homes substantially decrease the value of neighboring properties, which in turn lowers the tax revenue cities can collect to help alleviate the blight caused by abandonment.[10] Moreover, abandoned homes become public nuisances, such as fire hazards, that can endanger the community.[11]

Due to the complexity of the secondary mortgage market, city officials frequently encounter great difficulty holding lenders accountable for the maintenance and upkeep of these properties.[12] A deed may list the original lender's name, but because financial institutions sell loans into the secondary mortgage market and use a private registry system to handle mortgage assignments, the real mortgagee for both the loan and home is often hidden.[13]

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[6] *See* Press Release, Chris Dodd (D-CT), Dodd, Shelby Announce Housing Bill to be Considered by Senate (June 17, 2008) *available at* http://dodd.senate.gov/index.php?q=node/4462.

[7] Consider for example, "Ismael," a Naval officer in California, who qualified for a $370,000 loan, with no money down, despite his earning only about $45,000 annually. Judi Hasson, *U.S. Homeowners Just Walking Away*, MSNFINANCE, Apr. 9, 2008, http://finance.sympatico.msn.ca/banking/mortgages/article.aspx?cp-documentid=6740202. His monthly payments were $2,700 for an adjustable rate mortgage with an 8.25 percent interest rate. *Id.* That mortgage payment was roughly triple what he probably would have qualified for under traditional lending guidelines using a housing affordability calculator. *Id.* Now Ismael is almost certain to walk away and abandon his home like thousands have already done nationwide. *Id.*

[8] *Id.* You Walk Away charges homeowners in California $995 to help homeowners abandon their homes, claims to have helped about 1,000 homeowners, and has operations "in 11 other states: Arizona, Colorado, Connecticut, Florida, Illinois, Nevada, New York, Michigan, Ohio, Oregon and Washington." *Id. See also* You Walk Away, http://www.youwalkaway.com (last visited Sept. 18, 2008).

[9] James J. Kelly, Jr., *Refreshing the Heart of the City: Vacant Building Receivership As a Tool for Neighborhood Revitalization and Community Empowerment*, 13 J. OF AFFORDABLE HOUSING AND COMMUNITY DEV. LAW 2, 212 (2004), *available at* http://www.vacantproperties.org/resources/ppts/Kelly_Refreshing.pdf (describing how property values may be outstripped by the cost of maintaining abandoned properties, causing lenders to defer foreclosure proceedings).

[10] *See infra* Part II.B (discussing the impact of abandoned properties upon local communities).

[11] *See infra* Part II.B.

[12] *See infra* Part II.C (discussing the problems with finding the responsible parties).

[13] *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2280 (2007) (describing Mortgage Electronic Registration Systems, Inc. (MERS),

Current legal remedies were not designed to address the level of foreclosure and abandonment some cities are now facing and pursuing certain remedies takes too long to prevent irreversible damage to the surrounding neighborhoods.[14] Although some municipalities have crafted ingenious responses—such as criminal trials of lenders in absentia—new legal tools are needed to adequately remedy this growing problem.[15]

Part II of this Article will describe the problems associated with abandonment, including the blight on surrounding neighborhoods, and the difficulty cities experience in trying to hold lenders accountable for abandoned properties.[16] Lenders apparently did not do anything to prepare for the mortgage foreclosure meltdown.[17] Some lenders instead place responsibility upon others, complain about the damage to their property, and let neighborhoods and cities suffer the consequences.[18]

Part III of the Article analyzes the civil and criminal nuisance abatement proceedings available to city officials to make lenders responsible for their abandoned properties.[19] This part explains why these proceedings, which usually handle only one property at a time, are insufficient to remedy the effects of foreclosure and abandonment given the current volume of abandoned properties.[20] Part III also analyzes mass litigation cases filed by Baltimore, Buffalo, and Cleveland. Those cases aim to hold multiple lenders accountable on the grounds that the lenders violated either federal housing discrimination laws or state public nuisance statutes.[21] For cities coping with a substantial spike in foreclosed and

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which is a company that keeps track of who owns a mortgage after it is signed by a borrower). MERS has enjoyed some success with several courts upholding MERS's practices despite legal challenges accusing MERS of hiding the true mortgagee. *See, e.g.*, Mortgage Elec. Registration Sys., Inc. v. Azize, 965 So. 2d 151, 153 (Fla. Dist. Ct. App. 2007). This case doesn't mention MERS hiding the true mortgagee, although it is a case where MERS is victorious.

[14] *See infra* Part III.A (explaining the mechanics of remedies such as receivership and tax foreclosure and discussing the shortcomings of these responses).

[15] *See infra* Part III.B-C (discussing litigation efforts in various cities).

[16] *See infra* Part II.B.

[17] *See* Doug Leeper, Code Enforcement Manager, City of Chula Vista, California, Testimony before House Oversight and Government Reform Subcommittee on Domestic Policy (May 28, 2008) ("In short they didn't prepare for disaster, they didn't feel they needed to. . . . In real estate terms, you could always 'flip it,' sell the house or mortgage and save yourself . . .").

[18] *Id.* (stating that lenders, trusts, and other beneficiaries holding mortgage on residential properties claim to be victims). While it is true the lenders' properties are the ones damaged, the neighborhoods and cities see the real consequences. *Id.* (stating the lender is not bearing the true cost but that "the real cost is passed on the local community through increased calls for police and emergency services and reduced property values and marketability").

[19] *See infra* Part III.A-B.

[20] *See infra* Part III.A.2.

[21] *See infra* Part III.C.

abandoned properties, Part III recommends that these cities pursue mass nuisance litigation against lenders with a substantial jurisdictional presence, either through the number of foreclosure proceedings filed or the number of mortgages held on abandoned properties within the cities' jurisdictions.[22]

Part IV describes the incorrect assumptions that homeowners, lenders, and other stakeholders have held about municipal governance and the housing and lending markets and explains how these assumptions have exacerbated the foreclosure and abandonment problem.[23] Part IV analyzes how these assumptions can be changed through legislative action to cause stakeholders to act in ways that protect communities from destabilization during the foreclosure crisis.[24] To combat the spread of abandoned properties, Part IV proposes comprehensive legislative measures designed to motivate lenders to implement plans to keep borrowers in possession of their homes either as mortgagors or as tenants and to incentivize lenders to maintain their collateral as any responsible corporate citizen would do.[25]

II. RISING FORECLOSURES, ABANDONED HOMES, AND BLIGHT ON SURROUNDING NEIGHBORHOODS

Although subprime mortgage loans arguably opened access to homeownership for many borrowers, frequently these loans were made irresponsibly, without regard to borrowers' ability to repay.[26] The media and lawmakers have focused heavily on one negative consequence of the subprime mortgage crisis—the well-documented sudden rise in foreclosures.[27] However,

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[22] *See infra* Part III.C.4.

[23] *See infra* Part IV.A.

[24] *See infra* Part IV.B.

[25] *See infra* Part IV.B.

[26] *See* Burkhart, *supra* note 3, at 1045–46 (stating that approximately 45% of subprime loans were made with little or no documentation of the borrower's income). Because most subprime loans were not for home purchases, one can argue that these loans did not significantly expand home ownership. *See generally* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 996 (2006) (stating that "only 16% of subprime mortgages are used for home purchases" and, therefore, most subprime loans are used to refinance existing mortgages); Nelson D. Schwartz & Vikas Bajaj, *Credit Time Bomb Ticked, but Few Heard,* N.Y. TIMES, Aug. 19, 2007, at A1 ("As far back as 2001, advocates for low-income homeowners had argued that mortgage providers were making loans to borrowers without regard to their ability to repay. Many could not even scrape together the money for a down payment and were being approved with little or no documentation of their income or assets.").

[27] *See, e.g.*, Stephanie Armour, *Foreclosures Skyrocket 65% in April*, USA TODAY, May 15, 2008, at B1 (stating that "[f]oreclosure filings in April rose from a year earlier in *all but eight states*" and that the states "hardest hit by the tsunami of foreclosures included Arizona, California, Florida and Nevada—states where runaway subprime lending and escalating home prices symbolized the real estate boom that fizzled in 2006" (emphasis added)); Michael Powell, *A Bane Amid the Housing Boom: Rising Foreclosures*, WASH.

another negative consequence that has not received much attention is the surge in abandoned homes as a result of the foreclosures and its social and economic cost to cities.[28] Thousands of abandoned homes have become so blighted that they have become public nuisances, burdening cities with the costs of bringing nuisance abatement actions.[29] This section will discuss how predatory subprime mortgages have led to widespread property foreclosure and abandonment. It will enumerate many of the economic and social repercussions of increased abandonment. Finally, this section will explain why cities are having difficulty determining which lenders hold mortgages on abandoned properties in order to make the lenders accountable for repairing their properties.

A. Predatory Subprime Loans Are the Cause of Increased Foreclosures and Abandonments

Subprime mortgages, which are not necessarily predatory,[30] are loans made to borrowers at interest rates higher than prime rate loans because lenders judge these borrowers to be less creditworthy.[31] The popularity of these loans skyrocketed over

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POST, May 30, 2005, at A1 ("Foreclosure rates rose in 47 states in March, according to Foreclosure.com, an online foreclosure listing service. The rates in Florida, Texas and Colorado are more than twice the national average. Even in New York City and Boston, where real estate markets are white-hot, foreclosures are rising in working-class neighborhoods."); *see also* Ken Maguire, *Foreclosures in State Up 34 Percent Last Year*, THE PROVIDENCE J., Jan. 17, 2006, at C1, *available at* http://www.boston.com/news/local/massachusetts/articles/2006/01/15/home_foreclosures_on_the_rise ("Experts say the trend is a fallout from the housing boom of the past decade, in which people took out high-risk mortgages, such as interest-only and no-down-payment loans, in order to get into expensive homes.").

[28] Anne B. Shlay & Gordon Whitman, *Research for Democracy: Linking Community Organizing and Research to Leverage Blight Policy*, 5 CITY & COMMUNITY J. 153, 157–62 (2006); *see also* GLOBAL INSIGHT, THE MORTGAGE CRISIS: ECONOMIC AND FISCAL IMPLICATIONS FOR METRO AREAS 6 (2007) [hereinafter GLOBAL INSIGHT] ("Due to declining property values, property taxes in the state could ultimately decline by as much as $2.96 billion.").

[29] *See infra* Part III.B–C (discussing lawsuits filed by Buffalo and Cleveland alleging that thousands of abandoned residential properties are nuisances).

[30] Some courts have already recognized the fact that subprime loans have been beneficial to previously underserved borrowers, but this "new credit device was not without flaws, as the increase in home equity financing was paralleled by an increase in foreclosures." *See, e.g.*, United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 202 (D. Mass. 1998). Moreover, some "foreclosures were precipitated by the unscrupulous behavior of unregulated mortgage brokers and lenders who engaged in predatory lending practices that included offering high-rate and high-fee loans to borrowers who lacked access to mainstream banks because of redlining practices . . . ." *Id.*

[31] *See* Creola Johnson, *Stealing the American Dream: Can Foreclosure-Rescue Companies Circumvent New Laws Designed to Protect Homeowners from Equity Theft?*, 2007 WIS. L. REV. 649, 657.

the past decade.[32] While subprime mortgage loans made homeownership a possibility for previously denied consumers, many of these loans were "predatory," i.e., they were made in contravention of responsible and accepted lending practices.[33] Defaults on subprime loans have pushed America's rate of foreclosure to historic highs.[34] An understanding of predatory subprime lending will be relevant later because the success of two recently-filed, mass-litigation suits hinges on a finding that such lending led to public nuisances.[35]

There is no consensus on an official definition of predatory subprime lending. However, characteristics of predatory subprime mortgage loans include granting loans without verifying a borrower's income and ability to repay, and relying on home valuations based on inflated or falsified appraisals to justify the loans.[36] Predatory subprime lenders also charge high rates of interest, tack on unnecessary and deceptive fees, and include unfair terms such as mandatory arbitration clauses,

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[32] *See* Jim Rokakis, *Ohio's Foreclosure Crisis. . . and One County's Successful Intervention*, MUNICIPAL LEADER NORTHEAST OHIO, http://www.municipalleader.com/site.cfm/Summer-2007/Predatory-Lending.cfm (last visited Sept. 18, 2008) (stating that subprime mortgages represent "20 percent of all loans in the country totaling more than 1.2 trillion dollars of outstanding mortgages"); Burkhart, *supra* note 3, at 1045 (stating that "[i]n the last decade, subprime loans have increased from 5% of mortgage originations to 20%").

[33] *See* Rokakis, *supra* note 32 ("[T]he explosion in foreclosures in this country has been largely the result of predatory loans and questionable lending practices that should have been stopped by federal and state regulators a long time ago."). The rise of lax lending standards can be attributed in part to the growth of the mortgage securitization market. *See The Foreclosure Epidemic: The Costs to Families and Communities of the Predictable Mortgage Meltdown: Interview with Allen Fishbein*, MULTINATIONAL MONITOR, May 1, 2007, at 30. Securitization vehicles would purchase home mortgages, and then use bundles of these mortgages as assets backing securities to be purchased by private investors. *See id.* To meet the vigorous demand for mortgage loans generated by the securitization market, lenders offered mortgage loans to borrowers who would never have qualified under normal circumstances. *See id.*

[34] *See* Armour, *supra* note 27 (stating that foreclosure filings hit a record high and increased in "all but eight states"); Les Christie, *Foreclosure Rates Still Soaring*, CNNMONEY.COM, May 15, 2007, http://money.cnn.com/2007/05/14/real_estate/April-foreclosures/index.htm (reporting that foreclosures filings in April were up 65 percent over the previous year); Dina ElBoghdady & Nancy Trejos, *Foreclosure Rate Hits Historic High*, WASH. POST, June 15, 2007, at D1, *available at* http://www.washingtonpost.com/wpdyn/content/article/2007/06/14/AR2007061400513.html ("The percentage of U.S. mortgages entering foreclosure in the first three months of the year was the highest. . . [since 1979], according to the Mortgage Bankers Association." (insertion added to reflect corrected version of article, published June 19, 2008)).

[35] *See infra* Part III.C.1–2 (analyzing mass litigation suits filed by Baltimore and Cleveland).

[36] *See* Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 178 (2007).

balloon payments, and prepayment penalties.[37] Moreover, predatory subprime loans are often structured as adjustable rate mortgages, employing a low "teaser" rate for the first two or three years followed by precipitous increases in monthly mortgage payments.[38] The foregoing terms increase the likelihood that borrowers will default on the subprime loans and wind up in foreclosure.[39]

Predatory subprime lenders not only structure loans with such terms, they also unfairly target certain borrowers for home purchase or refinance loans. Evidence shows that certain homeowners—primarily minority homeowners—were pushed into subprime loans despite meeting the qualifications for prime rate loans or were issued loans on terms worse than loans issued to white borrowers despite having credit histories similar to white borrowers.[40] Evidence of a lender's targeting of minority borrowers for subprime loans is relevant because it shows intentional discrimination in violation of anti-discrimination housing laws.[41]

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[37] *See* A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. MARSHALL L. REV. 19, 30–32 (2004).

[38] Senator Chris Dodd, Opening Statement of the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 22, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3795 ("The subprime market has been dominated in recent years by hybrid ARMs, loans with fixed rates for 2 years that adjust upwards every 6 months thereafter. These adjustments are so steep that many borrowers cannot afford to make the payments and are forced to refinance, at great cost, sell the house, or default on the loan."). The new payments are frequently much higher than what the borrowers can afford. *Id.*

[39] *See* Austan Goolsbee, *"Irresponsible" Mortgages Have Opened Doors to Many of the Excluded*, N.Y. TIMES, Mar. 29, 2007, at C3; Kenneth C. Johnston, et al., *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125, 126–27 (2008) ("In the subprime mortgage environment, ARMs could present significant and widespread mortgage default risks because of the likelihood that subprime borrowers will be unable to service the debt after a rate adjustment."); Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: Not Again!*, AM. BANKR. INST. J., Sept. 2007, at 1, 46 (stating when the housing market slowed down, subprime borrowers with adjustable rate loans having prepayment penalties had no choice but to default, which has led to an increase in delinquencies and foreclosures); *see also* A. Brooke Overby, *Mortgage Foreclosure in Post-Katrina New Orleans*, 48 B.C. L. REV. 851, 905 n.224 (2007) ("Even if subprime loans were no more likely to foreclose than other loans, given the rapid increase in subprime originations, it would be expected that foreclosures of these loans would also increase.").

[40] DEBBIE GRUENSTEIN BOCIAN ET AL., UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 3 (2006), *available at* http://www.responsiblelending.org/pdfs/rr011exec-Unfair_Lending-0506.pdf ("Several analyses of this information, collected under the Home Mortgage Disclosure Act (HMDA), have shown that African-American and Latino borrowers received a disproportionate share of higher-rate home loans, even when controlling for factors such as borrower income and property location.").

[41] *See infra* Part III.C.1 (discussing Baltimore's suit against Wells Fargo for allegedly targeting African-Americans for predatory subprime loans).

Many of the subprime loans were for refinancing of existing mortgages, rather than for purchases of homes.[42] As a result, many homeowners obtained refinance loans that were far worse than their original mortgage loans, and some argue that the subprime foreclosure crisis has led to a net *decrease* in homeownership.[43] Although predatory subprime mortgage loans carry a high risk of default from their inception,[44] the "wisdom" from the industry was that homeowners could simply refinance their loans into more favorable loans at a later date.[45] Some lenders are even accused of issuing adjustable rate mortgage loans to generate repeat business, that is, to ensure borrowers would return in two or three years to refinance their loans.[46] But when housing prices began to decline and borrowers began to experience income disruptions and/or the rates on their adjustable mortgage began to reset, many borrowers could no longer afford their monthly payments, could not find lenders willing to refinance their mortgage, and could not sell their homes for greater than the debt owed.[47]

Foreclosures in the subprime market then began to explode.[48] Although both prime and subprime mortgages may end up in foreclosure, the delinquency and foreclosure rate for subprime loans can be 10 times the rate of delinquency and

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[42] *See* ELLEN SCHLOEMER ET AL., LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 7 (2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

[43] *See* Helen W. Gunnarsson, *Helping Clients Who Face Foreclosure*, 96 ILL. B.J. 76, 77 (2008). Some of these loans can be viewed as predatory because lenders persuaded homeowners that "borrowing against their homes [was] a sensible way to plug holes in household budgets." SCHLOEMER ET AL., *supra* note 42, at 8 (footnote omitted). This may have been an effective strategy when the economy seemed strong and the housing market was booming, as rising home values could offset the unprecedented riskiness of existing subprime loans. *See* Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 25 (Aug. 19, 2008) (unpublished manuscript, *available at* http://ssrn.com/abstract=1020396) ("Rapid appreciation in housing prices masked the deterioration in the subprime mortgage market and thus the true riskiness of subprime mortgage loans. When housing prices stopped climbing, the risk in the market became apparent.").

[44] *See* WILLIAM C. APGAR, THE MUNICIPAL COST OF FORECLOSURES: A CHICAGO CASE STUDY 2 (2005), *available at* http://www.nw.org/network/neighborworksProgs/foreclosuresolutions/pdf_docs/2005Apgar-DudaStudy-FullVersion.pdf. ("While mortgages of all types may end up in foreclosure, the rate of serious delinquencies and foreclosures for nonprime loans can easily be ten times higher than the rate for prime loans due to a number of factors, most obviously the generally lower credit quality of the borrowers.").

[45] *See* GLOBAL INSIGHT, *supra* note 28, at 1.

[46] *See* Azmy Baher, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295, 335–36 (2005).

[47] *See* Christie, *supra* note 34 ("Saccacio blamed the overall increase in foreclosures to a mix of risky loans taken out in the past few years and slowing gains in home prices. Soft home prices make it difficult for troubled borrowers to bail out of their loans by quickly selling their properties.").

[48] *See id.*

foreclosure for prime loans.[49] Studies have shown that homeowners have defaulted on 2.2 million subprime home loans, costing homeowners up to 164 billion dollars.[50] A recent report analyzing mortgage default data found that although subprime loans make up only 14% of all mortgage loans, subprime loans comprise "more than half of all loans in foreclosure."[51] Moreover, for the 2007–2009 period, an estimated *two million* subprime borrowers will lose their homes to foreclosures.[52]

Unable to refinance their subprime loans or sell their homes, many homeowners in default are resorting to desertion at unparalleled rates out of fear of imminent foreclosure and eviction.[53] An estimated *nine million* homeowners now owe more than their homes are worth.[54] In these cases, abandonment may not only

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[49] APGAR, *supra* note 44, at 13; *see also* United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 202 (D. Mass. 1998) ("[F]oreclosures were precipitated by the unscrupulous behavior of unregulated mortgage brokers and lenders who engaged in predatory lending practices that included offering high-rate and high-fee loans to borrowers who lacked access to mainstream banks because of redlining practices.").

[50] SCHLOEMER ET AL., *supra* note 42, at 11.

[51] THE PEW CHARITABLE TRUSTS, DEFAULTING ON THE DREAM: STATES RESPOND TO AMERICA'S FORECLOSURE CRISIS 4, 44 nn.3–4 (2008), *available at* http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Subprime_mortgages/defaulting_on_the_dream.pdf (analyzing two data sets: the Mortgage Bankers Association 4th Quarter National Delinquency Survey and the Center for Responsible Lending's foreclosure projections and subprime spillover data); *see also Foreclosures Jump 57% as Loans Adjust*, CHI. TRIB., Apr. 16, 2008, at B7 [hereinafter *Foreclosures Jump*] ("U.S. foreclosure filings jumped 57 percent in March from a year earlier as adjustable-rate mortgages increased and more owners lost their homes to lenders.").

[52] MAJORITY STAFF, JOINT ECON. COMM., THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 1 (2007); *see also* Lori Montgomery, *Paulson Upbeat on Economy and Markets, But Not Housing*, WASH. POST, May 17, 2008, at D1 (quoting the Secretary of the Treasury, Henry M. Paulson, Jr., as predicting that as many as three million loans will go into foreclosure within the next two years).

[53] *See* Alan Mallach, *Abandoned Property: Effective Strategies to Reclaim Community Assets*, HOUSING FACTS & FINDINGS (Fannie Mae Found., Wash., D.C.), 2004, at 5–6, *available at* http://www.fanniemaefoundation.org/programs/hff/pdf/HFF_v6i2.pdf (stating that homeowners who believe their homes are unmarketable are abandoning them); Eric Weiner, *Why Not Just Walk Away from a Home?*, NPR.ORG, Feb. 13, 2008, http://www.npr.org/templates/story/story.php?storyId=18958049 (stating that many borrowers are "voluntarily walking away from their mortgages, engaging in a practice the mortgage industry calls 'ruthless default'"); Lori Weisberg & Roger Showley, *Foreclosures Up and Down*, SAN DIEGO UNION-TRIB., Apr. 23, 2008, at C1, *available at* http://www.signonsandiego.com/news/business/20080423-9999-1b23foreclos.html ("Once values started to decline, cash-strapped homeowners faced with ballooning monthly payments found themselves unable to refinance their loans and began defaulting on monthly payments.").

[54] Vikas Bajaj, *As Housing Bill Evolves, Crisis Grows Deeper*, N.Y. TIMES, June 29, 2008, at A1.

be necessary but can seem like an economically rational decision.[55] Subprime lenders often required very little or no down payment; therefore, some borrowers have no incentive to continue making payments on underwater loans.[56]

No one knows the extent to which abandonment has occurred nationwide since homeowners can abandon their homes as early as default or as late as the completion of the foreclosure.[57] Moreover, housing inspectors lack the resources to keep abreast of the situation.[58] Nevertheless, abandonment is occurring, given that 2.25 million completely vacant homes are available for sale on the market—more than double the number of vacant homes on the market in 2004.[59] A recent poll of

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[55] *See* Stephanie Armour, *Rate of Home Foreclosures Expected to Get Worse*, USA TODAY, Apr. 16, 2008, at B1, (quoting Mark Zandi, chief economist at Moody's Economy.com as saying that he is seeing a new phenomenon—borrowers who owe more than their homes' value are simply "walking away" from their homes).

[56] *See* Les Christie, *Homeowners: Can't pay? Just Walk Away*, CNNMONEY.COM, Feb. 7, 2008, http://money.cnn.com/2008/02/06/real_estate/walking_away/index.htm?postversion=2008020610. While one would think that a foreclosure would be devastating to a defaulting homeowner's credit score, some experts say "[c]redit scores are hurt much more by missing multiple payments—on credit cards, cars and so on—than by a single foreclosure." *Id.*; *see also* Cheyenne Hopkins, *Paulson to Lenders: Fix Has to Come From You*, AM. BANKER, Apr. 25, 2008, at 1, *available at* http://www.financial-planning.com/asset/article/576961/paulson-lenders-fix-has-come-you.html (stating that Secretary of Treasury Henry Paulson "urged lenders to come up with a plan to help so-called 'underwater' borrowers, who owe more on their mortgages than the value of their home").

[57] *See* Cindy Tyrene Cooper, A City Foreclosed: Mortgage Default, Residential Abandonment, and Property Code Enforcement in Buffalo, New York 120 (Dec. 6, 2006) (unpublished Ph.D. dissertation, State University of New York) (on file with author).

[58] *See, e.g.*, David Garrick, *Foreclosed Homes a Messy Problem in Escondido*, N. COUNTY TIMES (Cal.), Sept. 21, 2007, *available at* http://www.nctimes.com/articles/2007/09/21/news/inland/25_07_559_21_07.txt ("The recent surge in housing foreclosures is creating new headaches for Escondido's code enforcement officers, who say they are struggling more than ever to contact homeowners who have broken windows, out-of-control shrubbery, or scummy swimming pools. Many properties with such problems have been abandoned by homeowners in the midst of foreclosure proceedings.").

[59] *See* Editorial, *A Blight-Prevention Workout*, BOSTON GLOBE, Apr.16, 2008, at 14A (stating that in the 1970s Boston's abandoned-property problem had been tamed but that this problem is reappearing in parts of Roxbury and Dorchester along with vandalism and gang infestation); JW Elphinstone, *U.S. Foreclosures Rise 5% in March*, SEATTLE TIMES, Apr. 16, 2008, at D2 (stating that "[l]enders took possession of homes at a sharply higher rate, up 129 percent over last year, as more homeowners relinquished their homes" and lenders "repossessed 51,393 properties nationwide, many of them without a public foreclosure auction"); *Foreclosures Jump*, *supra* note 51 (stating that according to RealtyTrac Chief Executive James Saccacio, "[a]uction notices rose 32 percent from a year ago, a sign that more defaulting homeowners are 'simply walking away and deeding their properties back to the foreclosing lender' rather than letting the home be auctioned"); Lew Sichelman, *Dire Warning on Housing Spiral*, NAT'L MORTGAGE NEWS, May 26, 2008, at 1 (stating that 8.5 million homeowners owe more than their homes are worth and describing circumstances under which some will abandon their homes).

211 cities found that 62% of the cities reported an increase in foreclosures and 33% reported an increase in vacant or abandoned properties or other forms of blight.[60] In Slavic Village, a small, low-income neighborhood located in Cleveland, Ohio, officials estimate that over 800 houses were abandoned—resulting in entire streets comprised of abandoned homes.[61] Because homeowners typically do not announce their intention to abandon, neighbors and city officials only learn homes are unoccupied when the symptoms of abandonment materialize, such as overgrown grass.[62]

B. The True Pecuniary and Social Costs of Abandoned Blighted Properties

The expense of dealing with blighted abandoned homes technically falls on the government, and ultimately on the taxpayers.[63] The accumulation of these expenses can cause a severe drain on cities' finances.[64] For example, the City of

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[60] National League of Cities, Housing Finance and Foreclosures Insta-Poll Fact Sheet (Questions), http://www.nlc.org/ASSETS/A279AFD7D50F4F9182A02E35B129F17D/InstaPoll%20Fact%20Sheet.pdf (last visited Sept. 18, 2008) [hereinafter NLC] (stating that the poll was conducted "online and via email of 1,240 local elected officials" reporting a response rate of 17 percent from 211 cities).

[61] Jim Rokakis, *The Shadow of Debt: Slavic Village Is Fast Becoming a Ghost Town. It's Not Alone*, WASH. POST, Sept. 30, 2007, at B1.

[62] *See, e.g.*, Garrick, *supra* note 58 (stating that abandonment is discovered after weeds overtake yard or trash accumulates); *see also* Georgia Tasker, *Left Out: Foreclosures, Rising Rents, Disappearing Trailer Parks Put Pets at Risk*, MIAMI HERALD, Feb. 24, 2008, at H1 (stating that rescue shelters are encountering more and more pets being left behind at abandoned foreclosed homes and that, in the last six months, the number of such pets left at South Dade homes has increased noticeably).

[63] These expenses include:

> increased policing; increased burden on fire departments (due to vandalism and/or arson); demolition costs; building inspections; legal expenses; costs associated with managing the foreclosure process or resulting from it (*e.g.*, record keeping/updating); and increased demand for city social service programs. In the case of completed foreclosures, costs are also incurred for human services programs aimed at reducing the negative effects of foreclosure on families, such as homelessness prevention activities. These costs accrue during the foreclosure process and in some cases afterwards as well. Especially in cases where the property has little no economic value, the city inherits the responsibility for securing and/or demolishing the unit, removing trash from the lot, mowing the lawn, and a range of other activities intended to keep the unit from becoming a dangerous eyesore.

APGAR, *supra* note 44, at 10–11.

[64] *See, e.g.*, Mallach, *supra* note 53, at 6 (stating that "[a]bandoned properties impose a massive fiscal burden on local taxpayers"); Mark Todd, *Foreclosed Houses Put Strain on City Services*, STAR BEACON (Ashtabula, Ohio), May 25, 2008, at A1 (stating that the

Cleveland faces a demolition bill of 100 million dollars.[65] Over a five year period, St. Louis spent 15.5 million dollars to demolish vacant properties, and Detroit annually spends an average of $800,000 just to clean vacant lots.[66]

The presence of foreclosed abandoned properties can also have a significant negative economic impact on tax revenues and property values in the surrounding neighborhood.[67] A National League of Cities poll about municipal financing and foreclosures found that 33% of the cities reported a decrease in city revenues or revenue estimates, and 60% identified this decrease as having a severe impact on their cities.[68] In a study conducted using the City of Philadelphia's housing market, researchers found that homes within 150 feet of an abandoned property suffered a net decrease in sales price of $7,627.[69] A drop in property values also impacts revenues for properties in close proximity to the vacant ones. When property values fall due to nearby blighted properties, neighboring residents object to their property's valuation and request reappraisal.[70] This reappraisal results in much lower revenues for city and state property taxes.[71] All of this can have a domino effect, leading to further abandonment, which in turn decreases a city's property

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foreclosure crisis has hurt Ashtabula County, Ohio and is costing taxpayers substantial sums to cover the cost of fixing vacant properties abandoned by homeowners or foreclosed upon by financial institutions); *see also* Rokakis, *supra* note 61 (stating that a federal bill, which would allocate towards demolition costs $100 million, was "met with peals of laughter at a conference on vacant properties" because the number was woefully inadequate).

[65] Rokakis, *supra* note 61.

[66] Mallach, *supra* note 53, at 6. Maintenance, repair, and demolition expenses are not the only costs associated with blighted property. Some are purely monetary, such as declines in the value of nearby homes or revenue from property taxes, but others, including increased risks of arson and higher crime, are harder to quantify. As stated by the National Vacant Properties Campaign: "[v]acant homes that have fallen into a sad state of decay and disrepair tear at the fabric of communities, causing crime, falling property values, fiscal strain on local governments, and social turmoil within neighborhoods." National Vacant Properties Campaign, Federal Policy Update, http://www.vacantproperties.org/fedpolicy.html (last visited Sept. 18, 2008).

[67] *See* Mallach, *supra* note 53, at 6 (stating that the existence of abandoned properties in a neighborhood negatively affects the value of the surrounding properties).

[68] *See* NLC, *supra* note 60, at 1.

[69] Shlay & Whitman, *supra* note 28, at 162. The decrease in value was attributed to the deterioration of the abandoned homes, increased crime, reduced neighborhood attractiveness, and adverse business location decisions; Apgar, *supra* note 44, at 11.

[70] Rokakis, *Ohio's Foreclosure Crisis, supra* note 32 (stating that "over 73,000 Cuyahoga County residents objected to their property valuation in the last reappraisal-many citing vacant properties in their neighborhood").

[71] *See, e.g.*, GLOBAL INSIGHT, *supra* note 45, at 6 ("Due to declining property values, property taxes in the state could ultimately decline by as much as $2.96 billion.").

tax revenues, and decreases the city's revenue for operating the local government and providing other social services.[72]

Besides negatively affecting property values and tax revenue, foreclosed vacant homes can become, in various ways, a hazard to the health, morals, and safety of a community. Long-term vacancies in a neighborhood lead to higher rates of crimes such as drug dealing, prostitution, looting,[73] arson, gang activity, and murder.[74] Abandonment can have a signaling effect on local criminals that leads them to believe they can do whatever they want, which fosters a sense of chaos.[75]

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[72] A few abandoned homes often lead to additional vacancies in the surrounding neighborhood, further compounding the impact of abandonment. MALLACH, *supra* note 53, at 5 ("The presence of abandoned property decreases a community's property values, discourages investment by existing residents and potential developers, and may encourage further abandonment."). The problems associated with vacant properties have caused a flight out of Cuyahoga County, the county in which Cleveland is located. Rokakis, *supra* note 32 (stating that the flight arising from the vacant home problem has resulted in over 50,000 residents leaving Cuyahoga County within the past five years). Due to increased crime, and eyesores such as unkempt landscaping, polluted swimming pools, and broken windows, many owners of nearby vacant homes are unable to locate buyers for their homes. *See* Garrick, *supra* note 58; APGAR, *supra* note 44, at 10 ("The presence of vacant homes and those in foreclosure also has an indirect effect that operates through their negative impact on local property values and price trends. As a result, these indirect effects are a major concern for existing homeowners and prospective buyers in the area, as well as other mortgage lenders and servicers operating in the area.").

[73] Scavengers strip these abandoned houses of all valuable items, including copper piping, furnaces, windows, aluminum siding, and doors. Rokakis, *supra* note 61 (stating that scavengers are so efficient that when code enforcement officials come to a house within 24 hours after it has been vacated, they find it stripped of anything of value); *see also* Joe Milicia, *Rust Belt Cities Battling a Glut of Abandoned Homes*, DESERET MORNING NEWS (Salt Lake City, Utah), Feb. 6, 2008, at A3 (stating that vacant homes that have been stripped clean dot the neighborhood and cast "a gloom on their well-maintained neighbors").

[74] MALLACH, *supra* note 53, at 6 (stating that vacant properties often become a hangout for a variety criminal activity, including drug dealing and prostitution); *see also* Apgar, *supra* note 44, at 10 (stating that police officers observe at abandoned properties a wide range of criminal conduct, including arson, rape, prostitution, gang activity, drug dealing, and even homicide).

[75] *See* Cooper, *supra* note 58, at 84. In a Cleveland neighborhood, Slavic Village, "the boarded up, abandoned homes and overgrown lawns were like beacons, signaling that the community's ranks had been thinned, that it would be unable to defend itself from takeover." Charu Gupta, *Stealing Home*, FREE TIMES (Ohio), June 29, 2007. This effect has been termed the "Broken Windows" theory. Raymond L. Pianka, *Nuisances*, CLEVELANDHOUSINGCOURT.ORG, http://www.clevelandhousingcourt.org/hc_rd_g.html (last visited Sept. 18, 2008) ("The 'Broken Windows' theory, first proposed by criminologists James Q. Wilson and George Kelling, suggests that small, isolated nuisances, if ignored, can lead to larger neighborhood problems. For example, the theory proposes that if a window is broken and left unrepaired, people will conclude that no one cares and no one is in charge. Subsequently, more windows will be broken, and the sense

Abandoned properties carry a very high risk of fire—either through poor maintenance or by arson.[76] A report by the National Fire Protection Agency (NFPA) stated that "in 1999, an estimated 11,400 structure fires in vacant properties caused 24 civilian deaths, 66 civilian injuries, and $131.5 million in direct property damage."[77] Abandoned properties also become dumping grounds for waste, such as construction debris and toxic materials,[78] and a site for vermin and insect infestations, such as mosquitoes.[79] The foreclosure crisis has even led to homeowners leaving pets behind —particularly dogs and cats—when abandoning their homes.[80] Because of the far-reaching harm inflicted on communities through foreclosure and abandonment, cities have to act to hold someone responsible for the abandoned properties.

C. Cities Encounter Difficulty Locating the Responsible Parties

City officials are having great difficulty locating a party who can be held responsible for maintaining abandoned properties.[81] After financially-strapped borrowers renounce ownership of their homes, one would think that lenders would

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of disorder will spread, sending a signal to the community that criminals can do as they wish.").

[76] These fires can be particularly hazardous in dense urban neighborhoods where it is easy for a fire to spread from building to building. Mallach, *supra* note 53, at 6.

[77] *Id.*; National Vacant Properties Campaign, Public Safety, http://www.vacantproperties.org/issues/safety.html (last visited Sept. 18, 2008) ("Fires are likely in vacant properties because of poor maintenance, faulty wiring, and debris."). Vagrants squatting in these homes also commonly burn candles, build fires, or cook inside with outdoor grills. *Id.* Furthermore, abandoned homes are frequent targets for arsonists. Over seventy percent of fires at abandoned properties are caused by arson or suspected arson. *Id.* Fires in abandoned homes are especially dangerous for firefighters because of holes and open shafts. The National Fire Protection Association studies found that six thousand firefighters are injured each year while fighting fires started in abandoned properties. *Id. See also* National Vacant Properties Campaign, Federal Policy Update, *supra* note 66 (describing the story of a veteran firefighter who suffered life-threatening injuries at a fire caused by an arsonist at an abandoned house in Buffalo, New York and stating that this fire was amongst numerous crimes that have occurred nationwide at abandoned homes).

[78] Mallach, *supra* note 53, at 6 (stating that abandoned properties become venues for infestation by rats and vermin).

[79] *Id.* at 5. In addition, when pools are left untreated for substantial periods of time, algae forms a thick green sludge over the surface of the water. *See* Edythe Jensen, *Abandoned Homes Concern Chandler Officials*, ARIZ. REP., July 28, 2007, at 1.

[80] *See* Tasker, *supra* note 62 (stating that the operator of Pets in Distress in Fort Lauderdale has noticed a significant increase in abandoned pets and has received several calls from homeowners being forced out of their homes through foreclosures).

[81] *See* Jensen, *supra* note 79.

be interested in taking care of properties that they have obtained via foreclosure.[82] However, due to general decline in the surrounding neighborhood[83] or due to numerous instances of "flipping" (i.e., frequent, often fraudulent, reselling),[84] the predefault appraised value of many abandoned homes cannot be obtained at a foreclosure sale.[85] Since some abandoned properties are now very difficult to resell and/or the cost of repair and maintenance increases the total cost of the foreclosure, lenders are dodging their responsibility for these abandoned homes.[86]

Both the structure of the modern mortgage market and tactics employed by individual lenders make it very difficult for interested parties to force lenders to maintain properties. In the past, a mortgage was a relatively simple two-party transaction conducted between the individual homeowner and his or her local bank.[87] Now, a mortgage loan involves "the borrower, the mortgage broker, the intermediate bank, the investment trust, the servicer, the rating agency, investors, trustees, and the credit enhancement provider."[88]

The securitization[89] of residential mortgages has served to further frustrate city officials attempting to locate the parties responsible for abandoned

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[82] *See* Todd, *supra* note 64 (stating that even though financial institutions are more likely to comply, this is not an absolute and it is "difficult to go after a bank").

[83] *See supra* notes 67–72 and accompanying text (discussing how the existence of abandoned properties decreases a community's property values).

[84] Ada Focer, *Flip... Flip... Flip... Flop: Mortgage Fraud and Property "Flipping" Skew Low-Income Housing Markets,* SHELTERFORCE, Sept. 2000, at 10, 10, *available at* http://www.nhi.org/online/issues/113/focer.html ("Land or property flipping (as distinct from loan flipping which is repeated refinancing by predatory lenders) happens when property is purchased and quickly resold for a large profit, after little or no meaningful rehabilitation. There is growing evidence that property flipping has become epidemic in low-income urban housing markets.").

[85] *See, e.g.*, Jensen, *supra* note 79 (discussing a home that sold for $701,000 in March, but was on the market for $689,000 in July).

[86] Kelly, *supra* note 9, at 223–24 ("Frequently, a vacant property can remain in limbo for a long time. The owner defaults on the mortgage payments, but the mortgagee does not act. The property's value, especially when weighed against the potential code enforcement liability, may not justify immediate foreclosure proceedings by a mortgagee.").

[87] Rokakis, *supra* note 32.

[88] *Id.*

[89] Securitization of the subprime market is extremely complicated and has numerous participants. Below is a simplified discussion of this securitization process:

> The growth of the subprime market was fueled by an influx of investment dollars into the mortgage market from non-traditional lending sources. This resulted in increased credit access for the subprime borrower through a financing vehicle for the securitization of subprime mortgage loans often referred to as mortgage backed securities (MBSs). MBSs can take a variety of structures, but their principal purpose is to transfer the right to receive the cash

properties.[90] Securitization deals ordinarily require a document custodian to keep track of ownership and servicing rights of the mortgages.[91] In today's mortgage market, this role is most often played by a unique company called Mortgage Electronic Registration Systems, Inc. (MERS).[92] MERS was originally created by lending institutions "to facilitate the transfer of mortgages on the secondary mortgage market and save lenders the cost of filing assignments."[93] Today, MERS plays a much larger role. When closing on a home mortgage, lenders list MERS as the "mortgagee of record" when filing in the county recorder's office instead of the actual lender's name.[94] Likewise, when a homeowner defaults on a mortgage, MERS initiates the foreclosure proceedings on behalf of the true lender-mortgagee.[95]

The astonishing fact about this process is that the true note and mortgage holder, remains hidden from public inquiry.[96] By concealing the identity of the actual mortgage holder from homeowners and city officials, MERS has been accused of undermining the accuracy of the public land and court records and frustrating the ability of homeowners and their advocates to negotiate workout deals with the true mortgagee.[97] MERS also makes it nearly impossible for cities to

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> flow from pools of mortgage loans, as well as to transfer the related default risks, to third-party investors.
>
> In a typical subprime mortgage securitization, a number of mortgage loans are pooled together and sold into a trust by an originator. Interests in the trust are in turn sold to investors, often known as certificateholders. [sic] The cash from the certificateholders goes to the originator, and the originator can then use that cash to originate more loans. Some MBSs issue pass-through certificates in which the trust passes through principal and interest payments as they are received, minus certain servicing charges, to the investors on a pro rata basis. Thus, if a loan in the pool is prepaid, the principal amount of that loan is repaid to the investor, requiring the investor to find another investment opportunity for that portion of the initial investment.

Kenneth C. Johnston et al., *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125, 128–29 (2008) (internal quotations and citations omitted).

[90] *See* Peterson, *supra* note 13, at 2280.

[91] *Id.* at 2211.

[92] *Id.*

[93] Brief of South Brooklyn Legal Services et al. as Amici Curiae Supporting Respondents, Merscorp, Inc.v. Romaine, No. 2004-04735, 2006 WL 3912394, at *4 (N.Y. App. Div. Oct. 19, 2006).

[94] Peterson, *supra* note 13, at 2212.

[95] *Id.*

[96] Brief of Amici Curiae at 5, Merscorp, Inc. v. Romaine, No. 2004-04735 (N.Y. Oct. 19, 2006) 2006 WL 3912394.

[97] *Id.* ("MERS is fundamentally unfair to homeowners who are trapped in the system because it transmutes public mortgage loan ownership information, required to be recorded in public databases, into secret and proprietary information, inaccessible to both the borrower and the public.").

do a simple inquiry to find the responsible mortgagee to cure the deleterious effects of the increasing number of abandoned homes.

In addition to MERS, lenders also take steps to avoid their responsibility for maintenance and repair costs. One common strategy employed by lenders is to buy the borrower's property at a foreclosure sale but never record the deed.[98] Even when legal ownership is established, large national lenders have little or no investment in local communities and routinely ignore notices to appear in court to defend against municipal code violations on their properties.[99]

As a result of the lenders' use of MERS and the lenders' failure to record deeds in their names after foreclosure, local authorities have created the term "toxic title" to describe the dubious ownership status of the property and their inability to find the true owner.[100] Signs of toxic title first arise when the city's public record inquiry lists a consumer as the legal owner of an abandoned blighted property. When the city tracks down the consumer, the consumer points a finger at the bank that initiated foreclosure.[101] The homeowner, who took the lender's threat of foreclosure seriously, walked away or filed bankruptcy, assuming the lender would foreclose and take possession of the house.[102] Problems arise in a declining housing market because lenders are making an economic decision not to complete

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[98] *See* Geoff Dutton, *Lenders Play the Foreclosure Game*, COLUMBUS DISPATCH, Nov. 7, 2005, at A1; *see also* Kelly, *supra* note 9, at 226 ("Lenders had developed their own strategies for avoiding direct liability for code violations. Sometimes they would commence foreclosure proceedings in which they would buy the property at the sale but would not record a deed until they were ready to sell the property.").

[99] *See* CUYAHOGA COUNTY OF OHIO COMM'NS, COMMNS' REPORT AND RECOMMENDATIONS ON FORECLOSURES 5, (2005), *available at* http://www.dontborrowtroublecc.org/pdf_dontborrowtrouble/en-US/report_rec0905.pdf [hereinafter COMMISSIONERS' REPORT] ("[T]he concentration of mortgage defaults in the Cleveland area does not concern investors in a national mortgage market."); *see also* Thomas Ott, *Absentee Owner Tried in Absentia: Housing Judge Cracks Down On Foreclosure Firm*, PLAIN DEALER (Cleveland, Ohio), Sept. 18, 2007, at A1 ("[Judge Raymond L.] Pianka has grown increasingly frustrated with companies, mostly lenders, that claim property and then refuse to appear in court on code violations. He has issued arrest warrants for executives, but the step is pointless because the businesses invariably have headquarters in another state.").

[100] Michael Orey, *Dirty Deeds*, BUS. WK., Jan. 14, 2008, at 46.

[101] *Id.*

[102] *See* Cooper, *supra* note 57, at 48. Property owners should instead stay in homes in order to prevent various problems. Joyce Miles, *Housing Court Looks to Buffalo's Judge Nowak for Ideas*, LOCKPORT UNION-SUN & J (N.Y.), Feb. 23, 2008 (quoting Judge Henry J. Nowak who stated "[t]he mortgager can't actually evict the homeowner until it gets the deed, but many homeowners falsely believe they're being evicted when the bank informs them foreclosure is pending. . . If homeowners had stayed to the end of foreclosure, as is their legal right, the properties would have been safe").

the foreclosure process, and, as a result, nothing can be done to rehabilitate the property until the courts determine who is responsible for it.[103]

III. CURRENT LEGAL RESPONSES TO COMBAT THE RISING TIDE OF FORECLOSURES AND ABANDONMENT

Recognizing that abandoned properties have a deleterious impact on neighborhoods and wanting to hold lenders accountable for the abandoned properties, cities employ a variety of civil proceedings aimed at rehabilitating affected neighborhoods. The primary proceedings are: (1) nuisance abatement actions, sometimes in conjunction with receivership proceedings, and (2) tax foreclosure actions.[104] Some cities have found these civil proceedings to be largely ineffective in getting lenders to take responsibility for abandoned properties and have resorted to using criminal nuisance lawsuits to get lenders to abate nuisances at individual properties.[105] Criminal proceedings have sometimes been effective, particularly in instances where courts have used the doctrine of clean hands to motivate some lenders to correct the nuisance.[106] These criminal and civil proceedings are usually *in rem* and involve only one property.[107]

As the discussion unfolds, note the reoccurring verbal references: identifying, notifying, waiting, ordering, taking, and foreclosing. Reference to these terms is indicative of how time consuming these procedures are. As a result, several cities have recently come to the realization that the sudden increase in thousands of foreclosed and abandoned properties cannot be adequately dealt with through individual civil or criminal nuisance actions. These cities have filed mass-litigation lawsuits against national lending institutions to hold them responsible for thousands of abandoned properties.[108] This section will first discuss the individual civil and criminal nuisance proceedings and explain why they are ineffective in the current foreclosure crisis. Following will be a discussion of the trend among cities

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[103] *See* Cooper, *supra* note 57, at 120 ("In essence, these cases of foreclosure often have no 'true owner' with whom the inspector can negotiate repairs, so they are written for court in the hope that the heavy hand of the law will resolve these situations."); *see also* Gupta, *supra* note 75 ("Recently, [Cleveland Municipal Judge Raymond] Pianka heard the case of a man who'd been cited by Cleveland housing inspectors for garbage in his front yard. But the man explained to the judge that he'd lost the property six months ago, and the bank that bought it at a sheriff's sale had left his name on the deed. Pianka dismissed the case and sent inspectors back out to find the bank in question.").

[104] *See infra* Part III.A.

[105] *See infra* Part III.B.

[106] *See infra* notes 167–176 and accompanying text (discussing how a housing court judge in Cleveland uses the doctrine to force lenders to abate the nuisance).

[107] Gregory B. Ewig, *Will Innocent Owners Ever Have a Constitutionally Defensible Claim in a Civil Forfeiture? Don't Bet on it:* Bennis v. Michigan, *116 S.Ct. 994 (1996)*, 20 HAMLINE L. REV. 167, 190 (1996).

[108] *See infra* Part III.C (discussing large scale litigation efforts in various cities).

to use mass litigation and how it may provide an effective means of dealing with the dramatic increase in foreclosures and abandonment.

A. Individual Civil Proceedings: Nuisance Abatement, Receivership, and Tax Foreclosures

Civil receivership and foreclosure actions are common, and potentially effective, methods for holding the appropriate parties responsible for the restoration of blighted properties. Cleveland and Baltimore frequently employ nuisance abatement and receivership actions, while officials in Columbus, Ohio, have relied upon a similar measure, nuisance abatement and foreclosure.[109] Both approaches have been successful in returning select properties to productive use.[110] However, as explained later, when these civil proceedings involve out-of-state lenders, the proceedings are too labor intensive and time consuming to rehabilitate entire neighborhoods hit by a large number of foreclosures and abandonments.[111]

1. The Mechanics of Nuisance Abatement, Receivership, and Foreclosure

The goal of both receivership and foreclosure is the same: to restore abandoned, blighted properties to productive use.[112] Although receivership and tax foreclosure share a basic goal, substantial differences exist in the mechanics of each procedure. Most significantly, in a receivership action, the city does not obtain legal title to the property.[113] Conversely, with a foreclosure, the city does

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[109] *See infra* notes 139-43, 152-53 and accompanying text.

[110] *See* Robert Jaquay, *Cleveland's Housing Court: A Grassroots Victory 25 Years Ago Paved the Way for a Reliable, Much Needed Institution*, SHELTERFORCE, May-June 2005, at 11, *available at* http://www.nhi.org/online/issues/141/housingcourt.html (relating how Ohio's receivership statute was used to rehabilitate eleven nuisance properties in Slavic Village).

[111] *See, e.g.*, Kermit J. Lind, The Perfect Storm: An Eyewitness Report from Ground Zero in Cleveland's Neighborhoods (May 22, 2008) (unpublished article) (on file with author) (describing the situation in Cleveland where dockets are overloaded and cases take years to complete); Todd, *supra* note 64 (stating that the nuisance abatement process can be "painfully slow" and particularly difficult in going after the bank, especially when ownership of the property is in dispute).

[112] ALAN WEINSTEIN ET AL., PUBLIC NUISANCE ABATEMENT AND RECEIVERSHIP: A GUIDE TO IMPLEMENTING OHIO REVISED CODE § 3767.41, 5 (2001) ("Demolition depletes the affordable, albeit substandard, housing stock of many older communities, thus contributing to the lack of available housing for low- and moderate-income families.").

[113] ALAN MALLACH, RESTORING PROBLEM PROPERTIES: A GUIDE TO NEW JERSEY'S ABANDONED PROPERTY TOOLS 67 (2005), *available at* http:\\www.hcdnnj.org/NJToolkit FINAL.pdf ("Possession is a powerful tool. It gives a municipality, or a CDC or other party acting under the authority granted by a municipality, control of an abandoned property without actually taking title, granting it all the powers it needs to raise the funds, obtain the approvals, and carry out the work needed to restore the property to productive use.").

acquire legal title.[114] This section will explain the steps that must be taken to implement an abatement/receivership and a foreclosure action.

Vacant property receivership is a civil remedy that allows a court to appoint a special agent to oversee the rehabilitation of a blighted property, including repairs, maintenance, and/or demolition.[115] A number of steps must be taken to successfully implement a nuisance abatement and receivership proceeding.[116] Ohio law will be used to explain these steps and how they are ultimately ineffective in dealing with the current foreclosure and abandonment crisis. The description of the process may seem tedious, but it is nevertheless provided to drive home the point that civil nuisance actions against a single property are very time consuming.

The first step in a nuisance abatement and receivership proceeding is to identify the relevant parties.[117] This begins with locating a party with standing to bring a nuisance abatement action.[118] Under Ohio law, an action for nuisance abatement can be instituted by a landowner nearby the blighted property, a municipality where the property is located, a nonprofit corporation that deals with housing issues, or a tenant of the blighted property.[119] The owner of the property,

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[114] *Id.* at 26.

[115] JOSEPH SCHILLING, NUISANCE ABATEMENT OF VACANT PROPERTIES: INNOVATIVE USES OF CIVIL RECEIVERSHIP 1 (2006), *available at* http://www.mcdpinfo.org/images/Tenn_Legislation_Nuisance_Abatement_of_Vacant_Properties.doc ("Receivership is a specialized civil remedy that allows a judge to appoint a special agent of the court to oversee the repair, abatement or demolition of vacant properties. Courts of general jurisdiction in most states can appoint receivers to minimize waste, preserve assets, and maintain properties in safe and habitable conditions."). Nuisance abatement and receivership falls under a "nuisance exception" to the takings clause elucidated by the Supreme Court. Mugler v. Kan., 123 U.S. 623, 668–69 (1887) ("A prohibition simply upon the use of property for purposes that are declared, by valid legislation, to be injurious to the health, morals, or safety of the community, cannot [sic], in any just sense, be deemed a taking or an appropriation of property for the public benefit. Such legislation does not disturb the owner in the control or use of his property for lawful purposes, nor restrict his right to dispose of it, but is only a declaration by the state that its use by any one, for certain forbidden purposes, is prejudicial to the public interests.").

[116] For purposes of clarity, unless otherwise indicated, the proceeding paragraphs will refer to the receivership process under Ohio's abandoned properties receivership statute, OHIO REV. CODE ANN. § 3767.41 (LexisNexis 2006).

[117] *See* NEIGHBORHOOD PROGRESS, INC. ET AL., O.R.C. § 3767.41 RECEIVERSHIP: PRACTICE AND PROCEDURE IN THE CLEVELAND MUNICIPAL COURT, HOUSING DIVISION (2006) (explaining the steps for having a receiver appointed).

[118] *See id.*

[119] *Id.*; *see also* OHIO REV. CODE ANN. § 3767.41(B)(1)(a) ("[I]f a building is alleged to be a public nuisance, the municipal corporation, neighbor, tenant, or nonprofit corporation may apply in its complaint for an injunction or other order as described in division (C)(1) of this section, or for the relief described in division (C)(2) of this section, including, if necessary, the appointment of a receiver as described in divisions (C)(2) and (3) of this section, or for both such an injunction or other order and such relief.").

as well as any other "interested parties" must also be identified.[120] Due to the frequent reselling of mortgages, it can be very difficult to identify all interested parties.[121] Throughout the proceeding, adequate notice must be provided to each interested party.[122] Failure to provide such notice can "cloud" the title, preventing resale after a receiver has rehabilitated the property.[123]

Once a party with standing to bring suit is located and all interested parties are identified, the plaintiff will file a complaint requesting injunctive relief.[124] A complaint for nuisance abatement must include both a petition for abatement of the nuisance and a verification of the plaintiff.[125] At this time, the plaintiff may also file a motion for the appointment of a receiver.[126] During the hearing, the court determines whether to grant an abatement order and will do so if it decides that the property is a "public nuisance."[127] A public nuisance is a residential property[128] that is

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[120] *See* WEINSTEIN ET AL., *supra* note 112, at 7 ("An 'interested party' is any owner, mortgagee, lien holder, tenant, or person that possesses a legal interest in the property.").

[121] Rokakis, *supra* note 32.

[122] *See* OHIO REV. CODE ANN. § 3767.41(B)(2)(a) ("In a civil action described in division (B)(1) of this section, a copy of the complaint and a notice of the date and time of a hearing on the complaint shall be served upon the owner of the building and all other interested parties in accordance with the Rules of Civil Procedure."); *see also* WEINSTEIN ET AL., *supra* note 112, at 17 ("All mortgagees, lien holders, or other parties with an interest in the subject property must also be named as defendants because they are entitled to notice of the court's finding prior to the appointment of a receiver.").

[123] WEINSTEIN ET AL., *supra* note 112, at 3 ("The court's decision to appoint a receiver and/or sell the property may subsequently be overturned if a party with legal rights to the property was not properly notified of the court proceedings. Failure to provide proper notice to a necessary party may also result in a defect in the title when the property is subsequently sold.").

[124] *See id.* at 17–19.

[125] *Id.* ("The plaintiff initiates the proceeding by filing with the court a 'Petition for the Abatement of a Public Nuisance' with an attached 'Verification of Plaintiff . . . .'").

[126] *Id.* ("A 'Motion for Appointment of a Receiver' . . . with attacked 'Brief'. . . may be filed with the original petition or after the court conducts a hearing on the plaintiff's request for injunctive relief."). The motion can also be filed after the court has granted the plaintiff injunctive relief. *Id.* All defendants are afforded twenty-eight days to respond to the complaint. *See* OHIO REV. CODE ANN. § 3767.41(B)(2)(b).

[127] NEIGHBORHOOD PROGRESS, INC. ET AL., *supra* note 117 ("The judge at the hearing will determine whether the building is a 'public nuisance.'").

[128] OHIO REV. CODE ANN. § 3767.41(A)(1) (stating that the property must be "used or intended to be used for residential purposes"). It does not matter whether the owner of the property subjectively intended to use the building in question for residential purposes, only whether the building was constructed to be a residence, within a residential neighborhood. *See* Northeast Shores Dev. Corp. v. Euclid Beach L.P., No. 05-CVH-03844, 2005 WL 1131729, at *2 (Cleveland Mun. Ct. Mar. 25, 2005) ("[T]he statute is intended to apply to buildings constructed to be residences, within residential areas. Analyzed in light of the

> a menace to the public health, welfare, or safety; that is structurally unsafe, unsanitary, or not provided with adequate safe egress; that constitutes a fire hazard, is otherwise dangerous to human life, or is otherwise no longer fit and habitable; or that, in relation to its existing use, constitutes a hazard to the public health, welfare, or safety by reason of inadequate maintenance, dilapidation, obsolescence, or abandonment.[129]

After a property is deemed a public nuisance, the judge then determines whether the owner has been given a reasonable opportunity to eliminate or rectify the nuisance but has either refused or failed to do so.[130] If the owner has not been given such an opportunity, the court will issue the order to abate.[131] Under the order, the owner is provided with 30 days to abate the nuisance.[132] Should the owner refuse or fail to correct the nuisance conditions, the judge will then provide all other interested parties with the opportunity to do so.[133] If it is subsequently determined that the owner has failed to abate the public nuisance, and no interested parties have demonstrated the willingness and ability to undertake the responsibility within a set time, the judge is permitted to appoint a receiver.[134]

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objective of the statute, then, this court concludes that the phrase 'intended to be used' refers to the construction and location of the building and not the subjective intention of the owner.").

[129] OHIO REV. CODE ANN. § 3767.41(A)(2)(a).

[130] *Id.* at § 3767.41(C)(1) ("[I]f the judge additionally determines that the owner of the building previously has not been afforded a reasonable opportunity to abate the public nuisance or has been afforded such an opportunity and has not refused or failed to abate the public nuisance, . . . then the judge may issue an injunction requiring the owner of the building to abate the public nuisance . . .").

[131] *Id.*

[132] *Id.* (providing that the defendant has "no more than thirty days from the date of the entry of the judge's order to comply with the injunction, unless the judge, for good cause shown, extends the time for compliance").

[133] *Id.* at § 3767.41(C)(2) ("[I]f the judge additionally determines that the owner of the building previously has been afforded a reasonable opportunity to abate the public nuisance and has refused or failed to do so, . . . then the judge shall offer any mortgagee, lienholder, or other interested party associated with the property on which the building is located, in the order of the priority of interest in title, the opportunity to undertake the work and to furnish the materials necessary to abate the public nuisance."). However, to take advantage of this provision, interested parties must "demonstrate the ability to promptly undertake the work and furnish the materials required, to provide the judge with a viable financial and construction plan for the rehabilitation of the building . . . and to post security for the performance of the work and the furnishing of the materials." *Id.*

[134] OHIO REV. CODE ANN. § 3767.41(C)(2) ("If the judge determines, at the hearing, that no interested party is willing or able to undertake the work and to furnish the materials necessary to abate the public nuisance, or if the judge determines, at any time after the

If a receiver is appointed, his or her duties include making decisions regarding rehabilitation, demolition, or maintenance of the property, and managing any rental income derived from the property.[135] A receiver does not acquire a legal interest in the property. Rather, a receiver obtains a judgment from the court for a receiver's fee and all expenses incurred in dealing the property, and all these costs are secured by a first-priority receiver's lien on the property.[136] Should the property be sold, the receiver will be reimbursed for expenses and provided the receiver's fee before any other liens are satisfied.[137] Based on the foregoing, the reader can readily determine that a nuisance abatement/receivership action can take considerable time.

Nuisance abatement and foreclosure is another method by which cities can acquire control over abandoned homes. Unlike receivership, the city holds legal title to the vacant property after foreclosure is completed.[138] This procedure has been especially popular in Columbus, Ohio,[139] where the city sought foreclosure

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hearing, that any party who is undertaking corrective work pursuant to this division cannot or will not proceed, or has not proceeded with due diligence, the judge may appoint a receiver pursuant to division (C)(3) of this section to take possession and control of the building."). Before doing so however, the owner and interested parties must be given time to: (1) establish the nuisance has been abated, (2) present an alternative plan to accomplish abatement, or (3) argue against the appointment of a receiver. *See* WEINSTEIN ET AL., *supra* note 112, at 21.

[135] NEIGHBORHOOD PROGRESS, INC. ET AL., *supra* note 118 (listing receiver's responsibilities, including "[p]ermanent abatement of the nuisance by rehabilitation or demolition; financing the abatement plan; responsible for management of all real property, personal property on or about the premises; and income from renting the rehabilitated property").

[136] *Id.* ("Receiver gets judgment for all expenses incurred, plus receiver's fee; receiver's judgment is the first priority lien on the property ahead of all other liens, including taxes.").

[137] *See id.* Baltimore's vacant building receivership ordinance reverses the order of this process, allowing the receiver to foreclose on the lien before any rehabilitative work is done, and auctioning the property off to developers who have proven their ability to make the necessary renovations. Kelly, *supra* note 9, at 217 ("Baltimore's law, however, allows the court to have the receiver foreclose on this lien before rehabilitation work has even begun and auction the property off to a developer who has demonstrated the ability to rehabilitate the property immediately. Rather than require the receiver to go out and locate the monies necessary to make repairs, vacant building receivership, under the Baltimore code amendment, offers the court the option of privatized nuisance abatement."). *See also* BALT., MD., INT'L BUILDING CODE § 121.10 (2008).

[138] *See* MALLACH, *supra* note 113, at 26.

[139] The Home Again Project, created by Columbus Mayor Michael B. Coleman in 2006, utilizes a combination of foreclosure actions and purchases by non-profit organizations to convert vacant, blighted properties.

> In some cases, the non-profit will purchase properties, while at other times the City will use its enforcement team to acquire properties. Once the properties

for unpaid property taxes as well as foreclosure for unpaid fines for nuisance code violations.[140] When both the abandoning homeowner and the mortgagee cease to pay property taxes, the city acquires a tax lien on the property.[141] Generally, a tax sale is held each year to recoup these unpaid taxes.[142] The properties themselves are not sold, but rather assigned a tax sale certificate, i.e., the right to collect unpaid taxes from the legal owner, or, if efforts to collect are unavailing, the right to foreclose on the property.[143]

A tax foreclosure is executed by filing a complaint with the courts and providing the requisite notice to all interested parties, including the owner and any known lien holders.[144] If the owner does not redeem the property by repaying overdue taxes before the date of judgment, the holder of the tax sale certificate secures clear title to the property.[145] The entire process can take three years.[146]

2. Painstakingly Slow: The Ineffectiveness of Individual Civil Proceedings

Many significant benefits are associated with nuisance abatement, receivership, and foreclosure actions. Obtaining public possession of vacant,

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> are acquired, City staff writes rehabilitation specifications and the non-profit selects a City-approved contractor to perform the work. From there, the non-profit is responsible for marketing and selling the rehabilitated properties. The City will strongly encourage the use of local Community Development Corporations as partners in this process in an effort to build local capacity and community involvement.

City of Columbus, Home Again, http://www.columbus.gov/homeagain.asp (last visited Sept. 18, 2008).

[140] Dutton, *supra* note 98 ("In a new tactic, Columbus has begun foreclosing on vacant property for unpaid fines for code violations. The city has seized only a few but plans to expand the effort to force owners either to take responsibility or surrender the property.").

[141] MALLACH, *supra* note 113, at 26 ("If a property owner fails to make timely property tax payments, the property may be subject to tax foreclosure, either by the municipality or by a third party who has bought the tax lien from the municipality.").

[142] *Id.* ("The first step in the process is the tax sale. In order to recoup the value of unpaid property taxes, the statute requires that each municipality must hold an annual tax sale of properties in arrears on their property taxes.").

[143] *Id.* Often, in cities particularly hard hit by abandonment and foreclosure, few private bidders are interested in purchasing these tax sale certificates. *Id.*

[144] *Id.* Clear title cannot be obtained unless adequate notice has been provided, as a tax sale wipes out any other existing liens. *Id.* Notice by publication is also frequently required. *Id.*

[145] *Id.* (if all of the required steps are followed, the tax lien holder "will now have clear title to the properties on which it has foreclosed.").

[146] Rokakis, *supra* note 32 (stating that foreclosures in Cuyahoga County, Ohio were taking over three years to complete).

blighted properties can be very effective in making a delinquent owner internalize the cost of the nuisance and not just impose the cost on the neighbors; "in short, the owner should feel their pain."[147] Moreover, legal responses focusing on possession, rather than demolition, not only eliminate nuisances but also restore the usefulness of these properties.[148] In addition, because receivership is perceived by defendants as a severe response to the nuisance, it may garner more attention from defendants than fines alone—which are often ignored or just repeatedly paid off.[149] Receivership and foreclosure, in theory, also act as a deterrent against property "free riding," in which speculators purchase cheap, run-down properties, paying nothing but taxes in hopes that the revitalization efforts of community organizations will increase the value of the properties.[150] Finally, receivership and foreclosure empower members of the local community to take an active role in battling the onset of blight.[151]

Unfortunately, the current forms of receivership and foreclosure actions are ill-suited to combat the unprecedented wave of foreclosures and abandonment following the subprime mortgage crisis. In Baltimore, the average vacant property receivership action takes an estimated 240 days.[152] In Cleveland, city officials complain that individual foreclosure proceedings to rectify nuisances were taking over three years to complete, "creating eyesores and forcing suburbs to deal with maintenance issues and destabilizing these communities."[153] These legal responses are also very costly and labor intensive, reducing the number of properties that cities and nonprofit organizations are able to rehabilitate.[154] Because possession-oriented methods such as receivership and foreclosure require separate actions to

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147 Kelly, *supra* note 9, at 213.

148 MALLACH, *supra* note 113, at 57 ("The purpose of possession . . . . goes beyond nuisance abatement by incorporating the positive goal of preservation, rather than solely eliminating a negative feature of the property. While a nuisance may be abated through demolition of a building, the object of possession is the rehabilitation and reuse of the building.").

149 *Id.*

150 Lavea Brachman, *Vacant and Abandoned Property: Remedies for Acquisition and Redevelopment*, LAND LINES, Oct. 2005, at 1, 5, *available at* https://www.lincolninst.edu/pubs/dl/1055_Final%20PDF%20Land%20Lines%2010.05.pdf.

151 Kelly, *supra* note 9, at 227 ("Vacant building receivership involves community residents not merely as witnesses or advisors but as the actual petitioners requesting the judicial relief.").

152 HOUSING AUTHORITY OF BALTIMORE CITY, BALTIMORE'S RECEIVERSHIP PROGRAM: RECLAIMING VACANT PROPERTIES 24, (2007), http://www.vacantproperties.org/conf/2D_Baltimore.pdf.

153 Rokakis, *supra* note 32.

154 MALLACH, *supra* note 113, at 67–68 ("At the same time, [possession] demands that the municipality or entity go through a legal procedure that involves spending funds not only on legal expenses, but also for title searches, notices and the cost of preparing a rehabilitation plan to be submitted to the court.").

be initiated for each individual property, economies of scale cannot be realized by bundling court proceedings.[155] A receiver's lien also creates a serious encumbrance upon the property, clouding title and reducing the likelihood that banks will lend to a buyer to purchase the property.[156] Finally, the difficulty associated with locating and providing notice to all interested parties can even pose a risk of civil liability for the municipality.[157]

B. Individual Criminal Nuisance Actions: Judicial Efforts in Cleveland and Buffalo

Serious difficulties arose when cities attempted to use civil proceedings alone to combat the spread of foreclosures and abandonment. Seeking to use more effective measures to combat the abandonment problem, the cities of Buffalo and Cleveland began using individual criminal nuisance lawsuits to hold lenders responsible for the maintenance of abandoned homes. Often the civil fines associated with a single property are not sufficient to change the behavior of national lenders, but both Cleveland and Buffalo have come up with creative ways of adding some "teeth" to these fines.

In Buffalo, prosecutor Cindy T. Cooper and Judge Henry J. Nowak took action, forcing banks to properly maintain the properties following abandonment or foreclosure.[158] Under the Property Maintenance Code of New York State, an "owner" is a responsible party in a nuisance action and is described as the person holding legal title to the property.[159] Even though lenders do not hold legal title if they fail to have the deeds recorded in their names after foreclosure, the Code describes the "owner" as one "otherwise having control of the property."[160] Cooper and Nowak contend that by sending letters threatening eviction or foreclosure against defaulting homeowners, the lenders have asserted control over the property, triggering a responsibility to maintain the home after the homeowner vacates.[161]

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[155] *Id.* at 68.

[156] Brachman, *supra* note 150.

[157] MALLACH, *supra* note 113.

[158] Orey, *supra* note 100 ("Cooper and Nowak are at the forefront of a pioneering effort to deal with a vexing problem: the surging number of vacant and abandoned homes resulting from the mortgage market meltdown."); *see also* Milicia, *supra* note 73 ("Buffalo, N.Y., brings property owners and lenders together in court on monthly 'Bank Days' to find solutions for cleaning up vacant homes.").

[159] N.Y. PROPERTY MAINTENANCE CODE ch. 2, § 202 (2007). The Code specifies the responsibilities of owners, operators, and occupants regarding the proper maintenance of residential and non-residential buildings. *See id.* ch. 1, § 101.2–.3.

[160] *See id.* ch. 2, § 202.

[161] Orey, *supra* note 100 ("Nowak contends that the letters banks send to defaulting homeowners threatening to boot them from their houses show that they have begun to 'assert some measure of control.'").

Unsurprisingly, most national lenders initially ignored the criminal summonses to appear in Buffalo's housing court.[162] However, Judge Nowak began entering default judgments against these banks for the maximum amount allowed under the statute—$10,000 to $15,000 per property.[163] While this may not be much for a large bank, unpaid fines provide the city with a lien that may be used to restrict the bank's ability to buy or sell other properties in the city.[164] Judge Nowak will turn away these same lenders if they seek to evict homeowners from other properties due to the failure to abate the nuisances under the default judgments.[165] This tactic has caused out-of-state lenders to negotiate with Cooper to abate the nuisances so they can be free to evict borrowers from properties the lenders deem worthy of completing foreclosure against.[166]

Like Judge Nowak in Buffalo, Judge Raymond Pianka, in charge of the Cleveland Municipal Court, Housing Division, has taken action against large national lending institutions for failing to abate nuisances on local properties.[167] Frustrated with these lenders' persistent refusals to rectify code violations, Judge Pianka began trying these lenders in absentia.[168] Under Ohio law, if a representative of a corporation does not appear in response to a summons by the court, the court is permitted to proceed to trial without the defendant being present.[169] Prior to holding trials in absentia, Pianka would issue criminal summons against both the banks and their top executives, but these summons were largely ineffective, as corporations cannot be arrested and the executives generally live out-of-state.[170] Now, using the criminal trials in absentia, Pianka hears testimony from the housing inspectors and then if he makes a finding of guilt, he will proceed to sentencing, usually by assessing fines for all code violations listed for that particular property.[171] The resulting criminal fines have reached amounts as high as

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[162] *Id.* ("Nowak says, Buffalo began contacting banks 'en masse' about foreclosed properties, but 'a lot of times we'd just be rebuffed and ignored.'").

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] *See id.*

[167] *Id.* ("A similar initiative is under way in Cleveland, where Judge Raymond L. Pianka puts lenders on trial in absentia when they fail to respond to charges.").

[168] *See, e.g.*, Ott, *Housing Judge*, *supra* note 99.

[169] OHIO REV. CODE ANN. § 2941.47 (LexisNexis 2006).

[170] *Id.*; Ott, *Housing Judge, supra* note 99; *see also* Gupta, *supra* note 75 ("Pianka has issued arrest warrants against some 30 banks for not showing up in court to answer criminal code violations. But the warrants have no teeth—you can't arrest corporations.").

[171] Ott, *supra* note 99; *see also* Orey, *supra* note 100 ("On Dec. 10, for example, he assessed a $50,000 fine against an absentee defendant, Mortgage Lenders Network USA, for 21 code violations at a home."). The Court of Appeals for the Eight District of Ohio recently upheld the use of a criminal trial in absentia against a non-resident real estate investor for failing to abate a nuisance. *See* Cleveland v. Destiny Ventures, L.L.C., No. 91018, 2008 WL 4175026, at *2 (Ohio App. Sept. 11, 2008). Because the facts of this case

$40,000 or $50,000 for a single property.[172] To increase the gravity of these penalties, Judge Pianka also refuses to hear eviction proceedings initiated by guilty banks and threatens corporate executives with fines of $5,000 per day if found guilty.[173] Furthermore, lenders who have not paid their fines are forbidden to sell other properties in the area.[174] Recently, banks have started appearing to present a defense for alleged code violations[175] and some lenders are complying with the orders to repair the homes.[176]

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are very similar to abatement cases against non-resident lenders, it is very likely that the appellate court would uphold a conviction against a non-resident lender for non-compliance with nuisance abatement orders.

[172] Orey, *supra* note 100; Ott, *supra* note 99. As of October 2008, Judge Pianka has held 47 trials in absentia and entered judgments against guilty defendants in excess of $1.37 million in criminal fines. *See* Judge Raymond L. Pianka, Housing Court Initiatives, Cleveland Municipal Court, Housing Division (Oct. 23, 2008).

[173] Gupta, *supra* note 75. Judge Pianka uses the doctrine of clean hands: "he who comes into equity must come with clean hands," to hold that a lender that is guilty of reprehensible conduct on one property will not be able to obtain an eviction order against an occupant at another property. *See* Pianka, supra note 172, at 1. When obtaining guilty pleas from a lender, Judge Pianka "endeavors to include in plea agreements and sentences solutions that address all problem properties owned by the defendant in the City of Cleveland." *Id.* at 2.

[174] Milicia, *supra* note 73 ("[Judge Raymond Pianka] put 12 companies on trial in absentia and has fined most, leaving each unable to sell any properties in the area until it pays up."). Pianka recently announced his intent to continue holding these trials in absentia against lenders every other Monday until his docket is cleared. Gupta, *supra* note 75. Non-resident lenders are not the only violators. Non-resident real estate investment firms also are violators and are expected to pose a growing problem due to lenders selling, for pennies on a dollar, blighted properties to these investors, who in turn flip the properties. *See* Thomas Ott, *Second Foreclosure Crisis? Firms Buy, Resell 'As Is' to At-Risk Buyers*, PLAIN DEALER (Cleveland, Ohio), Feb. 24, 2008, at B1. Judge Pianka convicted Destiny Ventures of Tulsa, Okla., and criminally fined it $140,000 for numerous code violations at house located in Cleveland. *See id.,* Cleveland v. Destiny Ventures, L.L.C., No. 91018, 2008 WL 4175026, at *2 (Ohio App. Sept. 11, 2008) (holding that the municipal court correctly criminally tried Destiny Ventures in absentia after failing to appear and that the company was not denied its right of confrontation). The City of Cleveland garnished Destiny's bank accounts for $40,000, plus $13,000 in penalties and interest. *See* Ott, *supra* note 174.

[175] Gupta, *supra* note 75.

[176] *See, e.g.*, Staff Reports, *Law & Order*, PLAIN DEALER (Cleveland, Ohio), Jan. 10, 2008, at B3 (Countrywide Financial, the nation's largest mortgage lender, in a response to a $50,000 fine issued Judge Pianka for failing to repair a house reclaimed at a foreclosure, plans to spend $77,000 to renovate a property with a market value of $97,900).

C. Large-Scale Litigation: Cities' Attempts to Recover Damages for Multiple Properties

While potentially effective in years gone by, the foregoing proceedings cannot stem the tidal wave of rising foreclosures and abandonment because these proceedings involve a single lawsuit against an individual lender for a single blighted property. Time—or, more specifically, delay—has been an egregious constraint on using civil and criminal proceedings in piecemeal fashion. Three cities, Buffalo, Cleveland, and Baltimore, are presently pursuing novel large-scale litigation to hold lenders responsible for thousands of abandoned blighted properties. Although each city has gone about this task in a slightly different way, the one unifying goal behind each method is to force mortgage lenders to claim responsibility for the abandoned properties in which they hold a mortgage or some other legal interest. A judgment against one lender may be enough to start a movement to enable cities to recover from lenders the harm their reckless lending has facilitated.

To prevail the three cities are required to (1) identify the wrongdoer, (2) link the wrongdoer's actions to the increase in foreclosures and abandonment, and (3) link the foreclosures and abandonment to injuries claimed by the city. The discussion below will begin by assessing the strengths and weaknesses of a lawsuit initiated by Baltimore against Wells Fargo under the Federal Fair Housing Act. Next will be a discussion of whether Cleveland's lawsuit against 21 lenders will be effective given that it fails to specifically name any blighted property for which the lenders are responsible and that it focuses heavily on the secondary mortgage market's role in funding subprime lending. Last will be a discussion of whether Buffalo's lawsuit against 36 lenders will be an effective means of using mass public-nuisance litigation to hold them responsible.

1. Baltimore's Disparate Impact Discrimination Claim Under the Fair Housing Act

As the discussion proceeds below, Baltimore's lawsuit may initially appear to be out of place given that the discussion heretofore has been devoted to individual civil and criminal nuisance abatement actions. Baltimore's case is nevertheless chosen for two reasons. First, the litigation brought by Baltimore, while unique, can provide a viable alternative theory of recovery to cities that have seen neighborhoods comprised of minorities ravaged by predatory subprime loans. Second, Baltimore's case is worth analyzing because of its similarities to the cases filed by Cleveland and Buffalo. Like these two cities, Baltimore seeks, in part, nuisance-type damages. Also, like Cleveland, Baltimore has to demonstrate that the subprime loans at issue were predatory and doomed to fail, and, therefore, would naturally lead to foreclosures and abandonment and subsequent harm to the city.

In its lawsuit, Baltimore claims that Wells Fargo's lending acts, policies, and practices are discriminatory and therefore violate sections 3604 and 3605 of the

Federal Fair Housing Act (FHA) by having a disparate impact on African-American neighborhoods.[177] Cities must establish standing in order to hold lenders liable for FHA violations because a "city" or "municipality" is not expressly included in the statutory definition of a "person."[178] The FHA prohibits racial discrimination against any "person" in any residential real estate transaction or in the financing of such transactions.[179]

The Supreme Court of the United States has ruled directly on the issue of whether a municipality has standing to bring a claim for an FHA violation. In *Gladstone, Realtors v. Village of Bellwood*, the Court held that even though there

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[177] *See* Complaint for Declaratory Relief and Injunctive Relief and Damages at 37–38, Mayor and City Council of Balt. v. Wells Fargo Bank, No. L08CV-062, (D. Md. Jan. 8, 2008) 2008 WL 117894 [hereinafter Baltimore Complaint]; *see also* 42 U.S.C. §§ 3601–3631 (2006).

[178] *See* Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L.J. 757, 768 (2007); *see also* Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355, 387–89 (2006) (discussing the fact that the FHA does not explicitly permit or preclude claims by governmental entities or include public entities in its definitions of person). Wells Fargo defended the lawsuit on the grounds that Baltimore lacks standing and is relying in part on a United States Supreme Court's decision, *Warth v. Seldin* , 422 U.S. 490, 491 (1975) (holding that a plaintiff must allege "specific, concrete facts demonstrating that such practices harm *him*, and that he personally would benefit in a tangible way") (emphasis in original). *See* Defendant's Motion to Dismiss, Mayor of Baltimore v. Wells Fargo Bank, No. 08 Civ. 00062 (D. Md. Mar. 3, 2008) ("[I]t was pure speculation [for Baltimore] to argue that 313 foreclosures attributable to Wells Fargo over seven years could have caused any discrete and palpable injury to the City."). At issue in *Warth* were claims by various individuals and organizations that the New York suburban town of Penfield employed zoning ordinances that effectively excluded persons of low or moderate income from living in the town. 422 U.S. at 504. Although the Supreme Court held the petitioners in *Warth* did not have standing to bring a cause of action, the Court's holding was largely based on the fact that none of the petitioners held any present interest in any Penfield property or were subject to any of the restrictive zoning regulations. *Id.* ("[N]one of these petitioners has a present interest in any Penfield property; none is himself subject to the ordinance's strictures; and none has ever been denied a variance or permit by respondent officials.").

[179] Section 805(a) of the Fair Housing Act provides:

> It shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.

42 U.S.C. § 3605(a). Section 805(b)(1) defines covered transactions to include "the making or purchasing of loans or providing other financial assistance" for the purchase, construction, improvement, repair, or maintenance of a dwelling as well as loans or other financial assistance that are "secured by residential real estate." *Id.* § 3605(b)(1).

is no explicit language providing a municipality with an FHA claim, a city can be an "aggrieved person" for purposes of the statute.[180] The FHA grants standing to an aggrieved person, which is anyone who has been or will be injured by a discriminatory housing practice.[181] In *Gladstone, Realtors*, the city alleged that the defendant's discriminatory practices caused a substantial reduction in property values thereby directly injuring the city by diminishing its tax base, and consequently threatening the city's ability to bear the costs of running the local government and providing social services.[182] This allegation was sufficient to give the city standing.[183]

Following the *Gladstone, Realtors* decision, the United States Court of Appeals for the Seventh Circuit held that Chicago had standing in a case that may be the most analogous to Baltimore's current foreclosure and abandonment problem. In *City of Chicago v. Matchmaker Real Estate Sales Ctr., Inc.*, Chicago claimed that racial steering by real estate sales agents destabilized the community, increased the burden on the city in the form of increased crime, and eroded the city's tax base.[184] Relying on *Gladstone, Realtors*, the Seventh Circuit held that Chicago had standing because in addition to community destabilization and tax base erosion, the city's fair housing agency had to use its scarce resources to ensure compliance with fair housing laws rather than perform its routine services.[185]

The injuries suffered by the two cities in *Gladstone, Realtors* and *Matchmaker Real Estate Sales* are similar to those suffered by Baltimore. Baltimore's complaint alleges that Wells Fargo's lending practices violated the FHA because they resulted in high-interest, high-priced subprime loans issued to African-American residents at a disproportionately higher rate than it did to whites.[186] In seeking to obtain a multi-million dollar verdict, Baltimore asserts that the foreclosures related to Wells Fargo's alleged discriminatory lending practices inflicted multiple injuries, including a rise in the number of abandoned homes in Baltimore, a decrease in city tax revenues, an increase in expenditures to secure

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[180] 441 U.S. 91, 115 (1979) (allowing the Village of Bellwood to bring a claim against a real estate firm for violating the FHA through its pattern of racial steering).

[181] 42 U.S.C. § 3602(i).

[182] *Gladstone, Realtors*, 441 U.S. at 110–11.

[183] *Id.* at 110–11, 115.

[184] 982 F.2d 1086, 1095 (7th Cir. 1992). The court defined "racial steering" as

> [A] practice by which real estate brokers and agents preserve and encourage patterns of racial segregation in available housing by steering members of racial and ethnic groups to buildings occupied primarily by members of such racial and ethnic groups and away from buildings and neighborhoods inhabited primarily by members of other races or groups.

Id. at 1089, n.3.

[185] *Id.* at 1095.

[186] Baltimore Complaint, *supra* note 177, ¶¶ 1–3.

and rehabilitate the homes and provide fire and police services to the homes.[187] Based on these injuries, it is clear that the City of Baltimore would have standing to bring the FHA claim.[188]

In addition to establishing that it has standing, Baltimore will have to establish that Wells Fargo's subprime lending resulted in racial discrimination in the form of reverse redlining, as alleged in its complaint.[189] Reverse redlining is the practice of extending credit on unfair terms to specific geographic areas due to the income, race, or ethnicity of its residents.[190] Such redlining violates § 3605 of the FHA, which prohibits discrimination against any person "in making available *[a residential real estate–related] transaction, or in the terms or conditions of such* a transaction."[191] *Hargraves v. Capital City Mortgage* is the seminal case establishing that a reverse redlining claim against a lender can be established solely by evidence that the lender's actions had a disparate impact on minority borrowers.[192] There, the plaintiffs alleged that Capital City Mortgage, a loan originator and servicer, and its president had engaged in reverse redlining by targeting African-Americans in the District of Columbia (DC) with predatory loans.[193] The United States District Court for the District of Columbia adopted a two-pronged test for a reverse-redlining discrimination claim. Under that test, a plaintiff must establish (1) "the defendants' lending practices and loan terms were 'unfair' and 'predatory,' and [(2)] the defendants . . . intentionally targeted [the plaintiffs because of their] race" ***or*** that the defendant's lending practices had "a disparate impact on the basis of race."[194]

The court found a sufficient allegation of "unfair" or "predatory" lending practices where the plaintiffs had alleged the defendants charged excessive interest rates, lent based on the value of the home securing the loan rather than the borrower's repayment ability, and charged excessive fees for its loan servicing

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[187] *Id.*

[188] *See* Entin & Yazback, *supra* note 178, at 769–70 (stating standing may be established by the city showing "that predatory lenders were engaging in racial discrimination in real estate financing and that this discrimination harmed the city financially or socially").

[189] The City's case can be supported by research indicating that African-American borrowers are more likely to be steered toward subprime loans even though their credit history would cause them to qualify for prime rate loans. *See, e.g.*, Hargraves v. Capital City Mortgage, Corp., 140 F. Supp. 2d 7, 20 (D.D.C. 2000).

[190] *See id.* (quoting United Companies Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 203 n.5 (D. Mass. 1998)).

[191] *See* 42 U.S.C. § 3605(a) (2006). Such transactions include "[t]he making . . . of loans or providing other financial assistance—(A) for purchasing, constructing, improving, repairing, or maintaining a dwelling; or (B) secured by residential real estate." *Id.*, § 3605(b)(1).

[192] *Hargraves*, 140 F. Supp. 2d at 21–22.

[193] *Id.* at 15, 20.

[194] *Id.* at 20 (citing Jackson v. Okaloosa County, 21 F.3d 1531, 1543 (11th Cir.1994) (holding an FHA violation can be shown either by "direct discrimination" or "discriminatory effects")).

procedures.[195] While the defendants argued that such a ruling would result in lenders being reluctant to lend to minorities, the court opined that responsible lenders would be able to avoid liability by demonstrating the legitimacy of their lending practices.[196] The court concluded that a disparate impact on the basis of race had been shown based on the plaintiffs' statistical evidence that the lender had "made a greater percentage of its loans in majority black census tracts [in DC] than other subprime lenders, and made an even more disproportionately large number of loans in neighborhoods that [were] over 90 percent black."[197]

Baltimore has alleged facts to satisfy this two-prong test for a reverse redlining claim. Baltimore alleges the existence of loans with predatory characteristics including loans with low "teaser rates" for the first two or three years of the loan period.[198] Baltimore's complaint does not mention how high the interest rates were, but discovery could be used to determine a median interest rate. Courts have accepted expert testimony explaining that if the difference in interest rates between the lender's subprime loan and a prime market loan is greater than a three-point difference, the loan is a predatory.[199] A court is likely to find that the first prong of the test has been met if Baltimore can show Wells Fargo's loan products fit the common characteristics of predatory subprime loans, such as loans that include any combination of payment of high interest rates, paying off a low-interest mortgage with a high-interest mortgage, charging of prepayment penalties, and payment of high broker fees, points, yield spread premiums, undisclosed fees, and balloon payments.[200]

As for the second prong, disparate impact, Baltimore has evidence that Wells Fargo has issued loans in both predominantly white and black neighborhoods,[201] but will no doubt seek discovery to establish that the majority of these loans were issued to residents of predominantly African-American neighborhoods. Baltimore has alleged the majority of Wells Fargo's foreclosures have occurred in

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[195] *Id.* at 20–21; *see also* Engel, *supra* note 178, at 356 n.3 (describing features of suspect loans as: "(1) Loans structured to result in seriously disproportionate net harm to borrowers, . . . (2) harmful rentseeking, e.g., prepaid credit life insurance, (3) loans involving fraud or deceptive practices, (4) other forms of lack of transparency in loans that are not actionable as fraud, and (5) loans that require borrowers to waive meaningful legal redress." (citing Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1260–61 (2002)).

[196] *See Hargraves*, 140 F. Supp. 2d at 21.

[197] *Id.*

[198] Baltimore Complaint, *supra* note 177, at 8–9.

[199] *See* McGlawn v. Pa. Human Relations Comm'n, 891 A.2d 757, 770–72 (Pa. Commw. Ct. 2006) (finding the difference in interest rates between a sub-prime and a prime market loan to normally be no greater than three percentage points); M & T Mortgage Corp. v. Foy, 858 N.Y.S.2d 567, 570–71 (N.Y. Sup. Ct. 2008) ("[T]his Court holds that an interest rate exceeding nine percent [which is three percent more than the six percent prime rate] evidences the existence of a higher priced loan and creates a rebuttable presumption of discrimination.").

[200] *See McGlawn*, 891 A.2d at 769.

[201] Baltimore Complaint, *supra* note 177, at 1717.

predominantly African-American neighborhoods.[202] Compared with other lenders, Baltimore claims, Wells Fargo has the greatest number of foreclosures in Baltimore.[203] In 2005 and 2006, at least 50% of Wells Fargo's foreclosures "were in census tracts that are more than 80% African-American and *two-thirds* were in tracts that are over 60% African-American, but only 15.6% were in tracts that are 20% or less African-American."[204] Similar foreclosure patterns exist for the years 2000 to 2004 and for the first half of 2007.[205] These facts are compelling evidence of the disparate impact that Wells Fargo's subprime loans have had on African-American borrowers.

Alternatively, the second prong of the reverse-redlining test can be established by evidence of intentional targeting in addition to disparate impact on the basis of race.[206] *Hargraves* and its progeny may prove helpful to Baltimore in that those cases show what types of evidence of targeting are sufficient for a plaintiff to withstand a motion to dismiss. The *Hargraves* court held that while evidence of intentional discrimination was not necessary to establish a claim based on disparate impact, intent had been shown in the form of "targeting" based on "the defendants' solicitation of brokers who operate predominately in the black community, their distribution of flyers and advertisements in black communities, [their] decision to place their offices in black communities," and their use of a front-office picture featuring the defendant president next to well-known African-American politicians.[207]

Relying on *Hargraves*, the court in *Matthews v. New Century*[208] held that the plaintiffs had sufficiently pled a gender and age discrimination claim based on targeting where they had alleged that the lenders sent agents to the homes of elderly widows who had not initiated contact with the lenders or in any way sought their services.[209] Likewise, in *Barkley v. Olympia Mortgage Co.*,[210] the court found

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[202] *Id.*

[203] *Id.* at 17–18.

[204] *Id.* at 17 (emphasis added).

[205] *Id.*

[206] *See* Hargraves v. Capital City Mortgage, 140 F.Supp. 2d 7, 20 (D.D.C. 2000).

[207] *Id.* at 21–22. (stating that "plaintiffs allege that this [picture featuring former Mayor Marion Barry, Reverend Jesse Jackson, and former District of Columbia Councilmember Arrington Dixon] was an attempt to convey a message to African-Americans that [the company's white president] could be trusted").

[208] 185 F.Supp. 2d 874 (S.D. Ohio 2002).

[209] *Id.* at 886–87 (alleging that predatory lenders targeted elderly widows for home improvement loans on the basis of gender, age, marital status). In *McGlawn v. Pa. Human Relations Comm'n*, a Pennsylvania state court upheld a discrimination ruling by the Pennsylvania Human Relations Commission against a mortgage broker for "intentionally targeting" African-American communities when he advertised using several sources (radio, television, and newspapers) that were "oriented toward African-American audiences and readers." 891 A.2d 757, 769, 772 (Pa. Commw. Ct. 2006) (stating that plaintiffs resided in African-American communities in Philadelphia County, Pennsylvania and that the "broker engaged in extensive advertising on radio and television, in the newspapers and in the

the plaintiffs' allegations were sufficient to withstand a motion to dismiss where the plaintiff alleged that several defendants, including appraisers, lenders, and lawyers, had worked with one defendant that ran advertisements featuring African-American homebuyers in newspapers and other sources,[211] used employees who showed African Americans homes located only in predominately minority neighborhoods, and used minority salespersons who indicated that they "take care" of their own.[212] Allowing evidence of intentional targeting to establish a reverse-redlining claim is justified "because to hold otherwise would allow predatory lending schemes to continue as long as they are exclusively perpetrated upon one racial group."[213]

Baltimore alleged that Wells Fargo targets African-American communities but failed to provide any specifics as to how this targeting was accomplished.[214] Discovery is, therefore, necessary to demonstrate targeting. If the targeting was accomplished via third parties, Baltimore will have to persuade the court that Wells Fargo should be held responsible for the actions of third party brokers and

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yellow pages"). The claim was filed under the Human Relations Act, which is patterned after the FHA. *Id.* at 763.

[210] No. 04 CV 875(RJD) (KAM), 2007 WL 2437810 (E.D.N.Y. Aug 22, 2007).

[211] *Id.*, at *1, *11, *23. *See also* Honorable v. Easy Life Real Estate Sys., Inc., 182 F.R.D. 553, 561 (N.D. Ill. 1998) (certifying class in Fair Housing Act case in reliance on allegations that "defendants preyed on the plaintiff class by targeting their advertising to unsophisticated, first-time home buyers in the racially segregated Austin community, materially misrepresenting the condition and value of homes offered for sale, fraudulently arranging for government-insured mortgage loans, and making misrepresentations about future repairs").

[212] *Id.* at *2–6, *12 (holding that "the complaints against United Homes and the other defendants not only allege that plaintiffs were targeted for fraud because of their race, but also contain detailed allegations of defendants' efforts to accomplish this targeting through advertising and other modes of minority-focused outreach and race-sensitive recruiting").

[213] *Id.* at *14 (In addition, the court reasons that, "permitting evidence of intentional targeting as an alternative to evidence of disparate treatment or impact is also in keeping with the Fair Housing Act's twin aims of 'forbidd[ing] those practices that make housing unavailable to persons on a discriminatory basis as well as discriminatory terms and conditions with respect to housing that *is* provided.'"). The plaintiffs also alleged "that the company placed ads in the Caribbean Life community newspaper that serves the West Indian immigrant community, while not advertising in community papers that are part of the same newspaper chain but serve primarily white neighborhoods." *Id.* at *11.

[214] Plaintiff Mayor and City Counsel of Baltimore's Memorandum of Points and Authorities in Opposition to Defendants' Motion to Dismiss the Complaint, Baltimore v. Wells Fargo, No. 1:08-cv-00062-BEL, at 9 (D. Md. 2008) ("Wells Fargo intentionally exploits the City's African-American community for a quick profit by making loans that are not sound, and then selling those loans on the secondary market to avoid the risk to itself of default and foreclosure.").

other real estate professionals.[215] To do so, Baltimore can rely on the holding in *Matthews v. New Century Mortgage Corp.*[216]

In *Matthews,* the plaintiffs alleged that New Century, a subprime lender, had, in conspiracy with several independent brokers, engaged in a pattern of targeting single, elderly women, whose primary source of income was social security benefits, for predatory loans in violation of the FHA.[217] Ohio law provides that "the tort of civil conspiracy is 'a malicious combination of two or more persons to injure another in person or property, in a way not competent for one alone, resulting in actual damages.'"[218] A plaintiff alleging civil conspiracy must demonstrate an underlying unlawful act, such as fraud, for the conspiracy claim to succeed.[219] The court held that both the underlying unlawful act of fraud and the conspiracy had been pled based on a number of allegations, including the plaintiffs' assertion that the brokers had supplied falsified information in the loan applications, one of the mortgage brokers had close personal ties with two New Century employees, and New Century had approved fraudulent loan applications.[220] In reference to the fraud, the plaintiffs alleged that the brokers had provided phony occupations along with fraudulently inflated monthly incomes, which allowed the plaintiffs to qualify for larger loan denominations.[221] The brokers also led the plaintiffs to believe they were getting home-improvement loans that would lower their monthly bill payments when in fact they were issued adjustable-rate loans that ended up charging the plaintiffs higher fees while depleting their home equity.[222] Based on all of these allegations, the Court denied New Century's motion to dismiss because the plaintiffs had sufficiently pleaded that New Century had acted in conspiracy with the brokers and that New Century,

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[215] Baltimore's complaint implies that Wells Fargo's loans were originated through its own employees, not independent brokers. *See* Baltimore Complaint, *supra* note 177, at 1–3.

[216] 185 F.Supp. 2d 874, 886-87 (S.D. Ohio 2002) (alleging that predatory lenders targeted elderly widows for home improvement loans on the basis of gender, age, marital status).

[217] *Id.* at 889.

[218] Williams v. Aetna Fin. Co., 700 N.E.2d 859, 868 (Ohio 1998).

[219] *Id.* (citing Gosden v. Louis, 687 N.E.2d 481, 496 (Ohio Ct. App. 1996)).

[220] *See Matthews*, 185 F. Supp. 2d at 878–81, 890 (describing various loans that were issued and stating that "Rebecca Blankenship, the former president of Central Mortgage, had close personal ties with various employees at New Century (including her brothers and her husband, Kevin Blankenship, Jeff Snyder, and Robert Banhagel)."). In several instances, the brokers had provided phony occupations along with fraudulent monthly incomes. *Id.* at 879–80.

[221] *Id.* at 879–80.

[222] *Id.* at 880. The plaintiffs also asserted that copies of loan documents were not provided at signing; therefore, the specifics of the loans were not disclosed until years later. *See id.* at 879.

through its own loan officers, had itself engaged in fraud by knowingly making discriminatory loans.[223]

Although the *New Century* case is an Ohio case, Maryland has recognized a conspiracy claim in the context of a property flipping scheme and follows the same conspiracy definition as adopted by Ohio.[224] In *Hoffman v. Stamper*,[225] the court upheld a jury finding that all defendants involved in a property flipping scheme were liable on several counts, including a conspiracy to defraud.[226] Although the defendants, a corporate lender, its loan officer, and an independent appraiser, contended that the evidence was insufficient on the conspiracy count,[227] the court pointed out that a conspiracy may be proved by circumstantial evidence.[228] The court stated:

> a conspiracy may be established by inference from the nature of the acts complained of, the individual and collective interest of the alleged conspirators, the situation and relation of the parties at the time of the commission of the acts, the motives which produced them, and all the surrounding circumstances preceding and attending the culmination of the common design.[229]

Rather than some random isolated inflated appraisals, the court held that the evidence was sufficient to show that there was an overall consistent pattern of the

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[223] *Id.* at 890 (citing Williams v. Aetna Fin. Co., 700 N.E.2d 859, 868 (Ohio 2002) ("The Court recognizes, in regard to this finding, that New Century can be held liable for the intentional torts of its employee loan agents committed within the scope of their employment.")).

[224] *Compare* Hoffman v. Stamper, 867 A.2d 276, 290 (Md. 2005) (stating that a conspiracy is "a combination of two or more persons by an agreement or understanding to accomplish an unlawful act or to use unlawful means to accomplish an act not in itself illegal, with the further requirement that the act or the means employed must result in damages to the plaintiff"), *with Mathews*, 185 F. Supp. 2d at 889–90 (stating that civil conspiracy under Ohio law "is a malicious combination of two or more persons to injure another in person or property, in a way not competent for one alone, resulting in actual damages").

[225] In *Hoffman*, the plaintiffs alleged that an appraiser, vendor, lender, and loan officer conspired to defraud the plaintiffs in violation of Maryland's Consumer Protection Act by selling the low-income plaintiffs dilapidated homes at inflated appraised values. 867 A.2d at 279.

[226] *Id.* at 290–92.

[227] *Id.* at 285.

[228] *Id.* at 291 (stating that "in most cases it would be practically impossible to prove a conspiracy by means of direct evidence alone" (quoting Western Md. Dairy v. Chenowith, 23 A.2d. 660, 664 (Md. 1942))).

[229] *Id.* at 291.

appraiser supplying "automatic appraisals" that benefited every defendant involved in the property flipping scheme.[230]

The foregoing cases support the assertion that a lender can be held responsible under a conspiracy claim for other participants involved in a predatory lending scheme.[231] Baltimore need only find former loan officers employed by Wells

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[230] *Id.* at 291–92 (stating that "Hoffman [the appraiser] derived 99% of his income from appraisals done for Irwin [the lender], that he knew if the appraisal did not match the contract price, the deal would fall through, thereby depriving Wood [the lender's loan officer] of her commission and Beeman [the vendor] of his profit").

[231] A claim like Baltimore's against a subprime lender has already met with some success and may be harbinger of Baltimore's success against Wells Fargo. Consider a recent ruling by the Ohio Civil Rights Commission against Argent Mortgage Co., which had started originating loans in Cuyahoga County (seat of Cleveland) in 2003 and had been accused of housing discrimination. Probable Cause Determination, Housing Advocates, Inc. v. Argent Mortgage Co., No. 05-07-0938-8, (Ohio Civil Rights Comm'n Mar. 13, 2008). Mark Gillispie, *Argent Lender Found Biased Against Blacks*, PLAIN DEALER (Cleveland, Ohio), Mar. 19, 2008, at B1 (discussing the ruling of the Ohio Civil Rights Commission). Under Ohio law, it is unlawful to

> [d]iscriminate against any person in the making or purchasing of loans or the provision of other financial assistance for the acquisition, construction, rehabilitation, repair, or maintenance of housing accommodations, or any person in the making or purchasing of loans or the provision of other financial assistance that is secured by residential real estate, because of race, color, religion, sex, military status, familial status, ancestry, disability, or national origin or because of the racial composition of the neighborhood in which the housing accommodations are located.

OHIO REV. CODE ANN. § 4112.02(H)(3) (LexisNexis 2006). Argent, like Wells Fargo, was accused of reverse redlining, by issuing, via its brokers, subprime loans that were interest-only or adjustable rate mortgages, that were based on falsified income or no income documentation, and that gave borrowers cash back or required no money down. Charu Gupta, *Where It Lands Somebody Knows: A Small Measure of Justice*, CLEVELAND SCENE, Mar. 26, 2008, *available at* http://www.freetimes.com/stories/15/47/where-it-lands-somebody-knows. These mortgages were doomed to fail, particularly when the monthly mortgage payments sometimes comprised 50 percent of a borrower's income. *See Probable Cause Determination*, No. 05-07-0938-8, at *2–3. Argent, which did not issue prime rate loans, pooled its subprime loans together and sold them to Park Place Securities, Inc., which in turn securitized the pool and sold it to Wells Fargo as the trustee. The Commission ruled that sufficient evidence existed for Housing Advocates to proceed against Argent on the basis that it discriminated against African-American borrowers in the greater Cleveland area by targeting them with predatory, subprime home loans. *See id.* A study of Argent's loans in Cleveland's 36 statistical planning areas (SPAs) showed that Argent had the greatest market share of home-purchase and refinance loans. *See id.* In the ten SPAs with the greatest concentrations of African-Americans, Argent was the number one lender "23 of the 40 possible times (57.5%)" but was never number one in the ten SPAs with the highest concentration of Caucasians. *See id.* Moreover, 665 of Argent's loans went into foreclosure between 2003 and 2007, and, of those loans, 70 percent or 463

Fargo or its brokers to establish, for example, that Wells Fargo engaged in a pattern of approving liar loans.[232] Numerous brokers are now out of business or have filed bankruptcy and several lenders have laid off workers.[233] A few of these workers are now whistleblowers, shedding light on what knowledge lending executives had about past predatory lending practices perpetrated under their watch.[234] Thus, while Wells Fargo may try to claim that third-party brokers, not Wells Fargo, are responsible for any alleged subprime predatory lending, Baltimore's discovery proceedings could lead to sufficient facts to establish a conspiracy to defraud among Wells Fargo's loan officers, brokers, and appraisers.

Besides pursuing a conspiracy claim, Baltimore could pursue liability against Wells Fargo on the basis that its own discretionary pricing policy enabled its

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were in census tracts in Cuyahoga County that were 50 percent or more African-American. *See id.* In making its probable cause determination that Argent had engaged in housing discrimination, the Commission concluded that while Argent had its brokers agree to a code of conduct, it could not show that it monitored their conduct or had taken any action against the brokers who violated the code.

[232] *See* Floyd Norris, *Freddie Mac Stumbles On Loans*, N.Y. TIMES, Nov. 23, 2007, at C1 (stating that the terms NINA or liar loans do "not mean the loans went to people without either assets or income, only that the borrowers were not asked if they had either" and that the lender took the borrowers' words for how much they earned).

[233] *See* Sabry & Schopflocher, *supra* note 39, at 45 (listing recent bankruptcy cases filed by subprime lenders); LORE & COWAN, *supra* note 1, at 435–36 ("A steep rise in the rate of subprime mortgage foreclosures has caused more than two dozen subprime mortgage lenders to fail or file for bankruptcy . . . . The failure of these companies has caused prices in the $6.5 trillion mortgage backed securities market to collapse, threatening broader impacts on the U.S. housing market and economy as a whole.").

[234] For example, Mark Zachary is suing Countrywide Financial Corporation and its subsidiary Countrywide KB Home Loans for wrongful termination. Plaintiff's Second Amended Complaint 2,9–10, Zachary v. Countrywide Fin. Corp., No. 08-cv-00214, 2008 WL 1771816 (S.D. Tex. Apr. 9, 2008). Zachary was regional vice president in the Houston office of Countrywide KB and alleges that in 2006, he "began questioning Countrywide executives as to a questionable practice on the part of Countrywide where only one appraiser was being used to appraise homes" and alleges that "[t]he appraiser as known to Countrywide executives, was being strongly encouraged to inflate the homes' appraised value by as much as 6 percent to allow the homeowner to 'roll up' all closing costs." *Id.* at *3–4 ("This inflated value put the buyer upside down on the home immediately after purchasing it; thus, setting up the buyer to become more susceptible to defaulting on the loan. It also put the lender and secondary market end investor at risk because they were unaware of the true value of their asset."). Zachary alleges the company's executives knew or had reason to know about Countrywide's fraudulent lending practices via the numerous email messages that he sent to management voicing his concerns about the company's reliance on only one appraiser and the submission of loan applications that had inflated appraisals and that were in essence liar or NINA loans. *Id.* at *5 (alleging that he voiced his concern to management that "loans were being canceled at the prime regional operations center as full documentation loans and transferred to the sub-prime operations center in Plano, Texas as stated loans or No Income No Assets ('NINA') loans").

employees and brokers to engage in discriminatory lending practices.[235] In general, subprime lenders have discretionary pricing policies, under which lenders (1) set a minimum interest rate for a loan applicant based on objective criteria, such as income and credit score, and (2) permit third-party brokers or their loan officers to make the loan at an interest rate higher than the minimum rate established by the lenders.[236] Several pending class action cases allege that such policies, although facially neutral, have a disparate impact on minorities compared to similarly situated whites, in that the minorities pay substantially more in interest rates and fees than similarly situated whites.[237]

At present, no court has held that a lender's discretionary pricing policy is sufficient to hold the lender responsible for the brokers' steering of minority borrowers to subprime predatory loans.[238] However, a few courts have denied defendants' motions to dismiss and held that the plaintiffs had sufficiently supported their disparate impact claims based on allegations that minority borrowers paid higher costs than what their credit scores dictated because of the defendants' discretionary pricing policies.[239] For example, a California federal district court in *Ramirez v. GreenPoint Mortgage Funding* upheld allegations that

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[235] *See infra* notes 238, 245.

[236] *See* Stuart T. Rossman, *The Foreclosure Crisis: Can Impact Litigation Provide a Response*, 1656 PLI/CORP 195, 203–04 (2008).

[237] *See id.*; Christopher J. Willis & Catherine S. Bernard, *Recent Subprime Mortgage Lending Class Actions Under the Equal Credit Opportunity Act and Fair Housing Act: An Analysis of Class Certification Issues*, 1656 PLI/CORP 163, 165 (2008).

[238] There are cases pending where similar liability arguments have been made. For example, several minority borrowers have filed a complaint against H&R Block on the theory that the tax-preparing company created and used a system of discretionary pricing that resulted in minority borrowers being subjected to higher interest rates than similarly-situated white borrowers. Plaintiff's Memorandum in Opposition to Defendants' Motion to Dismiss on Basis of Fed. R. Civ. P. 12(b)(6) at 2, Barrett v. H&R Block, Inc., No. 08-10157-RWZ, 2008 WL 1966696 (D. Mass. May 1, 2008). This type of pricing policy causes minority borrowers to pay thousands of dollars more in interest charges even though their credit worthiness is very similar to white borrowers. *Id.* The plaintiffs argue that the discretionary pricing policy of H&R Block undermines any objective evaluations of credit worthiness resulting in a greater potential for race bias. *Id.* at 5. For other pending cases, see, e.g., Zamora v. Wachovia Corp., No. 3:07-cv-04603-JSW (N.D. Cal. Sept. 5, 2007); Ventura v. Wells Fargo Bank, No. 3:07-cv-04309-MJJ (N.D. Cal. Aug. 21, 2007); Puerto v. First Magnus Fin. Corp., No. 4:07-cv-00391-JMR (D. Ariz. Aug. 13, 2007); Jeffries v. Wells Fargo Bank., No. 3:07-cv-03880-MMC (N.D. Cal. July 30, 2007); Miller v. Countrywide Bank., No. 3:08-00448-JGH (W.D. Ky. Mass July 12, 2007); N.A.A.C.P. v. Ameriquest Mortgage Co., No. 8:07-cv-00794-AG-AN (C.D. Cal. July 11, 2007).

[239] *See* Order Granting in Part and Denying in Part Defendants' Motion to Dismiss, Garcia v. Countrywide Fin. at 17, 28, No. EDCV 07-1161-VAP (JCRx) (C.D. Cal. Jan. 15, 2008). There, the plaintiffs challenged the defendants' policy of permitting mortgage brokers to assess non-risk based fees. *Id.* at 15. The court held that the plaintiff's challenge to specific practices and not the defendants' overall rate determination processes was sufficiently specific to give the defendants notice as to the grounds on which the complaint is based. *Id.* at 18.

a lender's discretionary pricing policy allowed its brokers to mark up loans in violation of both the Equal Credit Opportunity Act (ECOA)[240] and the FHA.[241]

The lender argued that the plaintiffs failed to specifically identify a practice that led to the disparate impact and that the plaintiffs were "simply attacking the cumulative effects of pricing by thousands of *independent* brokers."[242] The district court rejected this argument and relied on a Supreme Court decision to hold that if a discretionary employment practice can form the basis of a disparate impact claim, so can a discretionary pricing policy.[243] The *Ramirez* court extended the reasoning of the Supreme Court to cover discretionary pricing policies in mortgage lending cases,[244] and, consequently, this case stands for the proposition that a lender can be responsible for the discriminatory acts of its third-party brokers where it is alleged that the lender's discretionary pricing policy facilitated the broker's actions.

Along with the *Ramirez* case, a 2006 settlement between Countrywide and the attorney general of New York may also have ramifications in Baltimore's case against Wells Fargo.[245] As early as April 2005, Wells Fargo was notified that it

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[240] Equal Credit Opportunity Act, Pub. L. No. 93-495, 88 Stat. 1500 (codified as amended at 15 U.S.C. §§ 1691a–91f (2006)).

[241] Ramirez v. GreenPoint Mortgage Funding, No. C08-0369 TEH, 2008 WL 2051018, at *6 (N.D. Cal. 2008). In *Ramirez*, GreenPoint, the lender, was accused of discrimination as a result of the actions of its own officers or brokers. *Id.* at *1. The plaintiffs alleged that GreenPoint's Discriminatory Pricing Policy had a disparate impact on African-American and Latino-American borrowers, because those borrowers paid higher fees and interest rates than similarly-situated white borrowers. *Id.* (stating that "the term 'minority' is intended to include black and Hispanic consumers"). According to the Home Mortgage Disclosure Act ("HMDA") data from 2004–2006, minorities were 50 percent more likely to pay high rates under GreenPoint's policy than similarly-situated whites. Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801–10 (2006)). *Ramirez*, 2008 WL 2051018, at *5. Specifically, the plaintiffs allege that GreenPoint used "a commission-driven, subjective pricing policy that it knows or should have known has a significant and pervasive impact on minority borrowers." *Id.* at *4.

[242] *Id.* at *4 (emphasis added).

[243] *Id.* (quoting Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 991 (1988)).

[244] *See id.* at *4.

[245] Along with the *Ramirez* case, Baltimore could cite to a lender's settlement with the attorney general of New York as further proof that a lender is responsible for its broker's discriminatory acts if the lender fails to control and monitor the broker's use of the lender's discretionary pricing policy. Attorney General of the State of New York, Civil Rights Bureau, Assurance of Discontinuance Pursuant to Executive Law 63(15), *In the Matter of* Countrywide Home Loans Inc. (Nov. 22, 2006), *available at* http://www.oag.state.ny.us/media_center/2006/dec/Countrywide%20Assurance%20Final%20Signed%20PDF.pdf. [hereinafter Assurance]. In 2005, the attorney general began investigating Countrywide Home Loans, Inc. and found that, based on HMDA data, Latinos were given high cost loans more than 15% of the time. *Id.* ¶ 2.1–2.2. Additionally, more than 27% of loans made to African-Americans were high cost, compared to less than 12% of the mortgages given to white borrowers. *Id.* ¶ 2.1. (Although Countrywide did not admit wrongdoing in the

was being investigated by the New York attorney general for practices equivalent to those addressed in the Countrywide settlement.[246] Since the settlement garnered media attention, Wells Fargo was on notice in 2006 as to what constituted acceptable pricing policies and broker monitoring practices and should have known what changes needed to be made to its own discretionary pricing policy in order to prevent discrimination by its brokers. Because of the Countrywide settlement and the prior investigation of Wells Fargo, the City of Baltimore could use discovery to determine what changes, if any, Wells Fargo made to its lending policies and to its training and monitoring of its brokers. If Wells Fargo failed to make any substantial changes in these areas, the failure to do so may serve as evidence the company knew its pricing policy led to discriminatory practices and yet it failed to take corrective action. As a result, Wells Fargo would be responsible for the conduct of its brokers and the disparate impact their conduct had imposed on African-American borrowers.

Baltimore's disparate impact claim against Wells Fargo is clearly based on its violation of the FHA, but Baltimore's complaint does not mention the word "nuisance" at all. Yet, the injuries Baltimore claims are, in part, the common types of injuries and damages alleged in a nuisance abatement action and its damages are similar to those sought by Buffalo and Cleveland in their recently filed nuisance lawsuits.[247] While it is clear that Baltimore's abandoned foreclosed properties are

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settlement, the Attorney General's Office found a disparate impact on minority borrowers in the form of higher charges for mortgages than offered to similarly-situated white borrowers. *See id.* ¶ 2.4 ("the OAG concluded [these practices] could support a claim under state and federal laws . . . that prohibit discrimination in the extension of credit."). Under the 2006 settlement with the attorney general, Countrywide agreed to make several changes, including agreeing to modify its discretionary pricing policies and to perform periodic statistical analysis to determine if any disparate lending is occurring. *Id.* ¶ 6.1. Countrywide must use statistical regression analysis to monitor broker compensation. *Id.* ¶ 6.1(b). The settlement's definition of broker compensation includes yield spread premiums, origination fees, and processing fees. *Id.* ¶ 1.4. This language is broad enough to cover third-party and company employed mortgage brokers. By using regression analysis, Countrywide will be able to control for race-neutral factors and determine if minority borrowers are being sold higher cost mortgages than similarly-situated whites. Countrywide also agreed to implement a fair-lending training program for brokers. See *id.* ¶ 9.1. The focus of this training program is to inform brokers about the law's prohibition on discriminatory pricing as well as Countrywide's policies against discriminatory lending. *Id.* The training program also must inform brokers of the company's requirement that customers receive information on the best mortgage products for which they qualify, as well as the advantages and disadvantages of available products including real dollar costs. *Id.* ¶ 9.1(b). Although the settlement did not require Countrywide to admit to discriminatory lending practices, it does represent the first instance where a major mortgage lender settled an unfair lending claim.

[246] Eric Dash, *New York Begins Inquiry into Possible Mortgage Bias*, N.Y. TIMES, Apr. 29, 2005, at C2.

[247] *Compare* Baltimore Complaint, *supra* note 177, at 35 (enumerating the various deleterious effects on neighborhoods of discriminatory lending practices), *with* 66 C.J.S.

public nuisances,[248] what is not clear from the city code is whether a lender, as mortgagee, is liable for the abandoned property if it has not taken possession of it.[249] This lack of clarity about which party is responsible for abating the nuisance, along with the time and expense of bringing piecemeal litigation to deal with individual abandoned properties, may help to explain why Baltimore chose to sue Wells Fargo under the FHA. A court's finding of liability on the FHA claim would, however, make Wells Fargo liable for the cost of abating the nuisance by rehabilitating or demolishing the abandoned homes in the African-American neighborhoods at issue. Wells Fargo could attempt to limit its liability for nuisance costs by identifying other lenders that hold mortgages on abandoned properties in these neighborhoods. The success of Baltimore's suit will be closely watched by other cities and states seeking to hold lenders accountable.[250]

NUISANCES § 4(c) (1998) ("A public nuisance consists of an unreasonable interference with the exercise of a right common to the general public, and includes conduct that significantly interferes with public health, safety, peace, comfort, or convenience; conduct that is proscribed by law; and conduct of a continuing nature that produces a permanent or long-lasting effect, and, as the actor knows or has reason to know, has a significant effect on public rights.") (citations omitted).

[248] Under Baltimore's city code, a vacant structure is "a fire hazard and a nuisance per se," BALTIMORE, MD., BUILDING, FIRE, AND RELATED CODES § 115.4 (2008) and "[a]ny structure or part of a structure found to be unsafe or unfit for human habitation or other authorized use must be rehabilitated or . . . demolished." *Id.* § 115.1.

[249] *See infra* notes 299–308 and accompanying text (discussing case law holding that a mortgagee not in possession cannot be held responsible to abate a nuisance on abandoned property).

[250] For instance, several months after Baltimore filed its lawsuit, Martha Coakley, the attorney general of Massachusetts, filed suit against H&R Block, Inc., and several related defendants, alleging that the companies issued subprime loans to residents of Massachusetts even though they were almost certain to fail. Complaint 2–3, 5, Massachusetts v. H&R Block, Inc., No. 08-2474-BLS (Mass. Super. Ct. June 3, 2008) [hereinafter Massachusetts Complaint] (Defendants to the complaint are H&R Block, Inc., Block Financial Corp., Option One Mortgage Corp., H&R Block Mortgage Corp., AH Mortgage Acquisition Co., and Am. Home Mortgage Servicing, Inc.). More specifically, African-Americans and Latinos were targeted and given loans at higher rates than similarly situated whites and paid higher points and fees. *Id.* at 6, 36; Press Release, Office of the Attorney General Martha Coakley, Attorney General Martha Coakley Files Lawsuit Against National Mortgage Lender Option One and Parent H&R Block for Deceptive and Discriminatory Lending Practices (June 3, 2008), *available at* http://www.mass.gov/?page ID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2008_06_03_option _one_suit&csid=Cago (stating that the subprime loans were underwritten based on unrealistic assessments of the borrowers' repayment ability, that some of the loans were 2/28, ARMs, stated income, no-doc, and low-doc loans, and that the defendants encouraged their employees and brokers to issue subprime loans to borrowers that qualified for prime loans). Massachusetts is claiming many damages related to foreclosure, including the cost of increased home abandonment. Massachusetts Complaint, *supra* note 250, at 5 (stating that abandoned houses require "law enforcement and emergency services" and lower property value). Unlike the lawsuits filed by Baltimore, Buffalo, and Cleveland,

2. Cleveland's Mass Public Nuisance Case Against Wall Street Investment Banks

Unlike Baltimore, which filed suit against only one lender under the FHA, the City of Cleveland has cast a wide net by filing suit against twenty-one lenders, including Wells Fargo, seeking to hold them responsible on grounds that their actions led to a public nuisance.[251] As explained more fully below, both cities have in common the assertion that the subprime mortgages issued to their residents led to the nuisance-related injuries. Specifically, Cleveland alleges the lenders' reckless securitization of subprime loans—packaging them into tradable securities and selling them—resulted in a widespread foreclosure and abandonment problem. The problem: "[a] rash of defaults inevitably followed [from the subprime loans], and the ensuing foreclosures have left homes abandoned and boarded-up, transforming them into eyesores, possible fire hazards, and targets for both looters and criminals."[252] Thus, Cleveland's lawsuit hinges on establishing that subprime mortgage loans are harmful products and establishing a causal link between these loans issued or securitized by the defendants and the subsequent public nuisance claimed by the city.

Before explaining what Ohio law requires to establish a public nuisance, this section explains the securitization process. Decades ago, a mortgage loan used to be a simple contractual relationship between a borrower and a local bank. The bank would issue and finance the loan, collect mortgage payments, restructure the

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Massachusetts is unique in that it is asking for $5,000 civil damages for each consumer harmed by the defendant's actions and seeking an injunction to prevent the defendants from "initiating or advancing a foreclosure, as an owner, servicer, or other agent, on any property secured by a Massachusetts loan issued by Defendants, without first providing the Commonwealth a 90-day period to review each such loan," and from selling or assigning any such loans). *See id.* 55–56; *infra* Part III.C.3 (discussing Buffalo's case against 36 lenders); *infra* Part III.C.2 (discussing Cleveland's case against 21 lenders). Baltimore's Complaint does request an injunction, but it focuses upon preventing Wells Fargo from issuing predatory subprime loans since these loans result in foreclosure and injure the city. Baltimore Complaint, *supra* note 177, at 38.

[251] The defendants are Deutsche Bank Trust Co., Ameriquest Mortgage Co., Bank of America Corp., Bear Stearns Cos., Citigroup Inc., Countrywide Financial Corp., Credit Suisse, Fremont General Corp., GMAC-RFC, Goldman Sachs Group, Greenwich Capital Markets Inc., HSBC Holdings, Indymac Bancorp Inc., JPMorgan Chase & Co., Lehman Bros. Holdings Inc., Merrill Lynch & Co., Morgan Stanley, NovaStar Financial Inc., Option One Mortgage Co., Washington Mutual Inc. and Wells Fargo & Co. Complaint, ¶¶ 12–32, City of Cleveland v. Deutsche Bank Trust Co., No. 1:08-cv-00139-DCN, 2008 WL 200271 (N.D. Ohio Feb. 4, 2008) [hereinafter Cleveland Complaint]. Cleveland filed a motion seeking permission to add additional defendants to its suit claiming their funding of subprime lending also caused a public nuisance due to the high rate of foreclosures that has led to blighted neighborhoods. Supplemental Memorandum in Support of Motion for Remand at 2–3, Cleveland v. Deutsche Bank Trust Co., No. 1:08-cv-00139-DCN, 2008 WL 345776 (N.D. Ohio Jan. 24, 2008).

[252] *See* Cleveland Complaint, *supra* note 251, ¶1.

loan if needed, and foreclose after the borrower's defaults.[253] Today, mortgage loans are packaged into bonds and are subsequently sold to investors.[254] This process, known as securitization, involves numerous additional parties to the traditional borrower-lender relationship.[255] At one end of the securitization process are borrowers who obtained loans from mortgage brokers.[256] Through a complex network of contracts, national or regional lenders, i.e., loan originators, first approve of the loan applications submitted by the brokers.[257] The lenders then pool the mortgages together and sell them to a "special purpose vehicle," also called a trustee, which operates the pool.[258] The buyers of the pooled mortgages, known as mortgage-backed securities, are underwriters who in turn sell slices or tranches of the securities to the investors.[259] The servicer is the entity responsible for collecting mortgage payments from the borrower and enforcing the loans.[260] Until the subprime meltdown, Wall Street investment firms regularly packaged and sold the securities to investors, and rating agencies told investors that the securities presented acceptable levels of risk.[261] The huge rise in subprime lending could have never occurred if the Wall Street investment firms had not given the originating lenders revolving credit facilities, i.e., lines of credit.[262] In other words, this securitization process transformed illiquid mortgage assets into tradable securities, which moved billions of dollars into the residential mortgage industry, which in turn increased the volume of subprime loans that could be made to borrowers with poor credit histories.[263]

Cleveland's complaint alleges that the Wall Street banks' securitization of subprime loans led to a public nuisance in the city.[264] Under Ohio law, a public nuisance "affects the public at large or such of them as may come in contact with it . . . , [by] injuriously affect[ing] the safety [and], health . . . of the public, or

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[253] *See supra* note 87–88 and accompanying text.

[254] *See supra* notes 88–91 and accompanying text.

[255] *Id.*; *see also* Cleveland Complaint, *supra* note 251, ¶ 35.

[256] *See supra* notes 87–91 and accompanying text.

[257] *See* Peterson, *supra* note 13, at 2208–09.

[258] *Id.* at 2209.

[259] *Id.* at 2203–04.

[260] *Id.* at 2210–11.

[261] *Id* at 2202–03.

[262] *See id.* at 2223–24 (explaining the mechanisms, including offering lines of credit, through which Lehman Brothers contributed to several First Alliance "predatory lending scandals").

[263] *See id.* at 2196–97. *See also* Zachary A. Goldfarb and Alec Klein, *The Bubble: How Homeowners' Missed Mortgage Payments Set off Widespread Problems and Woke up the Fed*, WASH. POST, June 16, 2008, at A1 (stating that mortgage-backed securities "fueled the housing boom by pumping trillions of dollars into the mortgage market").

[264] Cleveland Complaint, *supra* note 251, ¶ 9 ("The propagation of sub-prime mortgages in Cleveland and the corresponding foreclosures constitute a public nuisance as defined by Ohio common law.").

work[ing] some substantial annoyance, inconvenience, or injury to the public."[265] Such a nuisance is based on allegations of the widespread issuance of the subprime loans to Cleveland residents and allegations that the defendants are responsible for epidemic filings in recent years of over 14,000 foreclosure actions in Cuyahoga County. [266] These filings have negatively affected the safety and health of the public by depleting the city's tax revenue and imposing upon it the cost of "increased fire and police expenditures associated with vacant properties, demolition costs, and the like." [267]

Once the public nuisance is established, Cleveland can further characterize it as (1) "absolute," which involves either intentional or unlawful conduct by the defendant that is so inherently dangerous that it cannot be conducted without damaging someone else's property rights or causing harm, no matter the care utilized or (2) "qualified," which involves a lawful act by the defendant that is "so negligently or carelessly done as to create a potential and unreasonable risk of harm, which in due course results in injury to another."[268] Cleveland's lawsuit does not expressly refer to the nuisance as absolute or qualified; however, it seems to be characterizing the nuisance as qualified since the defendants' origination and/or securitizing of subprime mortgages under the barest of underwriting standards "made mass foreclosures the only possible result of flooding the local market with sub-prime mortgages."[269]

Cleveland's complaint estimates how many billions in subprime-mortgage-backed securities were issued by each defendant, identifies which defendants also originated or made subprime loans to borrowers in Cleveland, and provides an estimate of how many foreclosure actions were filed by each defendant in Cuyahoga County.[270] Cleveland then alleges that the lenders knew or should have known that their subprime lending would have resulted in a wave of foreclosures given that at the time the lenders flooded the greater Cleveland area with these loans, Cleveland had not experienced a boom in home prices, had the distinction of being named among the poorest cities in 2003, had suffered the permanent disappearance of manufacturing jobs, and had been unable to attract new jobs.[271] As pleaded, the federal district court should be able to conclude that Cleveland's complaint sufficiently alleges a public nuisance and is, therefore, sufficient to survive the numerous motions to dismiss that have already been filed by the defendants.

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[265] Crown Property Dev., Inc. v. Omega Oil Co., 681 N.E.2d 1343, 1350–51 (Ohio Ct. App. 1996) (citation omitted).

[266] Cleveland Complaint, *supra* note 251, ¶¶ 1–6, 12–32.

[267] Cleveland Complaint, *supra* note 251, ¶ 3.

[268] Cincinnati v. Beretta U.S.A. Corp., 768 N.E. 2d 1136, 1143 nn. 4–5 (Ohio 2002) (quoting Metzger v. Pennsylvania, Ohio & Detroit RR. Co., 66 N.E. 2d 203, 203 (Ohio 1946)); *see also* State *ex rel.* R.T.G., Inc. v. State, 780 N.E.2d 998,1010 (Ohio 2002) (outlining the distinction between an "absolute" and a "qualified" public nuisance).

[269] Cleveland Complaint, *supra* note 251, ¶¶ 1–6.

[270] *See, e.g.*, Cleveland Complaint, *supra* note 251, ¶ 31.

[271] Cleveland Complaint, *supra* note 251, ¶ 50–51.

The problem with Cleveland's lawsuit is that its theory of recovery resembles a collective or market-share theory of liability, rather than a straightforward public nuisance claim. Courts, in various contexts, have held that either a market-share theory of liability is not a cognizable claim or that it had not been established by cities seeking nuisance damages. In *Chicago v. American Cyanamid Co.*, the City of Chicago attempted to use a market-share liability claim in a public-nuisance action against makers of lead-based paint.[272] Chicago alleged these makers of lead-based paint created a public nuisance because "they knew or should have known that lead-based paint is hazardous to children," but continued to manufacture and promote the paint.[273] Under a theory of "market-share" liability, the plaintiffs need not identify the specific products or manufacturers responsible for their exposure to the defective product.[274] Instead, the plaintiffs need only identify the majority of participants in the market.[275] Assuming a significant number of the market participants are identified, each would then be responsible for the damages in proportion to their market share.[276] Once the major market players are identified, the burden of proof shifts to each of the individual defendants to show that they individually could not have manufactured the harmful products.[277]

In *Chicago v. American Cyanamid*, the Illinois Court of Appeals upheld the trial court's dismissal of the City's claim for failure to state a claim.[278] The court held that because Chicago could not link the manufacturers to the harmful paint, no cause-in-fact could be established.[279] The City could not match individual manufacturers to specific instances of lead-based paint usage.[280] If the court had allowed Chicago to proceed without making such an identification, the market-share liability theory would effectively hold the defendants liable regardless of which company actually manufactured the harmful paint.

Cleveland's case is both stronger and weaker than Chicago's case against American Cyanamid. Cleveland's case is stronger in that while Chicago could not identify which defendant manufactured the lead-based paint that wound up in the homes, Cleveland can search public records and use discovery requests to determine which defendants are connected to each abandoned property. For

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[272] 823 N.E. 2d 126, 134 (Ill. App. Ct. 2005).

[273] *Id.* at 128.

[274] *See id.* at 134 ("The market share liability theory provides an exception to the general rule that a plaintiff must show that the defendant proximately caused the plaintiff's injury.").

[275] *Id.*

[276] *See* Thomas C. Galligan, Jr., *The Risks of and Reactions to Underdeterrence in Torts*, 70 MO. L. REV. 691, 714 (2005).

[277] *Id.* at 715 n.135.

[278] *American Cyanamid*, 823 N.E. 2d at 140.

[279] *Id.* at 136.

[280] *Id.* at 134.

instance, if the lender is a member of MERS,[281] a city could seek discovery against MERS because for each loan registered with it, MERS has information about ownership and security interests and the property covered by the loan.[282]

Cleveland's case is weaker than Chicago's case in that while no one doubts that lead-based paint is a dangerous product, some will doubt that one can categorize subprime mortgages as automatically harmful products. Cleveland could overcome this weakness by using discovery and expert witnesses to show to what extent the defendants' loans fit the characteristics of subprime predatory loans.[283] Moreover, if the loan products are considered predatory or were issued under very relaxed underwriting standards that resulted in the lenders' approval of liar, NINA, or NINJA loans,[284] then Cleveland could make a strong case that the loans issued or funded by the defendants were toxic, harmful products that would result in defaults and foreclosures from the outset.

While the Illinois appellate court in *Chicago* declined to recognize the market-share theory of liability as a viable claim in the context of a public-nuisance action, Ohio courts have held that the market-share liability theory is not cognizable under Ohio law in the context of products liability claims.[285] In *Cincinnati v. Beretta U.S.A. Corp.* (*Beretta I*), the appellate court refused to recognize a market-share liability claim and held that the City of Cincinnati could not proceed in a mass tort claim against gun manufacturers on public nuisance grounds.[286] However, the Supreme Court of Ohio reversed the appellate court's holding regarding the nuisance claim, stating: "we find that under the Restatement's broad definition, a public-nuisance action can be maintained for injuries caused by a product if the facts establish that the design, manufacturing, marketing, or sale of the product unreasonably interferes with a right common to the general public."[287] The gun manufacturers argued that they could not be held liable for the harm alleged because they did not have control over the guns when the criminals used them to perpetrate a nuisance on the city.[288] The court disagreed,

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[281] *See supra* notes 13, 92–97 and accompanying text (discussing the lender's use of MERS, a private electronic registry system, makes it difficult for municipalities to discover which lenders hold a mortgage against abandoned blighted properties).

[282] According to MERS's handbook, "[m]embers provide pertinent ownership and security interest information along with certain loan and property-related information when registering loans. The MIN is one of the data elements required for registration." Plaintiff's Memorandum in Support of Motion for Class Certification at 15 n. 10, *In re* MERSCORP Inc., Real Estate Settlement Procedures Act (RESPA) Litigation, No. 07-1801, 2008 WL 936982 (S.D. Tex. Jan. 21, 2008) (quoting from MERS(R) Integration Handbook Volume I: Business Integration Environment, Release 15.0 (December 9, 2007) and stating that MIN is "the 'mortgage identification number' assigned to each MERS registered loan").

[283] *See supra* notes 30, 43 and accompanying text (discussing characteristics of predatory loans).

[284] *See supra* notes 3–5 and accompanying text (defining various risky loans).

[285] *See, e.g.*, Sutowski v. Eli Lilly & Co., 696 N.E.2d 187, 192 (Ohio 1998).

[286] No. C-990729, 2000 WL 1133078, at *3 (Ohio App. Aug. 11, 2000).

[287] Cincinnati v. Beretta U.S.A. Corp. (Beretta II), 768 N.E.2d 1136, ¶ 10.

[288] *Id.*, ¶ 12.

stating that it is not necessary to show that the defendants had control of the actual firearms at the moment that harm occurred.[289] Based on the holding in *Beretta II,* Cleveland's nuisance claims against the twenty-one lenders are viable. Cleveland should not have to prove that the lenders had control, that is, held the mortgages at the time of the foreclosures or at the time the homes were abandoned or became blighted. Cleveland will, however, have to show that the lenders at some point had involvement, via securitization or otherwise, in the subprime mortgages—the dangerous products—that led to a public nuisance. Cleveland's case can also be buttressed by the work of several scholars that have explained how securitization facilitates predatory lending.[290]

Moreover, unlike the guns in *Beretta II* that were moveable personal property in which the manufacturers held no interest once the guns were sold, the subprime mortgages in the Cleveland case were originated or somehow securitized by the lenders and these mortgages are capable of being tracked and in fact must be tracked because they represent the lenders' right to payment and other contractual rights.[291] Additionally, the mortgages are liens against real property in which the lenders either hold or previously held both legal and contractual interests.[292]

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[289] *Id.*

[290] *See* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 534–66 (2002); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007); Peterson, *supra* note 13; David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1001–09 (2006); *see also* Engel, *supra* note 178, at 383–84 ("Abusive lending interferes with the public health, safety, comfort and peace of individuals and communities. The lenders often obtain the loans through fraud in violation of various laws. Predatory lending is not a one-time event with limited consequences. Rather, it is a lending *modus operandi* in low and moderate income communities, with devastating effects on cities that may take years to reverse.")

[291] *See, e.g.*, *supra* notes 92–97 and accompanying text (explaining how MERS is used to keep track of information related to mortgage loans).

[292] Prior to 2003, the New York Court of Appeals had not recognized public nuisance claims based upon allegations involving lawful, heavily-regulated commercial activities such as the manufacture of handguns. People *ex rel.* Spitzer v. Sturm, Ruger & Co., Inc., 761 N.Y.S.2d 192, 195 (N.Y. App. Div. 2003). Then, in *Sturm*, the court opened up the possibility. *Id.* at 201 ("[I]f such a legal duty were held to exist so as to hold these defendants accountable . . . assuming plaintiff has sufficiently pleaded that element—i.e., that by their manufacturing and marketing decisions and practices defendants created and maintain a common-law public nuisance in violation of a duty to the public at large . . . ."). To find a legal duty for nuisance, the plaintiff must show that the harm is not "too remote from defendants' otherwise lawful commercial activity" and the activity is a "proximate cause of such harm." *Id.* In *Sturm*, the state asserted that a public nuisance claim had sufficiently been pled because the "defendants' conduct knowingly result[ed] in an increase in the number of guns in criminal hands and that defendants ha[d] the power to abate the consequences by adjusting their business practices." *Id.* at 199. This was allegedly based upon trace requests from the Bureau of Alcohol Tobacco and Firearms, because the traces allegedly showed which of the defendants' handguns wound up being used in criminal

Despite the fact that Cleveland's complaint has identified each lender as having foreclosed on properties located in Cleveland, some of the lenders have filed dismissal motions, claiming that they have never originated subprime loans in Cleveland.[293] Some of the lenders named as defendants claim that they are merely holding companies and have no connection with the mortgages, securities, or foreclosures at issue in Cleveland's case.[294] Discovery is, consequently, essential for Cleveland to identify exactly which lenders originated subprime mortgages, purchased them, packaged them as securities, or resold them to investors and which of the lenders held a legal or equitable interest in specific residential properties located in the city. Cleveland can then use case law to establish that the lenders being sued are or were closely connected to other lenders or participants and that their actions alone or in concert with others proximately caused the public nuisance.[295]

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conduct. *Id.* The court found this was not sufficient evidence to support the claim. *Id.* at 194 ("[T]race request information presently available to defendants is insufficient . . . ."). While the defendants were aware the traces were taking place, they did not have knowledge of the results. *Id.* at 199. The consequence of this is that based on this data alone, the plaintiff's assertion that the defendants were aware of the results of their conduct is not demonstrated. *Id.* If the defendants were not knowingly placing their handguns in the hands of criminals, their duty would be too general and far reaching. *Id.* at 200 ("[A] general duty of care would create not only an indeterminate class of plaintiffs but also an indeterminate class of defendants . . . ."). *Cleveland* can be distinguished from *Sturm* in several respects. First, the lenders and the properties can be identified. Second, once the lender forecloses, they have a right to investigate and inspect the property to maintain collateral. Finally, unlike guns, property does not move. It can be tracked by mortgage identification numbers.

[293] *See, e.g.*, Memorandum in Support of Defendant Indymac Bancorp, Inc.'s Motion to Dismiss Pursuant to Fed. R. Civ. P. 12(B)(2), ¶ 1, Cleveland v. Deutsche Bank Trust Co., No. 1:08-cv-00139, 2008 WL 744111 (N.D. Ohio Mar. 7, 2008) [hereinafter Memorandum].

[294] *Id.*

[295] *See supra* notes 223–229 and accompanying text (discussing the tort of civil conspiracy as a legal basis for holding lenders responsible for the actions of other participants such as brokers or appraisers). Favorable Ohio case law on this point exists. For example, in *Williams v. Aetna Fin. Co.*, an elderly widow living in a poor neighborhood was targeted by a "pitchman" for a home improvement contract. 700 N.E.2d 859, 861 (Ohio 1998). The contractor solicited Williams at her home and had its representative drive Williams to Aetna Finance several times to sign the loan documents secured by her personal property and home. *Id.* at 861 (Aetna Finance Company was doing business as ITT Financial Services). She signed most of the loan checks issued by Aetna over to the contractor to pay for the home improvements. *Id.* at 861–62. But the contractor failed to complete the improvements, leaving Williams owing two separate loans. *Id.* at 862. In alleging a civil conspiracy, the plaintiff has to demonstrate an underlying unlawful act for the conspiracy claim and fraud is one such unlawful act. *Id.* at 868. Moreover, "acts taken in furtherance of the conspiracy by one co-conspirator can be attributed to every co-conspirator, making each equally liable for the other's acts." Matthews v. New Century Mort. Corp., 185 F. Supp. 2d 874 (S.D. Ohio 2002). The court in *Williams* noted that the

Arguably, it may be a stretch for a court to find in Cleveland's favor, but prior to the subprime meltdown, consumer advocates and attorneys had been warning for years about the predatory practices of brokers, appraisers, and other participants in the residential mortgage business.[296] Given this warning, coupled with the depressed market conditions in Cleveland for the last seven years,[297] a court may be persuaded that the Wall Street banks were sophisticated investors who understood or should have understood the dangers of flooding Cleveland with predatory subprime loans via rapacious participants and are, therefore, responsible for the public nuisance.

Although case law holds that the plaintiff does not have to show that the defendant was in control of the properties that are the subject of a *public* nuisance,[298] the lenders sued by Cleveland will no doubt point to Ohio state court opinions that have held that mortgagees are not responsible for abandoned properties in individual nuisance abatement actions. These state court opinions may appear fatalistic to Cleveland's case, but a careful analysis of them should illustrate that Cleveland's case is distinguishable. As a result, Cleveland should be able to establish a strong case that some of the lenders are at least responsible for abating the nuisance at the abandoned blighted properties.

In *Hausman v. Dayton,* a lender had foreclosed against real property that had been abandoned by the owners but had not been sold at the sheriff's sale due to a

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contractor took the homeowner to Aetna, even though other lenders were available, because employees at Aetna's office sought referrals of loan customers from the contractor. 700 N.E.2d at 861. Under these circumstances, the court found that employees of Aetna had conspired with the contractor to defraud the homeowner, and that Aetna could be held liable for the torts of its employees. *Id.* at 868. The court further concluded that Aetna's role in the conspiracy was to "allow [the pitchman] to have access to loan money that was necessary to further his fraudulent actions against customers such as [the plaintiff]." *Id.* at 868-69. Thus, the court found that Aetna's employees "affirmatively committed fraud by the very acts of making loans to [the plaintiff] and others," and that the lender was liable for that fraud by virtue of the conspiracy. *See id.* Thus, a mortgage lender was liable not only for the intentional acts of its own employees, but for the fraud of other parties with which it has close personal ties. Under a civil conspiracy claim, a mortgage lender is liable not only for the intentional acts of its own employees, but for the fraud of other parties with which it has close personal ties. *See id.* at 869; *Matthews* 185 F. Supp. 2d at 874; Carver v. Discount Funding Assocs., Inc., No. CVH 20040126, 2004 WL 2827229 (Ohio Ct. Com. Pl. 2004).

[296] *See, e.g.*, Eggert, *supra* note 290, at 580–81 ("Subprime loans account for a vastly disproportionate share of foreclosures compared to their share of loan originations, with the share of subprime foreclosures as much as double the share of the subprime origination. A subprime loan, therefore, is not only foreclosed sooner, but is also much more likely to be foreclosed than a prime or FHA loan. This explosion in foreclosure rates among subprime loans is a national phenomenon, even where the overall foreclosure rate is declining.").

[297] Cleveland Complaint, *supra* note 251, ¶¶ 4, 51.

[298] *See* Cincinnati v. Beretta U.S.A. Corp. (Beretta II), 768 N.E. 2d 1136, 1143 (Ohio 2002).

lack of bidders.[299] Because the property contained hazardous materials, it was determined to be a public nuisance by the City of Dayton. [300] Under a city ordinance, Dayton had defined an "owner" as "owner(s) of record of the premises of fee or lesser estate therein, a mortgagee, vendee in possession, land contract purchaser, assignee of rents, receiver, executor, administrator, trustee, or lessee, as determined by an examination of the public records of Montgomery County, Ohio . . . ."[301] The City of Dayton alleged that the lender was the mortgagee of record and, therefore, an "owner" under the ordinance, and responsible for abatement of the nuisance.[302] The lender contended that it was not an owner of the property, because it was not a "mortgagee in possession."[303] Because the ordinance failed to make reference to possession, the lender contended the ordinance was too far reaching, thus making it unconstitutional.[304] The court agreed, holding that a mortgagee has "no right of possession or control" simply by holding a mortgage on a property.[305] Consequently, a mortgagee "has no ability to create or prevent a nuisance from arising on the mortgage property, and to hold such a mortgagee liable for abatement would be arbitrary and thus unconstitutional."[306] The court held that a mortgagee can become a mortgagee in possession and therefore liable as an owner *only* by the mortgagee recovering the property via ejectment proceedings, or if the mortgagee otherwise extinguishes the right of the mortgagor to redeem the property.[307] By interpretation of state law, the court held that the mortgagor's right of redemption is not extinguished until there has been a sale of the property and confirmation of it.[308]

The holding in *Hausman* appears to justify dismissal of Cleveland's case against the lenders; however, the municipal ordinances at issue in each case make the cases distinguishable. Under Cleveland's ordinance, "[t]he owner, operator, or ***person in possession or control*** of the property shall remove or otherwise abate any nuisance described in this Section."[309] However, the relevant portion of Dayton's ordinance defines as an owner a "mortgagee, vendee in possession."[310] A

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[299] 653 N.E. 2d 1190, 1192 (Ohio 1995).

[300] *Id.* at 1196.

[301] *Id.* at 1193 (quoting DAYTON, OH., CODE OF ORDINANCES § 152.01 (2006) (defining public nuisance)).

[302] *Id.* at 1193.

[303] *See id.* at 1193 (arguing by BancOhio that they cannot be held liable as a mortgagee in possession because they are not the titleholder).

[304] *Id.* at 1196.

[305] *Id.*

[306] *Id.* (preserving the ordinance as constitutionally valid, the court severed "a mortgagee" from the ordinance).

[307] *Id.* at 1194.

[308] *See id.* at 1194 ("In sales of real estate on execution or order of sale, at any time before the confirmation thereof, the debtor may redeem it from sale by depositing . . . the amount of the judgment or decree upon which such lands were sold, with all costs . . . .").

[309] CLEVELAND, OHIO, HEALTH CODE ch. 209 § 1(b) (2007).

[310] DAYTON, OHIO., CODE OF ORDINANCES § 152.01 (2006).

comparison of the two ordinances shows that Cleveland uses a broad term "person," not mortgagee, and the person's liability arises from being either in possession or in control of the property.[311] From general principles of statutory interpretation, one can reasonably infer that being in "possession" and being in "control" are not the same.[312] Cleveland could argue that lenders who have foreclosed on a property located in Cleveland or who have received a deed in lieu of foreclosure for the property are now in control of that property.[313] If the property has been vacated, a lender should not be able to hide behind a lack of a third-party bidder at the sheriff's sale to claim it is not in control. Industry practice indicates that lenders obtain keys to the foreclosed premises and sometimes hire contractors to at least board up the vacant premises.[314] This is further evidence of the lender's control of abandoned premises. Because the holding in *Hausman* is based on an ordinance that makes no reference to control, as is the case with Cleveland's ordinance, that holding is not binding precedent.

Besides the *Hausman* case, a lender may attempt to rely on *Trustcorp Bank v. Cartier*[315] to establish that a lender-mortgagee is not an owner of blighted property and, therefore, not responsible for its abatement. In *Trustcorp Bank*, the Toledo Municipal Code stated that written notice of a nuisance abatement order had to be served on the owner as well as the lienholder, but the code expressly provided that *only* the owner was responsible to abate the nuisance and did not define "owner" to include a lienholder.[316] As a result, the court held that the Toledo ordinance

> clearly and unambiguously differentiates between an owner and a lienholder of property and clearly imposes liability for abatement of nuisance conditions only upon one who is the owner or person in the position of owner of the property at the time the order is issued, and not upon one who is just a lienholder.[317]

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[311] CLEVELAND, OHIO, HEALTH CODE ch. 209 § 1(b) (2007).

[312] *See* Duncan v. Walker, 533 U.S. 167, 174 (2001) (holding that words should not be read in a way that leaves other words "insignificant, if not wholly superfluous"); Williams v. Taylor, 529 U.S. 362, 364 (2000) (describing the rule that courts should give each word effect as a "cardinal principle of statutory interpretation."); Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S, 552, 562 (1990) (noting that statutes are to be interpreted to avoid redundancy); Here, since the statute refers to both possession and control, they should be interpreted to have different meanings.

[313] *See generally* Levenson v. Feuer, 803 N.E.2d 341, 348 (Mass. App. Ct. 2004) (stating that a deed in lieu of foreclosure arises when, "after defaulting on the loan, the borrower agrees to deliver to the lender a deed to the property previously pledged as security for the debt.").

[314] *See , e.g.*, Vikas Bajaj, *Contractors are Kept Busy Maintaining Abandoned Homes*, N.Y. TIMES, May 27, 2008 at C1.

[315] No. L-91-337, 1992 WL 313323 (Ohio Ct. App., Oct. 30, 1992).

[316] *Id.* at *4.

[317] *Id.*

The ordinance never mentions the word "control" nor was issue of control addressed in Toledo's complaint. Therefore, the court dismissed Toledo's attempt on appeal to argue that the mortgagee was in control of the foreclosed property.[318]

The lenders sued by Cleveland may look to the *Trustcorp Bank* case as reinforcement that they are not the responsible parties when determining who should abate the nuisance. Reliance on this case would be inappropriate, again because Cleveland's case is not an individual nuisance abatement case but is a public nuisance case and, therefore, does not have to show a mortgagee is in control. [319] Moreover, even if a court incorrectly assumed control has to be established, Toledo's ordinance clearly stated that an owner is the party responsible for the abatement of the nuisance but never defined who an owner is.[320] By contrast, Cleveland's city ordinance mentions both possession and control for establishing ownership.[321]

The court should look to establish control through objective factors, such as abandonment of the property by the consumer-homeowner and the lender's initiation of a judicial foreclosure or receipt of a deed in lieu of foreclosure. Because Cleveland's ordinance is worded broadly to include as an owner anyone who is in control of the blighted property, Cleveland can also raise other indicia of control such as a lender's mere holding of a mortgage on property that has been abandoned by the homeowner.

3. Buffalo's Mass Nuisance Abatement Litigation Against 36 Lenders

Like Cleveland, the City of Buffalo has sued a large number of lenders seeking to hold them liable for abandoned properties on the grounds of statutory and common law claims of public nuisance.[322] While Cleveland's lawsuit alleges that Wall Street lenders' financing of subprime loans in Cleveland is the proximate cause of the public nuisance,[323] Buffalo's lawsuit against 36 lenders alleges that the lenders' ownership or control of the foreclosed properties is the proximate cause of the resulting public nuisance.[324] Therefore, Buffalo's ability to win is not conditioned on showing that the lenders issued or securitized subprime mortgages. This section discusses the viability of Buffalo's case.[325] This discussion is much

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[318] *Id.* at *5.

[319] *See* Hausman v. Dayton, 653 N.E. 2d 1190, 1196 (discussing case holding that a plaintiff does not have to show that the defendant was in control of the property at issue in a public nuisance case).

[320] *Trustcorp*, 1992 WL 313323 at *3.

[321] CLEVELAND, OHIO, HEALTH CODE ch. 209, § 1(b) (2007).

[322] Verified Complaint, ¶¶ 429–33, Buffalo v. ABN AMRO Mortgage Group, Inc., No. 2200-2008 (N.Y. Sup. Ct. Feb. 20, 2008) [hereinafter Buffalo Complaint].

[323] *See* Cleveland Complaint, *supra* note 251, ¶¶ 64–65.

[324] Buffalo Complaint, *supra* note 322, ¶¶ 430, 434.

[325] No doubt, some lenders' initial assault will be to challenge Buffalo on the basis that it lacks standing to bring its public nuisance action. To have a recognizable injury for standing purposes, a city needs to allege direct economic loss; a city usually cannot recover

shorter than the discussion of the viability of Cleveland's case because Buffalo's case does a better job of making the causal nexus between the lenders' conduct and the injuries claimed by Buffalo.[326]

In order for Buffalo to recover millions of dollars in lost tax revenue and expenditures for providing police and fire protection to an estimated 10,000 abandoned properties,[327] Buffalo will first need to establish that the properties are nuisances.[328] Buffalo's complaint identifies by address several residential

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for "indirect damages," such as expenses incurred for additional fire and police protection. Engel, *supra* note 178, at 374–76 n.106. But cities should be able to sue to recover for direct injuries, such as expenses incurred to secure or abolish the abandoned premises. Ganim v. Smith & Wesson, No. x06-cv-99-0153198S, 1999 Conn. Super. LEXIS 3330, at *10–11 (Conn. Super. Ct. Dec. 10, 1999); Bridgeton v. B.P. Oil, Inc., 369 A.2d 49, 55 (N.J. Super. Ct. Law Div. 1976) ("[I]f the city were the owner of adjacent land damaged by escaping oil, it like all landowners, may recover damages caused by this escape. It cannot, however recover costs incurred in fire prevention or extinguishment. That is the very purpose of government for which it was created."); *see also* Note, *Recovering the Cost of Public Nuisance Abatement: The Public and Private City Sue the Gun Industry*, 113 HARV. L. REV. 1521, 1522–33 (2000) (discussing the recoverability of damages in cities' public nuisance claims against gun industry defendants). In addition, cities seeking to recover for abatement costs should avoid claiming recovery for indirect damages in their allegation because this could lead courts to count their claims as private nuisance actions. Engel, *supra* note 178, at 385 n. 158 (discussing the difficulty a city may have pleading injury in fact in a private nuisance claim). The City of Buffalo is seeking costs related to the abatement of nuisances. Buffalo Complaint, *supra* note 322, ¶ 432. It does not allege any indirect costs; therefore, the court will find Buffalo has standing. *See* Restatement (Second) of Torts § 839 (1979). Buffalo's third basis for relief in its complaint is that the thirty-six lenders are jointly and severally liable and, therefore, seems to be asserting co-conspirator liability: "named defendants . . . *did together cause* to exist or allow to exist a public nuisance in the City of Buffalo and jointly and severally liable to the City of Buffalo for the costs related to the abatement of said public nuisance." Buffalo Complaint, *supra* note 322, ¶ 434. Civil conspiracy liability has previously been discussed. *See supra* note 223–229 and accompanying text. Co-conspirator theory of liability has had some success in attributing wrongful actions various players in the residential lending process. *See* Williams v. Aetna Fin. Co., 700 N.E.2d 859, 868 (holding a mortgage lender liable for fraud committed by a door-to-door salesman); *see also* Entin & Yazback, *supra* note 178, at 2251–52. Discovery in the Buffalo litigation may uncover evidence of a conspiracy, but at this juncture, it is too soon to tell if the lenders may be jointly and severally liable.

[326] The discussion of Cleveland's case took substantially longer because it was a more difficult case to prove in light of the fact that mass tort cases have often been unsuccessful in other contexts due to causation issues.

[327] Buffalo Complaint, *supra* note 322, ¶¶ 430, 434; *see* Jonathan Epstein, *City Sues Lenders Over Forgotten Houses*, BUFFALO NEWS, Mar. 1, 2008, at D1 (stating that the average demolish cost could be up to $40,000 each in case of fire).

[328] The Second Restatement of Torts defines a public nuisance as "an unreasonable interference with a right common to the general public." Restatement (Second) of Torts § 821B(1) (1979). Circumstances that may sustain a holding that an interference with a public right is unreasonable include circumstances that interfere with the public health, safety and welfare. *Id.* § 821B(2)(a) (1979). Blighted properties that are abandoned on

properties that the lenders have foreclosed against and that are currently abandoned.[329] Under Buffalo's city code, an abandoned, deteriorated, or dilapidated building is an unsafe condition and, therefore, a nuisance.[330] Accordingly, the abandoned properties identified in Buffalo's complaint are clearly nuisances.

Having established that the properties constitute a nuisance, Buffalo must next establish which parties are liable for the nuisance. Buffalo's complaint alleges that the lenders have violated the codes for both the city and the state.[331] Under Buffalo's city code, the "owner" of the building has an obligation to "repair, demolish or remove the same."[332] The code imposes personal liability for demolition costs on any "owner, occupant, or mortgagee in possession of premises or who shall have exercised dominion and control over said premises at the time they became abandoned, dilapidated, deteriorated, decayed or unattractive." [333] Moreover, under the Property Maintenance Code of New York State, an "owner," as a responsible party in a nuisance action, is "any person, agent, operator, firm, or corporation having legal or equitable interest in the property; or recorded in the official records . . . as holding title to the property; or otherwise having control of the property . . . ."[334] As a result of these code sections, the lenders, as mortgagees who have foreclosed on the abandoned properties, hold a legal interest in the foreclosed properties and, therefore, should be responsible for the nuisances. Also, because the city code refers to a "mortgagee in possession," the lenders who have

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account of foreclosures by predatory lenders should satisfy all of these circumstances. *See* Engel, *supra* note 178, at 383–84 ("Abusive lending interferes with the public health, safety, comfort and peace of individuals and communities. The lenders often obtain the loans through fraud in violation of various laws. Predatory lending is not a one-time event with limited consequences. Rather, it is a lending *modus operandi* in low and moderate income communities, with devastating effects on cities that may take years to reverse.").

[329] *See* Buffalo Complaint, *supra* note 322. In addition to the nuisance claims, Buffalo is claiming that the lenders are jointly and severally liable on what appears to be a civil conspiracy or an aiding and abetting claim. *Id.* ¶ 434 ("The named defendants by their actions and/or omissions . . . did together cause to exist or allow to exist a public nuisance in the City of Buffalo and are jointly and severally liable to the City of Buffalo for the costs related to the abatement of said public nuisance, including but not limited to the demolition [of] all properties specified herein.").

[330] BUFFALO, N.Y., CODE § 113.5 (2004).

[331] Buffalo Complaint, *supra* note 322, ¶ 14.

[332] BUFFALO, N.Y., CODE § 113.5 (2004).

[333] *Id.* § 113.14 (2004).

[334] PROPERTY MAINTENANCE CODE OF N.Y. ST. § 202. The Code specifies the responsibilities of owners, operators, and occupants regarding the proper maintenance of residential and non-residential buildings. *See id.* §§ 101.2, 102.2. If the right to recover for damages of a public nuisance is granted to a plaintiff, it also has the power to seek an injunction to abate the nuisance. Restatement (Second) of Torts § 821C(2) (1979).

already completed foreclosure should satisfy that term, unless the term "possession" is narrowly interpreted.[335]

Because both the city and state codes refer to "control," the lenders are in control as a result of having completed foreclosure against the abandoned properties specifically named in Buffalo's compliant.[336] Evidence that the lender or its agents have keys to the property or have taken action to board up the property would be further indicia of control.[337] One could also argue that if the lender has threatened foreclosure, it would be exercising "control" over the property, especially if the homeowner has abandoned the property subsequent to the threat.[338] Lenders could contend that the consumer-borrowers created the nuisance by abandoning their homes and should be responsible for abating the nuisance. One Buffalo housing court judge already issues nuisance abatement orders on the grounds that a lender that initiates foreclosure is in control.[339] The court adjudicating Buffalo's case against the 36 lenders is likely to conclude lenders are, at a minimum, in control as a result of having completed foreclosure.[340]

In theory, cities like Buffalo could expend the money to abate the nuisances and seek recoupment later.[341] However, cites are placed in a difficult situation

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[335] *See supra* note 299 and accompanying text (discussing case that held mortgagee could not be mortgagee in possession in the absence of the mortgagee's purchase and confirmation of the sale of the property).

[336] *See supra* note 313 and accompanying text.

[337] *See* Bajaj, *supra* note 314 (In Florida, "[i]f it is their first visit to a vacant home, the contractors change the locks on at least one door so the mortgage company can have access.")

[338] PROPERTY MAINTENANCE CODE OF N.Y. ST. § 202.

[339] *See* Miles, *supra* note 102 (discussing Judge Henry J. Nowak's position that because of the definition of owner, banks are in control when they initiate foreclosure).

[340] *See supra* note 158–60 and accompanying text. As a result of the foreclosure, the lenders could be viewed as successors in interest. *See* Friends of Sakonnet v. Dutra, , 738 F.Supp. 623, 626-27 (D. R.I. 1990) 396; *see also* Restatement (Second) of Torts § 839 (1979) ("A possessor of land is subject to liability for a nuisance caused while he is in possession by an abatable artificial condition on the land, if the nuisance is otherwise actionable, and (a) the possessor knows or should know of the condition and the nuisance or unreasonable risk of nuisance involved, and (b) he knows or should know that it exists without the consent of those affected by it, and (c) he has failed after a reasonable opportunity to take reasonable steps to abate the condition or to protect the affected persons against it.").

[341] Before a city can declare a property a nuisance and order its abatement (in a non-emergency situation), the city is required to give notice to the property owner of the declaration that a property is a nuisance. *See, e.g.*, Meyer v. Jones II, 696 N.W.2d 611, 615 (Iowa 2005) (holding that a city's failure to give record titleholder of property written notice to abate nuisance on property precluded city from billing property owner for costs of abatement). The toxic title phenomenon creates a situation in which cities must incur substantial time and expense trying to find the lender-mortgagee responsible for the property. *See supra* Part II.B–C (discussing the expense and difficulty that "toxic title" poses in locating parties responsible for blighted properties); *see also* Jennifer Bjorhus, *St.*

when deciding what to do in regard to an abandoned property that has become a nuisance. On one hand, the city has a duty to protect its citizens' health and safety and would want to abate the nuisance as soon as possible. But because of the extent of the foreclosure crisis, a city like Buffalo would drain its limited resources by incurring expenses first to abate the nuisances.[342] Buffalo projects that in the ensuing five years, it will need to spend between $16,000 and $40,000 in demolition costs for each of the 5000 vacant properties that are badly deteriorated.[343] Consequently, if Buffalo acts to abate the nuisance first, it would suffer severe financial consequences.[344] Because Buffalo has no legal obligation to expend funds to abate the nuisance *before* suing to recover damages, the state court should have no difficulty holding the lenders responsible as parties "in control" of the nuisance and allow the city to recover its damages.

4. Assessment of the Viability of the Mass Litigation Cases

Based on this Article's assessment of the three pending cases, Buffalo's case appears to be the strongest because it is grounded squarely in public nuisance law. Buffalo alleges that (1) the lenders being sued are the responsible parties because they fit within the statutory definition of "owners" as a result of their exertion of control over the properties via foreclosure proceedings; (2) the foreclosed vacant

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Paul Goes after National Lenders in Effort to Battle Foreclosure Blight, ST. PAUL PIONEER PRESS (MINN.), Apr. 10, 2008, at A1 (describing letter by City of St. Paul to lenders to get them to abate nuisances on properties that they hold title to and stating that one lender, U.S. Bancorp, claims it is simply a trustee and does not legally own the 94 properties on the list St. Paul officials attached to the letter).

[342] Ted Phillips, *Wall Street Woes Outdo the Mortgage Mess*, BOND BUYER, Apr, 15, 2008, at 34A ("According to RealtyTrac, foreclosures in the Buffalo metropolitan area, which is in Erie County, increased 74% to 3,850 in 2007 compared to 2006 . . . .").

[343] *See* Epstein, *City Sues Lenders, supra* note 327 (stating that the average demolish cost could be $40,000 each in case of fire).

[344] No city experiencing record foreclosures should expend money upfront to abate the nuisance, particularly given that some of the brokers and lenders responsible for originating the predatory loans will wind up defunct or in bankruptcy as a result of the subprime foreclosure crisis. For example, lender New Century Financial Corp. filed bankruptcy. *See* Vikas Bajaj & Julie Creswell, *A Lender Failed. Did Its Auditor?*, N.Y. TIMES, Apr. 13, 2008, at A1 ("A recently unsealed report by an examiner for the United States Bankruptcy Court in Delaware raises the question of whether New Century's accounting obscured an early signal that the mortgage freight train was about to run off the rails."); *see also* Jyoti Thottam & Barbara Kiviat, *Banker of America*, TIME, Jan, 28, 2008, at 48 ("[Countrywide Financial,] beaten-down mortgage lender, [and] whipping boy for everything that went wrong in last year's mortgage meltdown, was facing rumors of bankruptcy after burning through an $11.5 billion credit line."). In fact, several subprime lenders have already filed bankruptcy. *See, e.g.*, Donald R. Kirk, *How to Prepare for Subprime-Related Litigation*, ANDREWS DERIVATIVES LITIG. REP., Apr. 2008, at 6 (stating that "[s]everal subprime mortgage lenders have recently filed for bankruptcy, including American Home Mortgage, New Century Financial Corp. and Sentinel Mortgage").

properties have become a nuisance because they are dilapidated and, therefore, in an unsafe condition; and (3) the lenders' failure to abate the nuisance has resulted in a direct injury to the city because of the decrease in tax revenue and the increased costs in providing services related to the abandoned blighted properties.[345] Because its case is grounded squarely in nuisance law, Buffalo, unlike Cleveland or Baltimore, does not have to prove that the lenders flooded Buffalo with subprime predatory loans.[346] Buffalo does not have to engage in costly discovery to try to prove that the lenders should be responsible for the actions of independent third-party brokers, appraisers, or other real estate professionals who duped borrowers into getting subprime predatory loans.[347] Buffalo's complaint takes no position on whether subprime loans are predatory or are dangerous products;[348] therefore, whether the foreclosed vacant properties were subject to prime fixed-rate loans or subprime adjustable-rate loans is irrelevant as to whether the properties now constitute a public nuisance.

In addition to not having to prove that the blighted properties were subject to subprime predatory loans, Buffalo does not have worry about preemption under the National Bank Act.[349] Lenders have argued successfully for years that the National Bank Act broadly exempts national banks from state consumer protection laws and protects them from most regulatory oversight or enforcement by state officials.[350]

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[345] This is the author's analysis of what the complaint either explicitly or implicitly alleges. *See generally* Buffalo Complaint, *supra* note 322 (listing Buffalo's claims against the lenders).

[346] *See supra* note 251 and accompanying text (discussing how Cleveland needed to allege that the subprime mortgages issued or held in trust by the lenders were predatory and therefore dangerous to sufficiently plead a claim based on a collective theory of liability); *supra* note 188 and accompanying text (discussing how Baltimore has to prove that the subprime mortgages issued by Wells Fargo were predatory or unfair to sustain a reverse-redlining discrimination claim under the Fair Housing Act).

[347] *See supra* note 215 and accompanying text (explaining that because the lenders in the Baltimore case are likely to defend on the basis that any alleged predatory lending was done by third party brokers, the city will have to persuade the courts that the lenders should be held responsible for the actions of these brokers).

[348] *See generally* Buffalo Complaint, *supra* note 322 (listing Buffalo's claims against the lenders).

[349] *See* 12 U.S.C. §§ 85–86 (2006).

[350] *See* Watters v. Wachovia Bank, 127 S.Ct. 1559, 1568–69 (2007) (holding that because the Office of the Comptroller has exclusive jurisdiction to regulate a national bank's subsidiary's operation of banking business and mortgage lending, Michigan "cannot confer on its commissioner examination and enforcement authority over mortgage lending, or any other banking business done by national banks"); Loonin & Renaurt, *supra* note 36, at 174–85 (2007) ("The Office of the Comptroller of the Currency . . . and the Office of Thrift Supervision. . . have, via administrative fiat, aggressively pushed preemption of state laws for national banks and savings associations, especially since 1996."); *see generally* Nicholas Bagley, Note, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U. L. REV. 2274 (2004) (stating that the Office of the Comptroller of the Currency overstepped its bounds when it declared that new laws conflicted with the

However, "[i]t is fundamental that private property is held subject to the authority of the state to regulate its use for the protection of the public health and safety."[351] Moreover, the Supreme Court has made it clear that the United States Constitution does not "displace[] States' authority 'to shelter [their] people from menaces to their health or safety.'"[352] Consequently, it is extremely unlikely that a court would hold that the National Bank Act preempts a state's public nuisance law.

Because Buffalo's claim is based on public nuisance law, Buffalo can prove damages more easily than Baltimore or Cleveland. When a state or municipality pursues a tort liability claim under public nuisance law, the claim is sometimes viewed as a strict liability claim and the state or municipality need not prove fault or negligence.[353] That means the state regulator can recover damages flowing from the responsible party's failure to abate the nuisance.[354] The extent of a city's damages arising from abandoned blighted properties depends on a number of factors, including how many agencies had to respond to calls involving the properties, whether the city had to incur cost to secure the properties, and whether the properties became the site for criminal activity, fire, or other dangers.[355] For example, one Chicago case study identified twenty-six different foreclosure-related services, determined that fifteen separate governmental units are involved in the foreclosure process, and estimated that in 2004 the direct municipal costs on

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National Bank Act and issued a regulation preempting the laws); Christopher R. Childs, *So You've Been Preempted—What Are You Going to Do Now?: Solutions for States Following Federal Preemption of State Predatory Lending Statutes*, 2004 B.Y.U. L. REV. 701 (examining how the federal government has preempted states' efforts to protect consumers in the subprime market and what states can do now).

[351] State *ex rel.* Fisher v. Reno Hotel, Inc., 641 N.E.2d 1155, 1158–59 (Ohio Ct. App. 1994) (citations omitted) (holding that evidence of prostitution activities at hotel was sufficient to establish that hotel operators were culpable for conducting a public nuisance on the hotel's premises).

[352] Am. Trucking Ass'ns., Inc. v. Mich. Pub. Serv. Comm'n., 545 U.S. 429, 435 (2005) (quoting D.H. Holmes Co. v. McNamara, 486 U.S. 24, 29 (1988)).

[353] *See, e.g.*, SAN DIEGO, CA., MUN. CODE § 121.0311 (2000) ("Violations of the Land Development Code shall be treated as strict liability offenses regardless of intent."); Temple v. Fence One, Inc., No. 85703, 2005 WL 3436354, at *6 (Ohio Ct. App. Dec. 15, 2005) (stating that "[a] public or a private nuisance can be further classified as either an absolute nuisance (nuisance per se) or as a qualified nuisance," and that "strict liability attaches" to the former while the latter "hinges upon proof of negligence").

[354] *See generally*, New York v. Shore Realty Corp., 759 F.2d 1032, 1050 (2d. Cir. 1985) ("Under New York law, Shore, as a landowner, is subject to liability for either a public or private nuisance on its property upon learning of the nuisance and having a reasonable opportunity to abate it.").

[355] *See generally* Verified Complaint, ¶¶ 67-68, Minneapolis v. T.J. Waconia, LLC., No. 27CVHC08-2728, (Minn. Dist. Ct. Apr. 2, 2008) (alleging that Minneapolis's damages flowing from foreclosed properties once owned or managed by the defendants depend on several factors) [hereinafter Minneapolis Complaint].

account of one foreclosed property were $34,000.[356] Buffalo is seeking from the lenders all nuisance abatement costs, including the cost of demolishing properties that have become too dilapidated to repair.[357] Such demolition[358] will lead to further damages in the form of lost tax revenue for the City of Buffalo.[359] These are the type of damages that can be proven; therefore, Buffalo should be able to recover them.

Unlike Buffalo, Cleveland and Baltimore, because of the damages they are seeking, have to do more than get an expert to identify all the costs associated with the mere presence of the abandoned blighted properties in their cities. Cleveland and Baltimore are alleging that the toxic or predatory subprime mortgages led to the rise in foreclosures, which in turn led to the spike in abandoned properties, which in turn led to the injuries claimed by the cities.[360] No doubt, some of these homeowners lost their homes due to other factors such as the loss of employment by the homeowner or the divorce/separation from a working partner formerly in the home. Moreover, the assumption is that the borrowers were duped into getting predatory subprime mortgages. But what about the borrowers who were not duped, that is, they obtained, for instance, subprime adjustable-rate mortgages because they were hyperbolic discounters[361]—overly-optimistic about housing prices

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[356] *See* WILLIAM C. APGAR ET AL., THE MUNICIPAL COST OF FORECLOSURE: A CHICAGO CASE STUDY, HOMEOWNERSHIP PRESERVATION FOUNDATION, 1, 9, (2005), *available at* http://www.995hope.org/content/pdf/Apgar_Duda_Study_Full_Version.pdf [hereinafter Chicago Case Study]; WILLIAM C. APGAR & MARK DUDA, COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM, HOMEOWNERSHIP PRESERVATION FOUNDATION 4, (2005), *available at* http://www.995 hope.com/content/pdf/Apgar_Duda_Study_Short_Version.pdf (determining that vacant foreclosed properties foreclosures cost cities more than $30,000 for each property in some cases); FAMILY HOUSING FUND, COST EFFECTIVENESS OF MORTGAGE FORECLOSURE PREVENTION 16–17 (1998) (estimating that St. Paul and Minneapolis lost on average $2000 in tax revenues on vacant homes and incurred up to $40,000 for each home rehabilitated and $10,000 for each home demolished).

[357] Buffalo Complaint, *supra* note 322, ¶¶ 430–434 (stating that the city is also seeking "incidental charges [arising from demolition] for the plugging of water and sewer lines").

[358] *Id.* ¶ 7.

[359] *See, e.g.*, Chicago Case Study, *supra* note 356, at 51 ("The direct property tax loss due to demolition (as different from non-payment of property taxes) is due to the assessed value of the structure being removed from the tax rolls. The City loses the ability to collect this revenue until the property is redeveloped, often [after] a long period of non-use.").

[360] *See supra* Part III.C; Cleveland Complaint, *supra* note 251, ¶¶ 62–64; Baltimore Complaint, *supra* note 177, ¶ 19.

[361] *See, e.g.*, Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference among Low-Income Consumers*, 86 TEX. L. REV. 451, 467 (2008) (explaining that in the context of high credit-card spending, hyperbolic discounting or present-biased preferences are "terms [that] refer to the finding that people tend to be poor predictors of their future preferences"); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 776–78 (2006) (describing hyperbolic discounting in the context of mortgage loans, and stating that "[c]omponents of

continuing to rise and about their ability to refinance into fixed-rate mortgages at a later date?

Baltimore may also have difficulty proving additional damages based on the allegation that the foreclosures and subsequent abandonment harmed neighborhoods by "reducing the property values of nearby homes," which ultimately made it "harder for the City to borrow funds because the value of the property tax base is used to qualify for loans."[362] Proving these damages is not impossible for Baltimore, but it is seeking to broaden the scope of damages far beyond the damages sought by Buffalo.[363]

Similarly, Cleveland is seeking to recover a broad range of damages from lenders who have participated in varying degrees in the spread of subprime lending in Cuyahoga County. A court may decide to limit the scope of liability for various reasons, including its reluctance to open the floodgates of litigation by other cities or its concern that a broad recovery may cause the flow of subprime loans to unnecessarily dry up to future borrowers.

In summary, a city opting to use mass litigation to hold lenders responsible for a foreclosure and abandonment problem inflicted on its city should first consider suing under local ordinances and state statutes that give it standing to address public nuisances.[364] Cities should not only focus on clear nuisance violations but also widen their net to reach other potentially responsible parties like the City of Minneapolis, which is the first city to experience a measure of success for a substantial number of vacant properties.[365] If a city's applicable nuisance laws

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loan price that are uncertain at the time of loan purchase, or that do not come into effect until sometime long after the first monthly payment, are almost certainly underweighted, if not ignored altogether, in borrower decisionmaking").

[362] Baltimore Complaint, *supra* note 177, ¶ 19.

[363] *See* Donna Leinwand, *Cities Suing Lenders in Strategy Against Foreclosures; Various Legal Claims—from Federal Civil Rights Laws to City Codes—Used in Efforts to Stem Loss of Tax Base and Decline of Property Values*, USA TODAY, May 16, 2008, at A15 (stating that Alan Mallach, a senior fellow with the National Housing Institute, asserts that the pending lawsuits are "a bit of a reach under the laws of most states, but . . . a creative court could reasonably make some law in that direction").

[364] Cities may also go after brokers and other participants to the extent they are solvent. For instance, the City of Minneapolis filed a lawsuit against a real estate company. *See* Leinwand, *supra* note 363.

[365] At this juncture, Baltimore, Buffalo, and Cleveland are fighting motions to dismiss. However, in Minneapolis's case against a real estate company and several related entities, Hennepin County District Court Judge Robert Blaeser appointed an attorney in April 2008 as an administrator to manage 141 residential properties, most of which are abandoned rental properties in North Minneapolis. *See* Dan Heilman, *The Neighborhood Lawyer*, MINN. LAW., May 5, 2008, *available at* http://www.minnlawyer.com/article.cfm?recid=77319 (stating that the administrator's strategy is to facilitate the quick foreclosure sale of the properties to stabilize the surrounding neighborhoods); Leinwand, *supra* note 363 ("Minneapolis and three of its neighborhoods won their first legal battle last month in a separate lawsuit against real estate company TJ Waconia, when a judge appointed a legal caretaker to manage 141 mostly vacant properties."). The Minneapolis

are broad enough to cover a lender or other suspected bad actors as an "owner" or other responsible party, those laws make it fairly easy for a city to establish a causal link between the wrongful act (allowing the nuisance to continue or failing to abate it), and the harm sustained (the increased economic costs for the city in dealing with blighted, abandoned homes). If applicable nuisance laws are not broad enough to cover the lender as the responsible party, a city should use home rules to amend its local ordinances to broaden the scope of nuisance laws and join forces with interested groups to get the state legislature to pass laws to more effectively address foreclosure and abandonment.[366]

This Article does not conclude that lawsuits like Cleveland's and Baltimore's are not viable. Because the damages sought by Cleveland and Baltimore are greater than the damages sought by Buffalo, the potential damage award to Cleveland and Baltimore could be enormous. Therefore, the lenders sued by them have every incentive to fight fiercely to prevail and have given indication that they will.[367] As a result, if a city chooses to rely on FHA or public nuisance claims where the alleged wrongful conduct is the lender's issuance or securitization of predatory loans, the city needs to be prepared to engage in complex discovery and protracted litigation to prove a causal link between the wrongful conduct and the harm sustained.

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suit seeks damages from TJ Waconia, LLC, a company established by Thomas Balko, a real estate broker, and John Helgason, a real estate appraiser, which allegedly engaged in a fraudulent residential real estate scheme that converted 140 owner-occupied homes into rental units. Minneapolis Complaint, *supra* note 355, ¶¶ 15-22. Most of the properties were abandoned after the defendants failed to maintain the properties. *Id.* ¶ 31. Minneapolis's lawsuit seeks to hold the defendants responsible on the grounds that the properties are now public nuisances. *Id.* According to one Minneapolis City Council Member, "[t]he foreclosures and vacated dwellings resulting from TJ Waconia have caused damage to the City including increased costs for inspection of buildings for code violations, boarding vacant buildings, providing increased police and fire protection, acquiring and rehabilitating vacant buildings, and providing maintenance such as garbage removal and weed-cutting. . . . We deserve redress for these costs." Minneapolis Files Lawsuit to Stop Foreclosure Fraud Scheme in North Minneapolis, April 2, 2008, http://www.ci.minneapolis.mn.us/mayor/news/20080402newsmayor_minneapolisfilesforeclosurefraudlawsuit.asp.

[366] *See* 62 C.J.S. *Municipal Corporation* §143 (1999) (discussing home rule provisions and the right of municipalities to regulate issues of local concern and thus allowing cities to govern themselves without legislative oversight); *see also* 56 AM. JUR. 2D *Municipal Corporations, Etc.* § 108 (2000) ("Under home-rule amendments, cities no longer are dependent upon the state legislature for their authority to determine their local affairs and government, but have power granted directly from the people through the state constitution. . . ."). *See infra* Part IV (proposing enactment of comprehensive nuisance laws).

[367] *See, e.g.*, Memorandum of Law in Support of Defendant's Motion to Dismiss the Complaint, Mayor and City Council of Baltimore v. Wells Fargo Bank, No. 08 Civ. 00062 (D. Md. Mar. 21, 2008).

IV. LEGISLATIVE ACTION TO ABATE AND PREVENT NUISANCES

While cities nationwide are waging war against the foreclosure and abandonment problem via individual nuisance actions and mass litigation, state and local legislatures have begun to develop new laws tailored to the needs of the foreclosure and abandonment problem. These legislative efforts focus on identifying abandoned and/or foreclosed properties early on so that preventative, not only restorative, efforts can be taken.[368] Before describing some of those efforts, the section below will discuss incorrect assumptions that lenders, borrowers, and other stakeholders have operated under and how they have helped the foreclosure and abandonment problem to spread. A clear understanding of these assumptions is necessary for cities and states to amend or pass laws that allow them to deal with the current inventory of blighted properties and to prevent residential properties from becoming widespread nuisances in the future.

A. Understanding Incorrect Assumptions that Led to the Foreclosure and Abandonment Problem

To help explain the growing foreclosure and abandonment problem, researchers have begun to identify incorrect assumptions about the housing market, mortgage industry, and municipal governance.[369] First is the assumption that property values will only increase.[370] With this assumption, lenders have been too quick to seek foreclosure and not make workout deals with borrowers.[371] Believing the property values would continue to rise, lenders perhaps thought they could resell the property after foreclosure and thereby stay in line with their historical track records for foreclosures.[372] By refusing to work out deals with borrowers and not recognizing the housing bubble had already begun to burst, lenders scared off some borrowers with the threat of foreclosure. As one study of fifty-one foreclosed abandoned properties in Buffalo found, all of the borrowers abandoned their homes within a few months of defaulting and long before the foreclosure process was substantially completed.[373] The lenders' rush to foreclose has ultimately left them

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[368] *See infra* Part IV.B (discussing new laws in the cities of Columbus, Ohio and Chula Vista, California).

[369] *See, e.g.*, Cooper, *supra* note 58, at 46–51.

[370] *Id.*

[371] *See, e.g.*, Jonathan D. Epstein, *Some Lenders Won't Help Homeowners in Trouble*, BUFFALO NEWS, Mar. 30, 2008, at D1 (stating that one lender initially refused to do any type of workout deal with the borrower, and then later offered a loan modification on generous terms). Housing advocates and attorneys have been complaining for months that lenders and servicers have been unwilling to negotiate loan modifications with borrowers. *See, e.g.*, *id.* (stating that lenders, "stubbornly cit[ing] rules, regulations and restrictions, while losing paperwork and rerouting phone calls," have refused to do workout deals).

[372] *See* Leeper, *supra* note 17 (stating that lenders thought they could just "flip" the house).

[373] *See* Cooper, *supra* note 58, at 48.

with a backlog of property that cannot be sold at prices nearing breakeven, if it is sellable at all.[374] Despite representations in late-night infomercials, lenders do not want to sell the properties cheaply just to write them off the accounting books.[375] Cities and taxpayers are now bearing the load of deteriorating abandoned properties that lenders assumed would appreciate in value.

The second assumption that stakeholders operated under can be loosely stated as 'if the lender threatens to foreclose, it will follow through on that threat.'[376] The Buffalo study shows that homeowners, as well as other stakeholders, operate under a widely held assumption that if a borrower fails to make mortgage payments, the lender will take the home.[377] This assumption led borrowers to believe they could and should abandon the property.[378] In other words, some borrowers thought: why stall the inevitable? The lenders' threats of foreclosure and the borrowers' subsequent abandonment, followed by the lenders' failure to maintain the properties have resulted in abandoned homes that would have been maintained had the borrowers remained in possession.[379] Sometimes, borrowers who have abandoned their homes under threat of foreclosure have found out much later that they were still technically "owners" and, therefore, under a legal duty to maintain the property after city regulators sought enforcement actions against them for property code violations.[380] Some borrowers had even filed for bankruptcy and followed the required procedures to surrender their homes to the lenders, only to later have regulators track down the borrowers for code violations.[381] Whether cities have pursued broke borrowers who simply abandoned (the proverbial turnips lacking blood) or borrowers who lawfully discharged their mortgage debt in bankruptcy, cities have ultimately wasted limited time and resources seeking to hold such borrowers responsible to the abate the nuisances.

The third incorrect assumption that cities and other stakeholders held was that a lender will take reasonable steps to preserve its collateral; therefore, cities should have no difficulty getting lenders to bring residential properties in compliance once they have been notified of noncompliance.[382] That was probably a correct assumption long ago when local or in-state lenders held mortgages in their own

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[374] *See* Caroline Reaves, *Vacant Homes—The Next Frontier in Mortgage Servicing*, MORTGAGE BANKING, Feb. 1, 2008, at 115, 115–16.

[375] *See id.* at 115.

[376] *See* Cooper, *supra* note 58, at 48.

[377] *See id.*

[378] Miles, *supra* note 102.

[379] *See id.* (noting that Buffalo Housing Court Judge Nowak stated that the lender cannot get an order evicting the homeowner until the lender gets the deed, "but many homeowners [leave,] falsely believ[ing] they're being evicted when the bank informs them foreclosure is pending").

[380] *See* Cooper, *supra* note 58, at V., 48.

[381] *Id.* at 21–22, 48.

[382] *See, e.g.*, Todd, *supra* note 64 (stating that it is sometimes difficult to get banks to correct nuisances).

portfolio[383] and, therefore, had a reputation to preserve and an incentive to minimize their losses. But now that these mortgages are packaged amongst literally thousands of mortgages pooled as securities and, as a result, numerous investors hold a potentially very small interest in them, cities often have a very difficult time finding the lender rightfully holding the mortgage.[384] Cities have thus been largely hindered by MERS or the lenders' own actions in holding lenders responsible for abandoned blighted properties.[385]

There are several reasons why lenders choose not to take care of their collateral:

> 1. They hope the borrower remedies the default and makes up all the back payments and fees.
> 2. They hope property will sell prior to the foreclosure sale.
> 3. They hope to sell the mortgage to another lender.
> 4. They hope they are outbid at the foreclosure sale.
> 5. They hope the local jurisdiction will maintain the property for them.
> 6. They don't want to risk potential litigation from the borrower.
> 7. They have insurance that covers damage caused to the property prior to the foreclosure sale.[386]

Even when cities try to make lenders take responsibility, many lenders routinely ignore notices in individual abatement nuisance actions.[387] Therefore, new laws are needed to quash the assumption that the city will secure the lenders' collateral so that lenders will have an incentive to take responsibility for their own collateral.

Another assumption helping to create and exacerbate the harm to cities is a mistaken belief by market participants (lenders, borrowers, and neighborhood activists) that if property taxes are not paid on abandoned property, the city or state will seize the property for nonpayment of taxes and take over maintenance or sell

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[383] *See* Michael Braga, *Housing Decline Hurting Big Lenders; Local Lenders' Failure to Properly Qualify Borrowers Put into a Bind U.S. Banks That Bought Mortgage Securities*, SARASOTA HERALD TRIB. (Fla.), Oct. 22, 2007, at 10 ("Fifteen years ago, local lenders used to make home loans and keep them in their portfolios.").

[384] *See supra* notes 89–91 and accompanying text (discussing securitization and how it has become difficult to determine who holds the mortgage).

[385] *See supra* notes 92–97 and accompanying text (explaining how MERS or the lender's own actions prevent cities from finding which party holds a mortgage on a blighted property).

[386] Leeper, *supra* note 17. When lenders are denied insurance coverage for blighted properties or have to deal with lawsuits from insurers, the lenders will have a greater incentive to take care of their collateral. *See generally* Donna L. Wilson & Marla H. Kanemitsu, *Viewpoint: Another Type of Insurance for Bank Suits*, AM. BANKER, May 9, 2008, at 10 (suggesting that insurance companies sue lenders to recoup payment of insurance claims due to the lenders' irresponsible lending).

[387] *See supra* Part II.B.

the property.[388] While this may have been a reasonable assumption when the number of foreclosed or abandoned properties in cities was relatively low, the rapid increase in the number of abandoned homes precludes a city from stepping in and taking control of every property.[389] Cities, such as Cleveland and Buffalo, simply do not have the resources available to take responsibility for the upkeep and maintenance of the hundreds of homes abandoned by borrowers.[390]

Similar to the assumption that cities will take properties for nonpayment of taxes is the belief that nonprofit organizations will want the properties if borrowers or lenders determine they no longer want the properties. [391] The reality of the situation, however, is that if the property is subject to private liens (i.e., mortgages) or public liens (i.e., tax liens), nonprofit organizations often cannot accept the donation. [392] The nonprofit could expend resources to rehabilitate such properties, only to later be unable to sell them due to the liens.[393] Even when a nonprofit organization is appointed as a receiver, there is no guarantee that it will be able to recoup its losses.[394] Although several cities are in partnerships with nonprofit organizations through community revitalization programs,[395] such partnerships do not have the resources to handle the burgeoning foreclosure abandonment problem.

A final assumption that has increased the spread of vacant, blighted homes is the belief that if property becomes abandoned or unmanageable, some state actor will take control and dispose of the property in some fashion.[396] This assumption is based on the idea that the property will have value, but in cases of abandoned property, it is likely the state will act rationally and resist taking responsibility for property with zero or little value. [397]

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[388] *See* Cooper, *supra* note 57, at 49–50.

[389] *Id.*

[390] Leinwand, *supra* note 363 (noting that Mark Ireland of the Foreclosure Relief Law Project in St. Paul, Minn. concluded that because cities are facing a large economic crisis as result of foreclosures and abandonments, cities have no choice but to explore every legal avenue for recovery against the lenders).

[391] *See* Cooper, *supra* note 57, at 67.

[392] *See id.* at 131.

[393] *See supra* Part III.A (discussing receivership).

[394] *See* Cooper, *supra* note 57 , at 131.

[395] *See, e.g.*, Jonathan Riskind, *Cleveland Part of Effort to Revive Urban Areas: City Could Become Model for Reform*, COLUMBUS DISPATCH, May 23, 2008, at B2 (discussing funding of a urban revitalization project for City of Cleveland spearheaded by a partnership among Cleveland, the State of Ohio, and Living Cities, a consortium of banks and non-profit foundations, and stating that Living Cities expended more than $11 million over a 15-year period on housing renewal and other initiatives throughout Ohio); Vivian S. Toy, *New Cassel, First for a Change*, N.Y. TIMES, Apr. 4, 2004, at 14LI.1 (discussing approval of four redevelopment projects for blighted property located in New Cassel).

[396] *See* Cooper, *supra* note 57, at 51.

[397] *See id.*

B. Recommended Comprehensive Laws to Incentivize Lenders to Act Responsibly

Adherence to each of the foregoing assumptions has helped expand the harm done to cities when borrowers fall behind on mortgage payments and abandon their homes. Unfortunately, most housing courts were created before the rise in subprime mortgages and the corresponding foreclosures, and are thus ill equipped to handle the spike in abandoned homes through their overloaded dockets.[398]

In order to counteract these erroneous assumptions and stem the tide of abandonment, cities and states need to pass comprehensive nuisance laws that incentivize lenders to take control of the mortgage default situation and work either to keep borrowers in their homes or to assume responsibility for their maintenance upon abandonment. Comprehensive laws are also needed to avoid leaving foreclosed or abandoned homes in legal limbo and to enable these homes to be quickly sold to new owners.[399]

Federal lawmakers recently passed H.R. 3221, a bill intended to cover a host of issues arising out of the subprime foreclosure crisis.[400] On July 30, 2008, President George W. Bush signed into law the Housing and Economic Recovery Act of 2008 (HERA), a far-reaching law that not only provides an emergency safety net to mortgage lenders Fannie Mae and Freddie Mac[401] and loan assistance to up to 400,000 homeowners, but appropriates $3.92 billion in aid to states and local communities to buy foreclosed and abandoned properties.[402] Numerous

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[398] *See* Jaquay, *supra* note 110, at 11 ("During its first year, . . . [Cleveland's] Housing Court, with a staff of four (one judge, magistrate, bailiff and court specialist), heard 599 criminal cases and 6452 civil actions. Criminal cases involve code violations and civil cases are primarily landlord-tenant disputes. Twenty-five years later, the Housing Court (now with 45 employees and still one judge) processes over 4,200 criminal cases and nearly 12,000 civil actions each year."); *see also* Gupta, *supra* note 75 ("Earlier this month, Pianka started holding trials of banks with years-old housing code violations. He plans to continue doing so every other Monday afternoon until his docket clears.").

[399] Raymond L. Pianka, *Abandoned Properties: Facing the Challenge*, http://www.clevelandhousingcourt.org/hc_rd_b2.html (last visited Sept. 19, 2008) ("Once a property has been abandoned, it needs to move quickly through the system to a new owner. The foreclosure process, however, is time consuming, leaving properties in an indeterminate state.").

[400] *See* Benton Ives, *Mortgage Relief on the Horizon*, 66 CQ WKLY. 2056, 2056 (2008).

[401] Fannie Mae is the Federal National Mortgage Association and Freddie Mac is the Federal Home Loan Mortgage Corporation. *See* STUART M. SAFT, COMMERCIAL REAL ESTATE TRANSACTIONS § 9:2 (3d ed. 2008) ("Fannie Mae is a private corporation, regulated by the Department of Housing and Urban Development, to borrow money by issuing debentures, notes, and bonds, and to use the funds to purchase mortgages, thereby providing liquidity to the banks which l[end] the money in the first place. Freddie Mac purchases and resells mortgages, and issues debt instruments.").

[402] *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110–289, § 2301, 122 Stat. 2654, 2850–53 (2008).

supporters, including at least fifteen governors, lobbied the United States Congress and the President to pass the bill, claiming that the $3.92 billion would help stabilize home prices and curb the vicious cycle of home abandonment and decreasing property values.[403] President Bush initially threatened to veto the bill, claiming that the appropriation provided a windfall to lenders.[404]

Title III of HERA could provide a windfall to lenders because it allows states and localities to use allocated funds to "purchase and rehabilitate homes and residential properties that have been abandoned or foreclosed."[405] Because of the language 'abandoned or foreclosed,' state and local governments could use allocated funds to buy homes that are the subject of foreclosure proceedings but still occupied. Such use of the allocated funds would have no impact on the current inventory of abandoned properties and would allow lenders to benefit under the new law by decreasing their inventory of foreclosed properties.

Under Title III of HERA, the Department of Housing and Urban Development (HUD) created the Neighborhood Stabilization Program (NSP) to provide the funds to state and local governments.[406] The Secretary of HUD had a mandate to establish an allocation formula for deciding which states and localities would receive what amounts based on the number and percentage of home foreclosures, subprime mortgages, and homes in default or delinquency in each state or locality.[407] Nothing in the new law required the HUD Secretary to take into account the number and concentration of abandoned properties.[408] However, each state was guaranteed a minimum allocation of 19.6 million dollars (0.5 percent of the $3.92 billion) even if they do not face a crisis.[409] As result, Alaska, North Dakota, Wyoming, and Montana were allocated 19.6 million dollars even

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[403] *See* Victoria McGrane, *Advocates Lobby for Foreclosure Aid*, POLITICO, July 22, 2008, http://www.politico.com/news/stories/0708/11933.html.

[404] *See A Time for Urgency*, N.Y. TIMES, July 23, 2008, at A20 (explaining why the President's veto threat was politically wrong and misguided); Fact Sheet: Helping Responsible Homeowners Across America (July 1, 2008), http://www.whitehouse.gov/news/releases/2008/07/print/20080701-5.html ("The Administration strongly opposes the inclusion of a program to provide block grants that would allow States to purchase foreclosed properties. The principal beneficiaries of this type of plan would be private lenders—who are now the owners of the vacant or foreclosed properties—instead of struggling homeowners who are working hard to stay in their homes.")

[405] *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 2301(c)(3)(B), 122 Stat. 2654, 2851.

[406] Press Release, Department of Housing and Urban Development, Preston Allocates Nearly $4 Billion to Stabilize Neighborhoods in States and Local Communities Hard-Hit By Foreclosure (Sept. 26, 2008), http://www.hud.gov/news/release.cfm?content=pr08-148.cfm [hereinafter HUD PRESS RELEASE].

[407] *See* 122 Stat. 2654.

[408] *See* 122 Stat. 2654.

[409] HUD Press Release, *supra* note 406.

though they have the lowest foreclosure rates in the nation.[410] HUD has determined that not only are their foreclosure rates lower than the rest of the country, but they have a low abandonment risk.[411] Consequently, these states were not in need of almost 20 million dollars. Moreover, because Congress did not pass an earlier version of the new law that would have appropriated $15 billion,[412] the $3.92 billion appropriation will not go far in solving the foreclosure and abandonment problem in the hardest hit areas of the nation.[413] At the end of the day, states and localities will likely only be able to purchase and rehabilitate a small percentage of the glut of foreclosed and abandoned properties.[414] Giving more than is needed to

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[410] Elizabeth Bluemink, *State Foreclosures Hit 5-Year High: Silver Lining: Alaska's Rate is 2nd-Lowest in the U.S., and Home Prices Haven't Dropped Too Much*, ANCHORAGE DAILY NEWS (AK), Sept. 8, 2008, at A1, *available at* 2008 WLNR 17052938. Montana's foreclosure rate is 1.8%, North Dakota's and Wyoming's are 1.5%, and Alaska's is 2%. Neighborhood Stabilization Program Grants, Department of Housing and Urban Development, http://www.hud.gov/local/ index.cfm (last visited Sept. 17, 2008) (follow each individual state to download excel spreadsheet containing information) [hereinafter NSP STATE ALLOCATION].

[411] NSP State Allocation, *supra* note 410.

[412] *See Legislative Update*, AM. BANKER, June 12, 2008, at 6 (stating that the U.S. House of Representatives passed the Neighborhood Stabilization Act by a 239-188 vote and that it would have appropriated $15 billion to state and local authorities to buy foreclosed homes).

[413] A major problem is the allocation of the federal funds is that they are not going to communities with the greatest vacancies and, therefore, are not likely to be used to buy and rehabilitate a substantial number of abandoned homes. A good example of this is in Ohio. The Secretary of HUD has allocated around $116 million to Ohio. NSP State Allocation, *supra* note 410. Columbus has received around $22 million whereas Cleveland has received only $16 million. *Id.* This amounts to Columbus receiving 20% of the allocation and Cleveland receiving only 14%. *Id.* It is difficult to make sense of this when Cleveland has almost twice the foreclosure rate of Columbus. Cleveland's foreclosure rate is 12.7% and Columbus's foreclosure rate is 6.9%. *Id.* The author has spoken with several individuals who believe this is an unfair allocation based upon this and Cleveland's more severe abandonment problem. The author has spoken with several individuals knowledgeable about the conditions in Columbus and Cleveland and they believe this is an unfair allocation because Cleveland has the more severe abandonment problem. In addition, it appears that the Secretary of HUD has placed more of an emphasis upon foreclosure rate than the abandonment problem. For example, Arkansas is receiving only the minimum $19.6 million in funding despite having a high abandonment risk. NSP State Allocation, *supra* note 410. This is presumably because their foreclosure rate is very low. *Id.* Arkansas's foreclosure rate is 3.2%. *Id.* However, note that Alabama has only a slightly higher foreclosure rate (3.6%) and the same high abandonment risk, yet Alabama is allocated around double that of Arkansas. *Id.* In contrast, Colorado has a low abandonment risk, yet is receiving $34 million, probably because of its 4.7% foreclosure rate. *Id.* The misallocation appears evident on both the state and local level.

[414] *See* J.N. Sbranti, *Housing Bailout Bill Will Do Little, San Joaquin Valley Experts Say*, MODESTO BEE, July 29, 2008, http://www.modbee.com/local/story/374841.html (quoting analyst's conclusion that new law will have very little impact in decreasing the

states such as Alaska takes away money that could be given to areas that are truly in need.[415] Rather than being given a fixed percentage of the funds, each state should have been given funding only to the extent needed to fix the foreclosure and abandonment problem in that state.[416]

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number of abandoned foreclosed properties in the region given that "lenders [have] foreclosed on nearly $6.8 billion worth of home loans in San Joaquin, Stanislaus and Merced counties" and given that the local government will likely receive only $120 million under the new law to buy those homes) Anna Bahney, *Who Will Benefit from Housing Act? How the Legislation Could Ripple Through America -- from Banks to Buyers*, USA TODAY, July 28, 2008, at B1 ("The Center for Responsible Lending estimates that the second-hand effect of foreclosures on communities will result in a property loss of more than $350 billion for 40 million neighbors of foreclosed homes. [But] [t]he bill offers $4 billion for communities.").

[415] A total of 18 states are receiving the minimum $19.6 million in funding. NSP State Allocation, *supra* note 410. They are: Alaska, Arkansas, Delaware, Hawaii, Idaho, Maine, Montana, Nebraska, New Hampshire, New Mexico, North Dakota, Oregon, Puerto Rico, Rhode Island, Utah, Vermont, West Virginia, and Wyoming. *Id.*

[416] Some lawmakers and analysts were concerned that the HUD Secretary, in establishing an allocation formula, would put too much emphasis on the number of foreclosures and subprime loans and not enough emphasis on the number and extent of abandoned properties and, therefore, give some communities too much money while shortchanging other communities that have been really harmed by a large number of abandoned properties. *See, e.g.*, Letter from Dennis J. Kucinich, Chairman, Domestic Policy Subcommittee, to The Honorable Steve Preston, Secretary, US Dept. of Housing and Urban Development (July 30, 2008) (citing testimony given by several analysts). Several analysts agree that the United States Postal Service's data about the number and location of vacancies is the most credible data set for tracking the number of vacant properties in the United States and, consequently, such vacancies, as a proxy for abandonment, are essential in identifying localities in greatest need of the $3.92 billion allocation. *See Targeting Federal Aid to Neighborhoods Distressed by the Subprime Mortgage Crisis, J. Hearing Before the Subcomm. on Domestic Policy and the Subcomm. on Housing and Community Opportunity*, 110th Cong. 3 (2008) (written statement of Todd Richardson, Director, Program Evaluation Division of the HUD Office of Policy Development and Research) (stating that while USPS vacancy data have some anomalies not fully addressed, "they are a rare data set that tells us what is going on in neighborhoods across the country in real time with very current information on the trend that is the subject of today's hearing: increasing vacancy rates"). *See also Testimony of G. Thomas Kingsley*, *supra* note 435, at 4 (stating that the two best data sets for determining which states and localities are in greatest need "are the Home Mortgage Disclosure Act (HMDA) dataset on mortgage originations and the United States Postal Service (USPS) dataset on vacant properties"). Available data sets about the number of subprime loans, foreclosures, and abandoned properties are from multiple and incomplete sources, including proprietary sources, and therefore not considered as reliable as public sources. *See, e.g., Testimony of G. Thomas Kingsley, J. Hearing, Domestic Policy Subcomm., Oversight and Government Reform Comm. and Housing and Community Opportunity Subcomm., Financial Services Comm.*, 110th Cong. 4 (2008), *available at* http://domesticpolicy.oversight.house.gov/documents/20080522185849.pdf (G. Thomas Kingsley is a Principal Research Associate at The Urban Institute). HUD did take postal service data into account when determining

State and local governments receiving those funds can have an impact on the foreclosure and abandonment problem by using them to buy abandoned properties at substantially discounted prices only. The new law states that a foreclosed home must be purchased "at a discount from the current market appraised value of the home or property, taking into account its current condition, and such discount shall ensure that purchasers are paying below-market value for the home or property."[417] However, HERA does not define "current market appraised value," does not establish a fixed discount rate, and does not state whether the foreclosed properties should also be abandoned. Therefore, lenders with foreclosed properties will no doubt attempt to negotiate the purchase of them using prices based on appraisals that are two or three years old or were already inflated during the housing boom.[418] Consequently, recipients of the federal funds should give preference to purchasing properties that are both foreclosed upon and abandoned and should require new appraisals that are conducted by truly independent, expert appraisers.

Hopefully those requirements will translate into states and localities buying an abandoned home at a price that is discounted after taking into account a new appraisal that reflects the current dilapidated condition of the home, that deducts any costs government officials expended in dealing with the vacant home (*e.g.*, the cost of boarding up the premises and mowing the lawn), and that deducts lost property tax revenues, including projected revenue losses until the property can be rehabilitated.[419] Such acquisition prices will maximize the use of the federal dollars—cities can buy and repair a greater number of foreclosed and abandoned properties—but will not result in the lenders receiving a windfall under the new law. If lenders are not willing to agree to such discounted acquisition prices, local agencies should bring enforcement proceedings against them to force them to bring

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which areas have the greatest need. HUD Press Release, *supra* note 406. HUD also looked at the Mortgage Bankers Association *National Delinquency Survey* data, Census Bureau data, the Federal Reserve's HMDA data, the Office of Federal Housing Enterprise Oversight data, and Labor Department data. *Id.*

[417] *See* § 2301(d)(1), 122 Stat. 2851.

[418] It is widely believed that home appraisals during the subprime lending boom were inflated, even sometimes fraudulently inflated. *See* Mark Maremont, *Subprime Lender Made Problem Loans On Regulators' Watch*, WALL ST. J., July 21, 2008; at A1(discussing how the Federal Deposit Insurance Corp., which took over Superior Bank FSB, sold a pool of the bank's subprime loans and that this "pool was afflicted by the same problems for which regulators have faulted the [mortgage] industry: lending to unqualified borrowers, inflated appraisals and poor income verification"); Johnson, *supra* note 31, at 679 (stating that the "deliberate manipulation of property values is pervasive" in the residential mortgage industry).

[419] For example, if a foreclosed vacant home, appraised at $200,000 four years ago, has a $20,000 lien on it for unpaid property taxes and is worth only $100,000 today as a result of being neglected by the lender and looted by thieves, the city should purchase it at a price substantially less than $80,000.

their properties into compliance with state and local laws.[420] In other words, no lender should be able to refuse to negotiate but allow their properties to become or remain a public nuisance.

Besides refusing to accept cites' offers to purchase, lenders could continue to refuse to expand loan modifications to more homeowners in default. Some analysts predict that only a few consumers, less than 20% of homeowners, facing foreclosure will obtain loan modifications under the new law and thereby avoid foreclosure.[421] This is especially true for metropolitan areas hit hard by the crisis.[422] Consequently, the number foreclosures will continue to rise. More homes will wind up vacant, whether through abandonment by homeowners or eviction of them by lenders. Because the current housing crisis and credit crunch are expected to persist,[423] many of these vacant homes will not be sold in the near

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[420] *See supra* Part III.B (discussing use of state nuisance laws to hold lenders responsible for blighted foreclosed properties).

[421] *See* Dean Baker, *A Better Way to Help Families Caught in the Mortgage Crisis*, CHI. SUN-TIMES, July 29, 2008, at 27 (stating that between 2.5 million to 3 million foreclosures are likely to occur in both 2008 and 2009 and that because Congressional Budget Office estimates that only 260,000 homeowners will be helped to avoid foreclosure under the new law, "less than 5 percent of the families facing foreclosure over the next two years [will be helped], leaving 95 percent of this group out of luck"); *Bond: Taxpayers Should Not be Forced to Rescue Countrywide*, US Federal News, July 25, 2008, *available at* 2008 WLNR 14004477 (stating that U.S. Senator Kit Bond, who opposed the new law, explained that "only 18 percent of at-risk homeowners will participate in the program and few of these will likely be saved from foreclosure" based on a finding by the U.S. Congressional Budget Office that "about 400,000 loans would voluntarily participate in the program - out of approximately 2.2 million borrowers who would qualify").

[422] D.L. Bennett, *Housing Money Gets Weak Welcome*, ATLANTA JOURNAL & CONSTITUTION, Nov. 9, 2008, at A1, *available at* 2008 WLNR 21418739 (stating that "even supporters concede the money will have little impact against a vast metro Atlanta real estate market in decline. They say the best hope is for an impact on certain streets or in specific neighborhoods but not across cities or counties.").

[423] *See Nightly Bus. Rep.* (Community Television Foundation of South Florida broadcast on July 31, 2008), *available at* 2008 WLNR 14305865 (quoting economist James O'Sullivan of UBS as stating that the "credit crunch and housing crisis are far from over"); Michael Pollick and Aaron Kessler, *The Deepening Economic Angst: Investors Could Help Local Market Recover, if They Could Just Get Loans*, SARASOTA HERALD-TRIB., July 16, 2008, at A1 (stating that the credit crunch "cuts off legitimate borrowers as well as the illegitimate borrowers" from getting access to credit to buy homes); Dean Calbreath, *Homeowners Suffer While Mortgage Bill Sits in Senate*, SAN DIEGO UNION-TRIB., July 6, 2008, at C1 (predicting "very tumultuous times over the next two or three years[;] [w]e haven't come close to seeing the effects of the credit crunch"); *Barack Obama Holds Roundtable in Washington; Relief on the Way With Housing Rescue Bill?; Minding Your Money: How Safe is Your Bank?* (CNN television broadcast July 28. 2008) *available at* 2008 WLNR 14124312 (stating that "[j]obs are down, wages are falling, the financial markets threaten to be engaged in a protracted credit crunch, with long-lasting ramifications for investments").

future and will wind up becoming public nuisances.[424] Therefore, states and municipalities still need to enact comprehensive legislation that makes it costly for lenders to neglect maintenance of their properties.

Whether cities intend to pass laws to deal with current abandoned properties or to prevent lenders from allowing properties to become abandoned in the first place, the initial step in creating a comprehensive nuisance law is for cities to broadly define "owner" so that lenders are classified as responsible parties. For example, a recently passed ordinance broadly defines "owner" to include any mortgagee in possession, which "means someone who evidences charge, care or control of the premises, and includes someone to whom the sheriff . . . has issued a deed for the premises whether or not the deed has been recorded."[425] This definition would include lenders who attempt to escape regulatory oversight by refusing to record deeds after taking the property via foreclosure proceedings.

Along with a broad definition of owner, a comprehensive nuisance law should require that, upon sending the borrower a letter declaring the borrower's default, accelerating the debt owed, or threatening foreclosure, lenders must register the property with the city and pay a registration fee. Some recently passed ordinances fall short of this. For example, city leaders in Columbus, Ohio, passed a nuisance abatement code that mandates that owners of vacant properties register such properties when a public nuisance fails to be abated as required by a court order.[426] However, the major drawback of this ordinance is the timing of registration. The registration requirement is not triggered until the owner has failed to abate a public nuisance, and by this point the window for taking preventative

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[424] That means cities will have to stretch their limited federal funds received under HERA to deal with more vacant properties. Detroit is planning to use $23.5 million (half of its allocation) to demolish abandoned property. John Wisely & Steve Neavling, *Foreclosure Aid Heading to Metro Detroit*, DETROIT FREE PRESS, Nov. 16, 2008, at B1, *available at* 2008 WLNR 21889685.

[425] *See* COLUMBUS, OHIO, NUISANCE ABATEMENT CODE § 4703.01(E)(4) (2003). The latter portion of this definition addresses situations in which lenders avoid responsibility for properties by refusing to record deeds acquired through foreclosure sales. Not only must the property be registered, but the owners must provide the name of an individual charged with the care and control of the property. *Id.* § 4711.05(3) (2003) (requiring owners to provide the "name of an individual responsible for the care and control of the property. Such individual may be the owner, if the owner is an individual, or may be someone other individual").

[426] *See id.* § 4711 (2003); *see also* ALLAN MALLACH, LISA MUELLER LEVY, & JOSEPH SCHILLING, NAT'L VACANT PROPERTIES CAMPAIGN, CLEVELAND AT THE CROSSROADS: TURNING ABANDONMENT INTO OPPORTUNITY 11 (2005), *available at* http://www.clevelandhousingcourt.org/pdf/at_the_crossroads.pdf ("Several municipalities in Ohio—most notably Columbus and Cincinnati—have adopted vacant property registration ordinances. Registration ordinances basically require owners of properties that have become vacant or abandoned for a certain length of time (e.g., six months or more) to register formally with the local government.").

steps has already closed and irreparable damage may already have been done to the property and surrounding neighborhood.[427]

Unlike Columbus, city leaders in Chula Vista, California, passed an ordinance with a registration requirement that is triggered upon the first notice of default.[428] Charging lenders a registration fee is necessary to cover the city's cost of monitoring abandonment and cost of hiring additional staff to bring enforcement proceedings.[429] While some lenders have resisted compliance with the registration

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[427] If the property has been deemed a public nuisance, the owner must demonstrate the financial capability to abate that nuisance, as well as proof that the property is insured against fire and casualty losses. COLUMBUS, OHIO, NUISANCE ABATEMENT CODE § 4711.05(5) (2003) ("In those instances where the real property is vacant land or has on it a vacant building(s) or structure(s) and has been found to be a public nuisance, [the owner must provide] proof that the owner has sufficient financial responsibility to abate any nuisance condition which a court or the safe neighborhood review board finds exist on the property, and proof that the property is insured against fire and casualty loss in an amount equal to the fair market value of the property with an insurance company licensed to do business in the state of Ohio.").

[428] Scott Horsley, *Town Compels Lenders to Care for Vacant Homes*, (National Public Radio broadcast Aug. 9, 2007), *available at* http://www.npr.org/templates/story/story.php ?storyId=12623065 ("A lot can go wrong in a vacant house in the months before a lender can resell the property, which is why the law was passed for lenders to take care of vacant property as the buyer defaults."). Once a lender receives notice of the homeowner's default, the lender must check to see whether the property has been abandoned. *See* Tanya Mannes, *Chula Vista Orders Upkeep of Seized Homes*, SAN DIEGO UNION-TRIB., July 25, 2007, at A1 ("The ordinance will take effect in October. The program will be paid for by a $70 fee charged to title holders when they register an abandoned property with the city. The rules kick in with the first notice of default. At that point, a lender must check to see whether anyone is living in the home. If not, it must hire a property management firm to prevent any sign of disrepair from popping up, said Doug Leeper, the city's code enforcement manager."); *see also* CHULA VISTA, CAL., MUN. CODE § 15.60.040 (2008) ("Any beneficiary/trustee, who holds a deed of trust on a property located within the City of Chula Vista, shall perform an inspection of the property. . . . If the property is found to be vacant or shows evidence of vacancy, it is, by this chapter, deemed abandoned and the beneficiary/trustee shall, within ten (10) days of the inspection, register the property with the Director of Planning and Building."). Under Chula Vista's code, evidence of vacancy encompasses "any condition that on its own, or combined with other conditions present would lead a reasonable person to believe that the property is vacant." *Id.* § 15.60.020 (2008). Specific conditions listed include overgrown vegetation, accumulated mail, past due utility notices, trash and other debris, and statements by neighbors. *Id.*

[429] Editorial, *Foreclosure Registration Makes Sense for Cities*, THE EAGLE-TRIB. (NORTH ANDOVER, MASS.), Mar. 27, 2008; Sanford Nax, *Homesickness: As Foreclosures Climb, So Do Abandoned Properties That Become Eyesores*, THE FRESNO BEE, Mar. 16, 2008, at D1 (stating that Fresno adopted a registration ordinance similar to that of Chula Vista and that the fees would offset cost for additional staff and enforcement).

ordinance,[430] some are complying, and Chula Vista has generated $31,500 in revenue from its $70 per-property registration fee.[431]

In addition to requiring registration and charging a fee,[432] a comprehensive statute designed to incentivize lenders to take care of their collateral should require the lender to inspect the property *monthly* after a triggering event, such as the lender's receiving verbal or written notice that the property is abandoned or the lender's sending of a letter accelerating the debt owed or threatening foreclosure. If an inspection reveals that abandonment has occurred, the lender should be required to send an agent to secure the property and to maintain the property on an ongoing basis.[433] For instance, Chula Vista has an ordinance that requires the lender to inspect the property upon notice of the borrower's default and to maintain the property upon abandonment.[434] Such maintenance includes landscaping, clearing accumulated trash and debris, cleaning pools and spas, and securing properties against vagrants and squatters.[435] By passing ordinances with registration and maintenance requirements that mirror Chula Vista's regulations, cities should be able to prevent property values in the area from dropping and minimize the eventual cost of restoring an abandoned property to productive use.[436]

Besides imposing registration, inspection, and maintenance requirements upon lenders, cities should charge hefty fines for a lender's noncompliance with these requirements. Lenders are naturally resistant to the idea of imposing stiff

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[430] Leeper, *supra* note 17 (stating Chula Vista's Code Enforcement Manager received a call at home one weekend from high-level lending-industry representative who stated that the manager was "making too much fucking noise" about the ordinance.).

[431] *Id.*

[432] Other cities are considering property registration ordinances. *See, e.g.*, Shawn Regan, *Haverhill Law Would Require Banks to Register Foreclosed Buildings With City*, THE EAGLE TRIB. (NORTH ANDOVER, MASS.), Mar. 31, 2008 (stating that North Andover is considering passing a property registration law that covers foreclosed properties and would charge the a $100 registration fee, which would cover the cost of officials to inspect the properties and ensure they are properly boarded up and keep safe from vandalism).

[433] *See, e.g.*, CHULA VISTA, CAL. MUN. CODE § 15.60.040 (2008).

[434] *See id.* § 15.60.050-060 (listing requirements for maintenance and security).

[435] *See id.* (listing requirements for maintenance and security).

[436] *See* Mannes, *supra* note 428 ("To keep property values from dropping, Chula Vista adopted a program last week that forces lenders to maintain homes they seize and to register the abandoned properties with the city. Modeled on initiatives in Chicago and Detroit, the program will require lenders to hire local property management firms to prevent vacant homes from becoming neglected."); *see also* Horsley, *supra* note 428 ("Home foreclosures jumped nearly 60 percent during the first half of the year, and many of those foreclosed houses are sitting vacant. That's a problem because empty properties soon become unkempt lots that are an eyesore for neighbors, potentially devaluing their properties. Residents of Chula Vista, Calif., have fought back, passing a law that requires lenders to hire a management company to take care of houses that their borrowers can no longer afford.").

penalties for failure to register or maintain properties.[437] As of now, Columbus and Chula Vista only charge $100 per day for violations.[438] By charging hefty fines of, say $1000 per day, until violation of the ordinance is corrected, cities would make it too expensive for lenders to violate the law.[439] Fines also should be punitive for failing to abate a nuisance at an abandoned property.[440] Some advocates have called for increasing penalties and implementing steep fines against owners for leaving a property abandoned too long.[441] Included in the penalty portion of a comprehensive nuisance ordinance should be a provision granting the city a first priority lien, priming even the lender's mortgage, for all unpaid fines.[442] This would handcuff a lender's ability to sell or otherwise dispose of any property in foreclosure until full compliance with the ordinance is achieved.

Because some lenders cannot be trusted to initially come forward to register, cities and states could lobby the United States Congress to create a real estate federal registry for state and local regulators to access.[443] The registry would require each lender to list each residential property on which it holds notes or mortgages and to provide contact information for regulators to use for giving notices to the lenders. Until that happens,[444] any new state legislation should

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[437] *See* Meghan Hoyer, *Leaders Angry That Bills on Blight Are Put on Hold*, VIRGINIAN-PILOT (Norfolk, Va.), Feb. 7, 2008, at B1 (stating that lenders' lobbying efforts have thwarted some lawmakers' "attempts in recent years to raise the penalty for failing to register or take care of a vacant house from its current level of $50").

[438] COLUMBUS, OHIO, NUISANCE ABATEMENT CODE § 4701.99 (2004); CHULA VISTA, CAL., MUNICIPAL CODE § 1.20.010 (2008).

[439] For example, the city of Westminster, Colorado, imposes a fine of up to $1,000 per day. WESTMINSTER, COLO., MUNICIPAL CODE § 1-8-1 (1994). *See also* Nax, *supra* note 429 (stating that the City of Manteca approved an ordinance charging banks fines of up to $1,000 for failing to secure and maintain their properties after the former owners move out).

[440] *See, e.g.*, Ott, *supra* note 174, at B1 (stating that Judge Pianka fined a company $180,000 for code violations at two houses, and that the city garnished its bank accounts for $40,000, plus $13,000 in penalties and interest); *House Can't Beat Wrecker's Ball*, CHI. TRIB., Oct. 7, 2007, at 21 (stating that in response Judge Pianka's threat to fine it $20,000 for code violations, Wells Fargo hired contractors to make numerous repairs).

[441] *Inaction Leaves Door Open to Housing Fraud*, VIRGINIAN-PILOT (Norfolk, Va.), Mar. 4, 2008, at B8 (stating that Norfolk and Portsmouth wanted to implement $2,500 fines for owners who left properties boarded up for over a year). One city has proposed a "non-utilization" tax against lenders who leave properties empty and abandoned for over one year. This tax would amount to 10 percent of the value of the property. Laura Crimaldi, *City Aims to Tax Owners of Abandoned Homes*, BOSTON HERALD, Feb. 28, 2008, at 6.

[442] *See infra* notes 470-71 and accompanying text (discussing Iowa statute and case law allowing a city's lien on abandoned property to prime all public and private liens).

[443] Some scholars have advocated for a national system for recording of real estate interests. *See, e.g.*, John L. McCormack, *Torrens and Recording: Land Title Assurance in the Computer Age*, 18 WM. MITCHELL L. REV. 61, 65–66 (1992).

[444] Creation of a nationwide system is doubtful. *See id.* (stating that a "[nationwide] title registration has no realistic possibility of being implemented throughout the United States in the foreseeable future").

authorize judges to hold defendants, like MERS, in contempt for claiming not to hold the mortgage on blighted property or for delaying the production of information identifying the actual mortgagee to trigger that mortgagee-lender's obligation to register the property.[445]

New legislation could also enable borrowers and their neighbors to trigger the lender's obligation to register the property. For example, cities can create a notification system that would allow a borrower to send written notice to the county recorder of deeds or any other appropriate agency that the borrower has abandoned the property and pay a $100 fee for city officials to secure the property and post on the property a notice providing contact information in case problems arise at the property. Neighbors living in close proximity to the abandoned property should also be able to send in a written notice to the proper authority to get immediate attention focused on the property.

Cities could provide a safe harbor provision in their nuisance statute for lenders who have worked out a deal for the borrower to remain in the home. The current foreclosure crisis has some lawmakers considering enacting various measures designed to keep borrowers in their homes.[446] For example, California just passed a bill requiring a lender to contact a borrower to assess the borrower's financial situation and to explore alternatives to foreclosure before the lender can file a notice of default.[447] On a federal level, a bill was introduced that would allow eligible homeowners who are facing foreclosure to remain in their homes as renters paying fair-market rental value for up to twenty years.[448] State and local lawmakers should consider passing a similar bill because it would allow homeowners to

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[445] *See supra* notes 92–97 and accompanying text (explaining how MERS is filing foreclosure proceedings but claiming to be the nominee mortgagee and is accused of hindering the ability of borrowers and advocates to negotiate with the actual mortgagee).

[446] *See supra* notes 400–403 and accompanying text (discussing passage of the Housing and Economic Recovery Act of 2008, sweeping legislation that will afford loan modification assistance to up to 400,000 homeowners to help them avoid foreclosure).

[447] *See* S.B. 1137 (Cal. 2008) (requiring lenders to satisfy certain due diligence requirements to avoid foreclosure before notice of default is filed). The new law requires lenders, as legal owners that have purchased a residential home at a foreclosure sale or acquired it via a mortgage or deed of trust, to maintain the vacant home and authorizes imposition of fines of up to $1,000 per day on those who fail to maintain the home. *Id. See also* Mathew Padilla, *Does State Foreclosure Bill Help or Hurt Lenders, Homeowners?*, ORANGE COUNTY REGISTER (Santa Ana, Cal.), May 28, 2008 (arguing that the bill has "indefinite language" that could be problematic). For example, the bill fines lenders for "failure to maintain" without explaining what this standard is. *Id.* Some are also concerned that an increase in fees will just cause lenders to sell at lower prices which will further drive down the value of the neighborhoods. *Id.*

[448] Saving Family Homes Act of 2008, H.R. 6116, 110th Cong. (2008). In an upcoming article, the author will explore the impact that the foreclosure crisis is having on renters and will argue that "good cause" eviction statutes should be passed to protect innocent tenants from being evicted when a lender obtains a foreclosure judgment against the landlord-borrower.

remain in affordable housing while simultaneously benefiting the neighborhood.[449] A borrower seeking to stay in the home is vested and much more likely to maintain the property in conformity with neighborhood standards.[450] If state lawmakers pass a comprehensive nuisance statute, lenders should then be given a safe harbor against public nuisance violations if they either (1) restructure the borrower's defaulted loan on terms that are feasible[451] or (2) enter an agreement[452] allowing the borrower to remain in the home as a tenant at a reasonable rental rate.[453] Wanting to satisfy a safe harbor provision or fearing hefty fines, lenders should then be motivated to create plans focused on keeping homes occupied and maintained so that the risks of abandonment and blight are severely reduced.

If cities or states can successfully enact nuisance laws as described above, lenders would be compelled to act consistently with their contractual right to preserve the collateral[454] and, more importantly, would be stripped of their current

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[449] *See id.* Under this act, homeowners who could not obtain a loan modification with their lenders would be eligible to seek permission from a court to remain in their homes as renters provided that the homes were single-family dwellings occupied as their primary residences for at least two years and had been purchased for less than the median home value for the area in which the homes were located. Press Release, Raúl M. Grijalva (D-AZ), Rep. Grijalva Introduces Saving Family Homes Act (May 22, 2008), *available at* http://www.grijalvaforcongress.com/index.php?option=com_content&view=article&id=50%3Anr-save-family-home&Itemid=34. If the median home value in the metropolitan statistical area is unavailable, the median value for the state can be used. *Id.* Additionally, "[t]he rent would be set by a court-appointed appraiser and adjusted annually for inflation." *Id.*

[450] *See* Miles, *supra* note 102 (stating that according to Judge Henry J. Nowak, if homeowners had exercised their legal right and remained in their homes until the foreclosure process was complete, their homes would have not have become nuisances because they would have kept them safe).

[451] Lenders have several loss mitigation strategies that they can employ to allow the homeowner to remain the borrower-mortgagor. *See* Michael L. Zevitz, *Is Foreclosure Your Best and Only Option?*, KAN. NAT'L BUS. INST: KANSAS FORECLOSURE AND REPOSSESSION, (2004) (explaining various loss mitigation strategies). Such strategies include reinstating the loan after default, agreeing to a forbearance plan that gives the borrower time to cure the arrearage, and entering into a loan modification agreement. *Id.* at 7 (describing other strategies, such as short sales, that cause the borrower to lose the home).

[452] The author does not advocate a borrower signing any agreement containing a deed in lieu of foreclosure to obtain title to the property if the deed would leave the borrower owing a deficiency to the lender. *See generally* Levenson v. Feuer, 803 N.E.2d 341, 348 (Mass. App. Ct. 2004) (stating that a deed in lieu of foreclosure often waives the "lender's claim to any deficiency between the value of the property and the obligation due under the note").

[453] If a loan modification cannot be accomplished, lenders could find suitable tenants at reasonable rental rates to maintain the property until the housing market turns around and the property can be sold at a profit.

[454] *See* Leeper, *supra* note 17 (stating that Chula Vista's registration and maintenance ordinance compels lenders or mortgage holders to "exercise the abandonment clause in their contract[s]").

incentive to shirk their legal obligations after the borrower's property abandonment. Under comprehensive nuisance ordinances, lenders, when doing a cost-benefit analysis of whether to comply with an applicable law, should come to the rational choice to work to keep to borrower in the home or, if that cannot be done, maintain the property until a suitable tenant can be found to rent and maintain the home.

As for the current inventory of blighted abandoned properties, a city should do like Baltimore, Buffalo, or Cleveland and pursue the best litigation strategy given the law of its state.[455] Cities should, however, pass laws requiring that deeds be recorded in the lender's name if the lender accepts the property via a credit bid at the sheriff's sale or via a deed in lieu of foreclosure.[456] This will make it easier to find a lender who has completed foreclosure against a borrower. For instance, under Chula Vista's ordinance, if a lender acquires property through a foreclosure sale, the transfer of title must be recorded with the San Diego County Recorder's Office within ten days.[457] Similarly, several states have bills pending that would ensure that all sales are recorded promptly because regulators were frustrated with lenders' refusal to record their purchase of homes at foreclosure sales.[458] The Ohio legislature felt compelled to act after a recent study of one Ohio county alone found that over 1,300 deeds for post-foreclosure properties had not been filed in the lenders' names.[459] In addition to requiring prompt recordation of deeds, lenders

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[455] *See supra* Part III.C (analyzing large-scale litigation efforts in various cities).

[456] When a lender that filed the foreclosure action is the successful bidder at the foreclosure sale, it "buys" the property by doing a "credit bid," which allows the lender to complete a non-cash purchase of the property by bidding up to the amount of the total debt owed by the borrower. *See* Baxter Dunaway, 2 L. DISTRESSED REAL EST. § 16:41 (West 2002).

[457] CHULA VISTA, CAL., MUN. CODE § 15.60.030 (2008).

[458] *See, e.g.*, Mark Ferenchik, *Foreclosure's Ripple Effects: Who Owns Problem Homes? A State Bill to Require Timely Filing of Sale Records May Help City Officials and Frustrated Neighbors Find Out*, COLUMBUS DISPATCH, Oct. 27, 2007, at A1 ("A bill pending at the Statehouse would require the sheriff to quickly register the deeds of those buying property at sheriff's sales—usually lenders foreclosing on loans—making it easier to find those responsible for the houses."); *see also* H.B. 7149, 2008 Leg., Jan. Sess. (R.I. 2008) *available at* http://www.rilin.state.ri.us/billtext08/housetext08/h7149a.pdf (requiring registration of foreclosure deed and payment of any outstanding liens on the property within 30 days of filing.); S.B. 275 115th Gen. Assem., 2d Reg. Sess (Ind. 2008) *available at* http://www.in.gov/apps/lsa/session/billwatch/billinfo?year=2008&session=1&request=getBill&docno=275 (allowing for immediate execution of judgment of foreclosure or decree of sale if subject property is vacant); H.B. 365, 2008 Leg., 425th Sess. (M.D. 2008) *available at* http://mlis.state.md.us/2008rs/bills/hb/hb0365e.pdf (requiring a mortgage, deed of trust or any other instrument securing a mortgage loan to contain the name and state licensing number of the mortgage originator and the lender securing the loan.).

[459] OHIO FORECLOSURE PREVENTION TASK FORCE COMBINED LIST OF RECOMMENDATIONS 13 n.10 (2007), http://www.bricker.com/legalservices/industry/bank/ftfrecc.pdf ("One study from Cuyahoga County found over 1,300 post foreclosure properties where deeds had not been filed since 2005."). This tactic grew in popularity

and other purchasers of properties should be required to provide identifying information, including their name, address, phone number, and a contact person within the state's jurisdiction.[460] These measures again should be able to reduce the toxic title problem.[461]

Besides recordation measures, cities also should pass laws making it easier and quicker to complete a nuisance-abatement or tax-foreclosure proceeding. [462] Ohio's senate has introduced a bill to help remedy the state's current vacant

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among lenders in Ohio. *See* Dutton, *supra* note 98 ("Foreclosing lenders claimed 76 houses. Two months later, only 11 of the repossessions had been filed with the county recorder's office. At least 17 of the unrecorded sales involved properties with pending or recent code violations."). Consequently, city officials began checking records of the sheriff's sales occurring each week to identify the new owners. *Id.* ("Columbus officials have begun checking records of the weekly sheriff's sales to identify the new owner rather than waiting for deed filings. 'Our position is once the sheriff issues the deed, then that property belongs to the person who bought the property,' said City Attorney Richard C. Pfeiffer Jr., who presided over code- enforcement cases for 11 years as environmental judge."). Anticipating this strategy, some lenders still dodged responsibility by refusing to pay for the property for as long as possible. *Id.* ("But lenders are finding new ways to buy time. 'Now they're figuring out that we're catching on to it, so what they're doing is not paying for their property' until weeks after the sheriff's sale, said Paul Khoury, an assistant city prosecutor."). To relieve cities of this burden, the Ohio House of Representatives passed House Bill No. 138 to require sheriffs to quickly register the deeds for anyone purchasing a home through a sheriff's sale. *See* Mark Ferenchik, *Columbus Tackles Vacant Houses; Proposal Would Allow for Speedier Foreclosure Process*, COLUMBUS DISPATCH, Dec. 23, 2007, at B1 ("Pfeiffer said the city would marshal all the liens against a property—back taxes, mortgages, etc.—to file for foreclosure."); *see also* Sub. H.B. 138, 127th Gen. Assem., Reg. Sess. § 2327.02(C) (Ohio 2007) ("If the property is sold under an order of sale or transferred under an order to transfer, the officer who conducted the sale or made the transfer of the property shall collect the recording fee and any associated costs to cover the recording from the purchaser or transferee at the time of the sale or transfer and, following confirmation of the sale or transfer, shall execute and record the deed conveying title to the property to the purchaser or transferee.").

[460] *See, e.g.*, Sub. H.B. 138, 127th Gen. Assem., Reg. Sess. § 2329.271(C) (Ohio 2007) (listing information that must be provided). This information must be included in the record filed by the sheriff; *id.* § 2329.271(B). *See also* CHULA VISTA, CAL., MUN. CODE § 15.60.030 (2008) (stating that lender or "new beneficiary/trustee shall record . . . the name of the corporation, and/or individual, the mailing address and contact phone number of the new beneficiary/trustee responsible for receiving payments associated with the loan/deed of trust").

[461] *See supra* Part II.C (discussing how difficult it is for cities to find parties responsible for abandoned properties).

[462] *See* Raymond L. Pianka, Abandoned Properties: Facing the Challenge, http://www.clevelandhousingcourt.org/hc_rd_b2.html (last visited Sept. 14, 2008) ("Once a property has been abandoned, it needs to move quickly through the system to a new owner.").

housing problem.[463] As discussed earlier, one of the main difficulties when combating the spread of foreclosures and abandonment is the slow pace at which nuisance abatement and foreclosure actions currently progress.[464] Often years will pass before the property is put back into productive use,[465] taking a serious toll on the surrounding neighborhood. The senate bill, if passed, would allow a city to declare abandoned property a nuisance and to marshal all the liens against the property at one time, instead of the city having to wait to for a lien to arise for nonpayment of taxes.[466] By marshalling the liens, the city can dispose of all claims upon the property at one time, clearing title so that the property can be resold.[467]

Building on the concept of "fast tracking" foreclosure proceedings, a method for issuing a Certificate of Abandonment and Forfeiture should be implemented.[468] Under this method, a city would have the authority to declare a residential property an automatic nuisance by virtue of the property being abandoned. Once the city has filed a petition declaring the property a nuisance, a court would issue a Certificate of Abandonment and Forfeiture. At this point, if a lender (or other lienholder) decides to assert its rights to the property, and has demonstrated its willingness and ability to abate the nuisance and maintain the property, the lender or lienholder would be given reasonable time to cure all code violations on the property and sign

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[463] *See* Ferenchik, *Columbus Tackles*, *supra* note 480 ("Getting control of a vacant, ramshackle house can take cities years, delaying efforts to help the poorest neighborhoods. That's why Columbus City Attorney Richard C. Pfeiffer Jr. is shopping an idea to legislators that would give Ohio's large cities the power to foreclosure on such properties even if the cities held no liens against them.").

[464] *See supra* Part III.A–B (discussing current receivership and foreclosure actions).

[465] *See* Ferenchik, *Columbus Tackles, supra* note 459 ("When somebody abandons their property, they need to understand they've given up their ownership,' [sponsoring Senator Steve] Stivers said. 'We get cities stuck with cleaning up properties that are in a long process for foreclosure. The process shouldn't take three years.'").

[466] *See* S.B. 277, 127th Gen. Assem., Reg. Sess. § 1901.185(C) (Ohio 2007–2008) ("When in aid of execution of a judgment of the environmental division of the municipal court rendered pursuant to section 3767.50 of the Revised Code, in actions for the foreclosure of a mortgage on real property given to secure the payment of money, or the enforcement of a specific lien for money or other encumbrance or charge on real property, when the real property is situated within the territory, and, in those cases, *the environmental division may proceed to foreclose all liens and all vested and contingent rights and proceed to render judgments, and make findings and orders, between the parties, in the same manner and to the same extent as in similar cases in the court of common pleas*.") (emphasis added). The bill also seeks to expand the Code's definition of "owner" to include "[a] mortgagee in possession or vendee in possession who evidences charge, care, or control of the premises, including, but not limited to, a person to whom the sheriff has issued a deed for the premises after a judicial sale regardless of whether the deed has been recorded." *Id.* § 3767.50(A)(2)(c).

[467] *See* Ferenchik, *Foreclosure's Ripple Effects*, *supra* note 458.

[468] The author first learned of this idea from Kermit Lind, Clinical Professor of Law and Assistant Director of Law and Public Policy Program at Cleveland-Marshall College of Law, Cleveland State University.

an order agreeing to maintain the property.[469] If no lender or other lienholder steps forward to take responsibility for the property within reasonable time (e.g., sixty days), all liens would be extinguished and title to the property would pass to the city in which the property is located.

Consider for example an Iowa law under which a city can fairly quickly obtain title to abandoned land. If vacant property is located within city limits, the city can obtain title free and clear of all prior public and private liens after proving the property is abandoned or after the owner, mortgagee, or lienholder of record, or other known interested party has failed to comply in good faith with a local building inspector's instructions to repair the property.[470] The ability of a city to obtain abandoned property free of all public and private liens is necessary. Otherwise, the city would have no incentive to expend funds to rehabilitate the property or to create procedures for third-party purchasers willing to do so.[471]

While this Certificate of Abandonment and Forfeiture proposal may seem drastic, public nuisance statutes have been used as a means of holding defendants accountable for criminal activities by causing them to forfeit property.[472] Judges in Cleveland and Baltimore have already found lenders criminally liable for failing to abate nuisances.[473] Therefore, it is not a stretch to conclude that lenders who refuse to maintain their collateral should forfeit the property to the city.

In addition to granting a city the ability to quickly obtain title to abandoned property, a comprehensive nuisance statute should also grant that the city the right to sell the property free and clear of all liens. However, confirmation of the sale would not be completed until the new owner has cured all the code violations on

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[469] *See supra* notes 432–436 and accompanying text (recommending enactment of an ordinance that would require lenders to maintain abandoned property).

[470] *See* IOWA CODE ANN. § 657A.10 (West 2008) ("Not sooner than sixty days after the filing of the petition [to obtain title], the city may request a hearing on the petition"); Waterloo v. Bainbridge, 749 N.W.2d 245, 248 (Iowa 2008) (interpreting section 657A.10 and holding that "[i]f a person with an interest in the property does not make a good faith effort to comply with an order of a local building inspector or the city proves the property has been abandoned, the court will award title to the city free and clear of any claims, liens, and encumbrances held by the respondents."). Such title is also free and clear of any liens for non-payment of taxes. *Id.* at 248–51 (rejecting the defendant's claim that the statute was unconstitutional and upholding the trial court's award of title to the city free and clear of defendant's tax lien obtained via purchase of a tax sale certificate at a county public action).

[471] *See, e.g.*, *Waterloo*, 749 N.W.2d at 249 ("If the city cannot obtain clear title, a city would have little incentive to take title to the property. Once a city takes possession of the property, it must expend time and money to make the property safe. If the city had to pay the tax lien, there would be less money for the city to recoup its costs when it eventually transferred the property for development.").

[472] *See generally* Mary B. Spector, *Crossing the Threshold: Examining the Abatement of Public Nuisances Within the Home*, 31 CONN. L. REV. 547, 562–64 (1999) (discussing the use of public nuisance law to curb unlawful activities within the home).

[473] *See supra* Part III.B (discussing criminal nuisance proceedings).

the property.[474] These provisions are meant to get rid of the "toxic title" problem and allow abandoned property to be passed quickly to a new owner that will truly make productive use of the property.

V. CONCLUSION

The problem of foreclosure and abandonment has skyrocketed over the past few years and is expected to worsen as more homeowners become unable to afford their mortgage payments and conclude abandonment is the best option. Abandoned properties are very costly in numerous ways, including decreasing tax revenue, reducing the value of surrounding properties, and increasing calls for fire and police protection. Regardless of whether one believes the borrowers or lenders are at fault for the foreclosure crisis, the true victims of abandonment have been the neighbors, cities, and taxpayers forced to deal with the aftermath. Although efforts taken by public officials, nonprofit organizations, and members of local communities to alleviate this problem have been encouraging, the legal tools available to these advocates must be adapted to meet the needs of this growing crisis. To more effectively deal with the backlog of abandoned blighted properties, cities should bring mass public-nuisance claims against lenders on the grounds that the lenders are in control of the abandoned properties on which they hold mortgages. Cities should pass laws that make it easier and less time-consuming for cities to identify lenders holding interests in abandoned properties and extinguish their interest for failing to abate the nuisances. To prevent abandoned properties from becoming blighted, cities and states must pass comprehensive nuisance laws that require lenders to satisfy stringent registration, inspection, and maintenance requirements and that impose heavy fines on lenders for their noncompliance. These measures should incentivize lenders as mortgagees to implement more effective plans to keep borrowers in possession or to at least take responsibility for residential properties after abandonment.

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[474] This provision is designed to stop speculators from buying properties at foreclosure sales, doing very few or no repairs, and flipping–selling them to unsuspecting purchasers who do not realize the property has several code violations. *See* Miles, *supra* note 102 (stating that Judge Nowak interprets the law in a manner to hold responsible "banks and real estate 'flippers' who've been dodging conventional code enforcement").